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Tesla Takes On Michigan

By Will Zerhouni

EXECUTIVE SUMMARY

In the area of technology and startup innovation, new market entrants routinely find themselves besieged by analog-age incumbents hijacking the levers of government in an attempt to squelch competition. Nowhere is that phenomenon more apparent than at the state and local level.

In recent years, states and localities have worked to undermine beneficial economic disruption by using state and local laws and regulations to bar startup companies from competing fairly and freely in the market. Trailblazers such as Tesla, Uber, Lyft, and Airbnb are finding market entry barred in places as diverse as California, Florida, Indiana, Louisiana, Texas, Michigan, New York, Utah, and Washington, D.C.

In one particularly egregious case from 2014, Michigan amended its franchise auto dealer statute specifically to exclude Tesla from the Michigan market. This amendment was introduced on the eve of the adjournment of the legislature, and it was passed with no debate, no legislator input, and no committee process. In response, and after multiple unsuccessful efforts to gain the cooperation of Michigan regulators and legislators, Tesla finally sued Michigan in order to be able to sell its cars in that state.

This policy analysis will look at the Michigan legislative restrictions on Tesla as a case study of state and local interference with free-market operations on behalf of established market participants at the expense of newcomers to the market. It will also explore Tesla's legal arguments in its Michigan litigation and evaluate its prospects of success.

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INTRODUCTION

With the advent of the sharing economy has come the rise of what has been termed “regulatory entrepreneurship.”[1] Such entrepreneurship disrupts not only competitors and old business models, it also disrupts the regulatory and legislative regime that had been created in light of those business models. As Elizabeth Pollman and Jordan Barry explain, regulatory entrepreneurship involves business models “where changing the law is a significant part of the business plan.”[2]

Often, the legislation and regulation that affect regulatory entrepreneurs are as outdated as the competitors that those entrepreneurs seek to disrupt. Legal regimes that were created decades ago to tackle the problems of brick-and-mortar analog companies may not be appropriate for technology-based startup companies. Yet, state regulators and, even worse, competitors attempt to restrain the scope and pace of innovation by relying on such outdated legal systems. And new market entrants have to waste precious resources overcoming protectionism rather than developing groundbreaking new products and services.

State regulators have routinely targeted innovators such as Airbnb, Uber, Lyft, and Tesla in an attempt to protect established market competitors. Such regulators, in their zeal, have targeted new market entrants in a variety of realms—even going so far as to ban online education courses that had not paid tribute to the state’s regulatory regime for offline competitors.[3]

From California to New York, Airbnb landlords have been subjected to fines and punitive enforcement for having the audacity to rent out their properties to willing renters.[4] In Miami, legislators are specifically targeting Airbnb property owners who have spoken out in opposition to local Airbnb restrictions.[5]

Across the country, taxicab commissions and local authorities have attempted to stop Uber and Lyft drivers from using their own cars to drive willing passengers for a fee.[6] Often citing public safety as the rationale for barring startup car services, state and local governments effectively restrict competition by using taxi regulations that were formulated for the early to mid-20th century.

And state and national auto dealer associations, backed by legacy auto manufacturers in Detroit, have sought to bar Tesla’s entry into various state markets because of Tesla’s direct-distribution business model.[7] In states as diverse as New Jersey, Louisiana, Virginia, Utah, and Indiana, state governments and regulators have stood at the gates of the new car market to block Tesla’s entry.

One of the most egregious cases of such regulatory moat building can be found in Michigan, where, at the very end of the state legislative session in October 2014, the state legislature, without debate or legislative consideration, adopted a midnight amendment to its franchise-dealer law that specifically worked to bar Tesla from selling its cars to Michigan consumers.[8] As Tesla sought to negotiate entry into the Michigan market in the wake of that amendment, one state legislator memorably told Tesla representatives, “The Michigan dealers do not want you here. The local manufacturers do not want you here. So you’re not going to be here.”[9]

Litigation ensued in September 2016 when Tesla hauled Michigan officials into court. Tesla’s complaint in that suit was based entirely on constitutional grounds. In its complaint, the company alleged that the 2014 amendment violated the due process, equal protection, and the commerce clauses of the United States Constitution. That lawsuit is still pending in federal district court in Michigan.

With alarming frequency, regulators and competitors have claimed that innovators such as Tesla, Airbnb, and Uber would undermine safety protections found in established regulatory schemes. In many of these cases, these regulators offer little empirical proof of the protection that they claim their regulation provides. Instead, they inhibit innovation and free-market competition by using regulatory schemes designed for entirely different contexts and different eras.

In this paper, I examine the controversy

surrounding the Michigan statute as well as the legal arguments that Tesla has advanced. In addition, I will explore Tesla's prospects for success in its litigation against Michigan, and finally, I will suggest other avenues for Tesla to pursue should its litigation strategy fail.

THE BIRTH OF AUTO DEALER LAWS

The automobile got its start in France in 1769 when inventor Nicholas Joseph Cugnot debuted his steam-powered three-wheeled automobile.[10] The machine was cumbersome and slow, topping out at two-and-a-half miles per hour. (On the plus side, it could haul five tons of weight.) In addition, it had only about 15 minutes of range and its boiler made driving it uncomfortable at best.[11] At a demonstration in 1771, Cugnot's steam car crashed into a garden wall, putting a quick end to his visionary project.[12]

More than a century later, in 1887, German inventor Karl Benz offered his Model 3 internal combustion engine car, making it the first automobile for sale to the public in history.[13] By 1895, Benz was the largest carmaker in the world—producing all of 572 cars in that calendar year.[14]

The United States automotive industry got its start in 1895.[15] In those early days, American automobile companies were hot startups, peaking at 272 competitors in 1909—with most of those failing fast. In the areas surrounding Detroit, however, three major automakers sprouted up: Ford, General Motors, and Chrysler.[16] These "Big Three" auto manufacturers eventually accounted for 80 percent of all car production in the United States.[17]

At first, American automobile manufacturers sold their cars in department stores, in showrooms, through traveling salesmen, in catalogues, and in dealerships.[18] In 1898, William E. Metzger opened the first auto dealership in America.[19] Little did Metzger know that his pioneering dealership would foreshadow the principal method of automobile distribution in the United States.

The first cars were expensive and made by hand (like an artisan's product).[20] Very few cars were produced, and very few people could afford the ones that were. At the turn of the century, with constricted product supply and high costs of labor, the car did not appear to be the invention that would revolutionize transportation the world over or redefine the American identity. Indeed, with so few cars, carmakers could distribute and sell their product themselves—and many did.[21]

But in 1913, Henry Ford unveiled his moving assembly line and revolutionized the process of making cars, setting in motion forces that would reshape the American transportation landscape literally and figuratively, economically and politically.

The assembly line was not a new invention in 1913. Assembly lines had previously been used in assembling machinery, making wooden pulleys, and manufacturing firearms.[22] Ransom Olds was the first to introduce the concept of the assembly line to auto manufacturing (even receiving a patent for the innovation). In 1901, Olds manufactured the Curved Dash Oldsmobile using an assembly line, boosting his output of cars from 425 to 2,500 in one year.[23] Henry Ford's 1913 innovation was to make the assembly line mobile, thus allowing a worker to stay in one location for an entire day and focus on performing one specific task as well and as fast as possible.[24]

This innovation led to an auto boom, dramatically increasing production. With so many cars produced, Ford's focus quickly became manufacturing. Sales and distribution would come through its network of dealers.

Using dealerships to sell cars had several advantages for Ford and others. First, it allowed for discrete task specialization. Carmakers make cars, and car dealers sell and service them. In addition, car dealers would be distributors of information about manufacturer products. In the pre-internet days, where information was harder to come by, dealers would specialize in educating the public about the cars they were selling. Dealers would also advertise heavily in local markets to help

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disseminate information. This would allow for more specialized messaging from region to region (in the days before television created a national monoculture).

Second, using dealers to distribute its cars allowed Ford to shift warehouse and inventory costs to a third party. Ford would not have to build large warehousing and logistics operations for direct sales to millions of parties; it would rely on its dealers for that. Dealers, in turn, would invest in physical plants and real estate to allow for the warehousing and servicing of the cars they would sell.

Third, independent dealers gave Ford an outlet for risk mitigation. When Ford hit a cash crunch in 1921, it sold 125,000 Model Ts directly to its dealers and forced them to pay in full upon delivery (instead of on installment, as was the custom at the time). This compulsory sale, which saved the Ford Motor Company from potential bankruptcy, was permitted by a provision in the Ford dealership agreement.[25] Many other car manufacturer dealership agreements would contain similar provisions.

As cars became more plentiful and demand began to flatten in the 1920s, most manufacturers likewise turned to the dealership model as the primary means of distribution. In a more stagnant market, salesmanship and demand-creation become critically important. The asymmetry of power between the manufacturers and the dealers soon began to worry the latter. They feared that manufacturers would either open company dealerships in their territory, competing with them directly, or allow a multiplicity of dealerships in their territory, diluting the dealers' market share and squeezing the profit out of dealing in cars. In response, the dealers banded together and lobbied their state legislatures for protection.[26]

The argument for state auto dealership laws at the time was not that dealers could better service customers or protect drivers. Instead, it was based on contract—and on the dealers getting what they bargained for in their agreements with carmakers.[27] If a manufacturer could just sell in a dealer's territory at will or open as many dealerships in that territory as it wanted, the argument went, the large investment that was required to open a dealership in the first place would be for naught.

It is important to note that even in the early 20th century, the dealers' arguments were lacking in multiple respects.

First, assuming rational actors capable of recognizing their own interests, what the dealers succeeded in getting through the coercion of government regulation and legislation could have likewise been achieved through proper contract negotiations. Contracts are, after all, the private legislation and regulation arrived at between two willing parties. If the car manufacturer terms were so onerous as to make owing a car dealership too precarious an enterprise to pursue, the market would reflect that truth and carmakers would, presumably, adjust their terms until they could attract a sufficient number of car dealers to meet their needs.

Second, for auto dealer contracts already signed, one could make the argument that the price of nonexclusivity was already factored into the contractual terms. After all, the manufacturer–dealer agreements were written before the auto dealer laws were passed. Accordingly, the capture of state legislatures to tip the scales in favor of the auto dealers was an ex post renegotiation of valid contracts using the coercive power of the state. Such capture, then, was government interference with valid business relationships (which is presumably what the contracts clause was designed to prevent—but that, and the history of *Lochner v. New York*, *West Coast Hotel Co. v. Parrish*, and their progeny, are stories for another day).

In any event, arguments regarding the parties' rights to contract freely and the market's ability to set a proper equilibrium between carmakers and car dealers did not carry the day. Given the growing power and unity of auto dealers, states passed laws banning direct distribution of automobiles by manufacturers. Taking the dealers at their word, states passed legislation to protect the dealers from car companies.[28] That legislation often barred car manufacturers from selling directly to the

public so as not to compete with their own franchise dealer networks. These laws, crafted for an earlier time and a much different economy, have largely stayed on the state books, minimally disturbed for decades.

TESLA ARRIVES ON THE SCENE

Electric cars were introduced in 19th-century Europe by Scottish inventor Robert Anderson, who invented the first electric vehicle (albeit with a single-charge battery) in the 1830s.[29] Electric cars with rechargeable batteries came along in the late 1850s.[30] In the late 19th century, electric cars were used in urban areas in Britain and the United States. These cars were usually limited in speed and range, making them suitable only for city transportation. Without a large or reliable road system, the limited range of electric cars did not restrict their potential market. Indeed, in 1899 and 1900, electric vehicles (EVs) outsold internal combustion engine (ICE) cars.[31] In an environment where almost all driving was done within city limits, EVs were seen as the cleaner, easier to operate, easier to start, and easier to maintain alternative to electric cars.[32]

The strong position of EVs was not to last. As gasoline became more plentiful thanks to successful oil exploration worldwide, and as road networks became more extensive, EVs lost their market share to ICE cars. From the 1910s on, EVs were entirely eclipsed by gasoline-powered cars. It would take almost a century before EVs were considered economically viable again.

In the 1990s, concerns about pollution and energy independence created a renewed interest in EVs. Hybrid car and EV projects began to crop up in the research departments of Toyota, Honda, Ford, GM, and Chrysler. By the turn of the 21st century, battery technology had advanced to the point that a commercially viable EV was possible.

In California, engineers Martin Eberhard and Marc Tarpenning sought to take advantage of the accelerating advances in lithium-ion battery technology to build a purely electric car company. Their goal was to make EVs available for mass consumption.

In July 2003, Eberhard and Tarpenning incorporated Tesla Motors, taking the name of the company from Nikola Tesla who, nearly a century earlier, had patented the alternating current (AC) motors they would use for their cars' drivetrains. They promised to build "high-performance electric sports cars" that would provide superior acceleration and handling with no carbon monoxide emissions. They further promised a 300-mile range and a sales price of "less than half that of the cheapest competitive sportscar."[33]

It took five years and tens of millions of dollars of investment (with infusions of cash by follow-on collaborator Elon Musk), but in 2008, Tesla Motors, Inc. (renamed "Tesla, Inc." in February 2017) delivered its first commercial EV—the Tesla Roadster.[34]

Tesla unveiled the Roadster prototype to a select crowd of 350 invitees at an event in July 2006 in a hangar in Santa Monica, California. The event included a demonstration and an offer for sale of the first 100 Roadsters at the price of $100,000. All 100 Roadsters were quickly sold. Tesla thus launched not only its first car, but also its direct-to-consumer distribution model, with its inaugural sales.[35]

Tesla's strategy, as described by current CEO and then principal investor, Elon Musk, was "Build sports car. Use that money to build an affordable car. Use that money to build an even more affordable car. While doing above, also provide zero emission electric power generation options."[36] The Roadster would be the car that would prove that EVs were both viable and desirable to drivers. The revenues from the Roadster would be plowed back into the company, which would then make a car that would be even more economically accessible to consumers (what later turned out to be the Model S, introduced in 2012). And the revenues from that car would, in turn, be used to develop a car with broader mass-market reach (the Model 3, which entered the market in July of 2017). For this sales model to work, Tesla needed to maximize revenues and quickly

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determine market appetites for its products.

As a startup, Tesla relied on feedback from its customers to improve its product. Startup culture is profoundly dependent on customer input for product development, production, and improvement. The prevalent methodology for startup development comes from the "Lean Startup" ideas of Eric Ries, Stanford professor Steven Blank, and others.[37] This methodology emphasizes developing a business model, listing the market and consumer hypotheses behind a startup's offering, and engaging in a continuous process of "customer development" that allows a startup to learn from potential customers and users of a product.[38] Indeed, this methodology stresses immediate learning from customers in order to gauge market demand and user preferences. Filtering customer feedback through third parties (such as dealers) would provide less-reliable accounts of user experiences while creating lag time between input and product iteration, harming Tesla's ability to quickly find its product-market fit before its cash reserves were depleted.

In addition, as an EV manufacturer, Tesla had to educate customers on the benefits, maintenance, and nuances of EVs. Given their relative rarity, EVs suffered from the consumer perception that they lagged behind ICE cars in acceleration, performance, and range.[39] (In reality, EVs deliver instant torque and acceleration that ICE cars cannot.) Educating potential customers was going to be a big part of Tesla's challenge as it tried to enter the car market.

Furthermore, Tesla's marketing efforts built such a buzz around its brand and products (particularly in states such as California with strong environmental movements and emissions regulations) that it could organize its production around pre-orders of its vehicles, delivering them directly to owners only upon completion. This cut out the need that legacy automakers had for maintaining a deep inventory of cars to sell. And without the need to warehouse an excess supply of cars, Tesla could distribute cars directly and retain more of the profits of sales and service of its cars for itself.

For all of the above reasons, Tesla eschewed the traditional dealership distribution model that had been adopted by previous car manufacturers and decided to distribute its cars directly to consumers. By integrating its operations into nonproduction activities such as distribution and sales, Tesla attempted to maximize the efficiencies associated with educating and servicing its own customer base.[40]

That decision, sensible as it was for Tesla, put the startup automaker on a collision course with the auto dealers' lobbies in dozens of states. Those lobbies would see Tesla's business and distribution model as a direct threat to their market standing.[41] And the state auto dealers, particularly those in Michigan, would use their lobbying might and the statutes developed to protect them from auto manufacturers (more than half a century earlier) to try to shut down Tesla's disruptive distribution model.

TESLA MOTORS, INC. V. JOHNSON ET AL.

As Tesla made its first big push into mass-market car distribution in 2012 with its Model S, auto dealers and their lobbyists were waiting for it in a multiplicity of states. Armed with state franchise-dealer laws that had been on the books for more than half a century, the auto dealers fought Tesla's market entry in states that included Texas, New Jersey, Louisiana, Virginia, Missouri, Indiana, Utah, and Ohio. Realizing that appearing to protect their market position at the expense of consumers would not be politically or commercially acceptable, the dealers began to argue that the statutes originally drafted to protect them against asymmetrically powerful automakers were actually *consumer protection* measures designed to keep drivers safe on the roads.

For example, in its arguments to the public, the National Association of Auto Dealers (NADA) claimed that auto dealers served a necessary purpose for consumers in the car market. Pointing out that "[u]nlike virtually any other product, if a car is operated incorrectly, people

could be hurt or killed," NADA argued that car dealers served various purposes, including:

- keeping prices competitive and low ("A Ford dealer's biggest competitor is the Ford dealer down the street or in the next town."[42])
- cost minimization ("[W]hen local dealers compete against each other there are great incentives to minimize costs as much as possible."[43])
- consumer safety and accountability ("Franchised dealers also create extra accountability for consumers, with warranties and safety recalls. When a consumer has a warranty or recall issue, dealers are incentivized to act on behalf of the consumer because they are paid by the factory to do the work. If manufacturers retailed their cars, they would be incentivized to reduce warranty and recall work."[44])
- efficiency and specialization ("Throughout the history of the auto industry, manufacturers have experimented with selling directly to consumers—but have inevitably gravitated back to the franchise model because of its efficiencies and effectiveness."[45])
- local economic benefits ("Dealers generate good local jobs and significant tax revenues, delivering a huge impact on their local economies."[46])
- convenience and consumer education ("Dealers simplify a complex process and personalize the car buying experience."[47])

In addition, NADA argues that auto dealers do not create "middleman costs" (calling such costs "a myth").[48] They further argue that franchise auto dealer statutes do not limit competition.[49]

Michigan's franchise auto dealer law, as originally passed in 1981, reads (in relevant part) as follows:

> A manufacturer shall not do any of the following:
>
> (i) Sell any new motor vehicle directly to a retail customer other than through *its* franchised dealers, unless the retail customer is a nonprofit organization or a federal, state, or local government or agency. This subdivision does not prohibit a manufacturer from providing information to a consumer for the purpose of marketing or facilitating the sale of new motor vehicles or from establishing a program to sell or offer to sell new motor vehicles through franchised new motor vehicle dealers that sell and service new motor vehicles produced by the manufacturer.[50] (Emphasis added)

In 2012, when Tesla first started selling its cars in Michigan, it interpreted the above statute as not affecting its sales strategy. The rationale was that since Tesla had no franchised dealers ("*its* franchised dealers"), the statute, on its face, could not apply to Tesla.

In October of 2014, bowing to the pressure of auto manufacturers and car dealers, Michigan state senator Joe Hune, whose wife, Marcia Hune, is a registered lobbyist for the firm that represents Michigan auto dealers, inserted a late amendment to Michigan H.B. 5606 (a bill first introduced in May of 2014).[51] The amendment struck the word "its" from Michigan Compiled Laws Section 445.1574(i), forcing all carmakers selling cars in Michigan to do so solely through franchised car dealers. The Hune amendment was added on October 1, 2014, at the dusk of that year's legislative session. It passed without comment or debate the next day.[52] Indeed, many of the legislators who voted for the Hune amendment claimed to not even know the purpose of the amendment or that it was aimed at taking Tesla out of the Michigan market.[53]

The Hune amendment dealt Tesla a significant blow. For the rest of 2014, all of 2015, and most of 2016, Tesla tried to keep up with Michigan's moving goalposts by complying with the statute, seeking dealership licenses and negotiating its way into the Michigan market.[54]

In November 2015, Tesla applied to the Michigan Department of State for a vehicle

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dealer license and for registration of a dealer repair facility.[55] The Department of State denied the vehicle dealer license in September, but left open the question of whether Tesla could apply for a used vehicle dealer license under a different provision of the Michigan code.[56]

In a parallel effort to the licensing process, Tesla attempted to negotiate its entry into the Michigan market with state legislators, but meeting with Michigan legislators and representatives of the auto dealers and car manufacturers proved an exercise in futility for Tesla. One Michigan legislator, Jason Sheppard, told Tesla representatives, “The Michigan dealers do not want you here. The local manufacturers do not want you here. So you’re not going to be here.”[57]

On September 22, 2016, Tesla filed a complaint against Michigan’s governor, attorney general, and secretary of state in the United States District Court for the Western District of Michigan in order to secure its place in Michigan’s new car commercial market.[58]

In early 2017, Tesla sought discovery from Hune, Sheppard, and auto dealer lobbyist Kurt Berryman.[59] The requests covered all emails and communications between Hune and Sheppard and auto lobbyists for the time surrounding the passage of the Hune amendment. Hune, Sheppard, and Berryman aggressively opposed the subpoenas seeking discovery, claiming legislative privilege and alleging harassment on the part of Tesla.[60] United States Magistrate Judge Ellen Carmody rejected those arguments and required Hune, Sheppard, and Berryman to provide the requested information to Tesla’s lawyers under seal.[61]

Tesla’s experience in Michigan is a perfect example of market incumbents using the legislative process and the coercive power of government to prevent a new market entrant. As in this case, such subversion of legislative processes for the benefit of individual market participants often takes place in the shadows with minimal debate, transparency, or oversight. Even in high-stakes litigation, the legislators and incumbent market participants that erect barriers to market competition prefer their deeds to stay in the dark—hence, the vigorous objection to the production of communications between Hune, Sheppard, Berryman, and all of those responsible for the midnight passage of the Hune amendment.

ANALYSIS OF TESLA’S LAWSUIT

Tesla advances two classes of argument in its complaint: first, that the Hune amendment is a violation of the dormant commerce clause (also known as the negative commerce clause); and second, that it fails rational basis review under the due process and equal protection clauses of the Fourteenth Amendment.[62]

The dormant commerce clause allows courts to strike down state laws that unduly burden interstate commerce. Where Congress has not preempted state laws, states may not pass their own restrictions that would have the effect of discriminating against out-of-state commerce.[63] Tesla intends to argue that the state of Michigan is discriminating against it because it is a California manufacturer.

There are, unfortunately, a couple of problems with this argument. First, the Michigan statue, on its face, does not discriminate against out-of-state commerce. Michigan may thus attempt to argue that the statute was not intended for such a purpose, although the credibility of such an argument is an open question given the course of the dealings between Michigan and Tesla. That is not the end of the inquiry, however. Courts could still find that the law violates the dormant commerce clause because of the legislative intent and its effect to knock Tesla out of Michigan. Because the statute is neutral in its wording (despite its disparate impact), however, Michigan will probably benefit from a more relaxed standard of review than if the statute had expressly tried to discriminate against out-of-state manufacturers.

The bigger problem for Tesla’s dormant commerce clause argument is negative case law coming out of other courts. University of Michigan law professor Daniel Crane has done a detailed review of the legal landscape Tesla

faces as it embarks on litigation in the Western District of Michigan.[64] As he notes, the Ford Motor Company attempted to use the dormant commerce clause almost 20 years ago to assert its right to sell its used cars directly to consumers:

> In 1999, Ford dipped its toes into the water [of direct distribution to consumers]. It set up a website to re-sell used Fords that had been previously leased, used as service vehicles, or rented out by national car rental companies. Interested customers could place a $300 deposit and then inspect the car after it was delivered to a participating dealer. If the customer opted to purchase the vehicle at the Ford-determined "no-haggle price," Ford would receive payment from the customer and then transfer the title through the dealer, which was paid a fee for its service. This model did not cut out the dealers entirely, but provoked sufficient consternation among the dealers that the Texas Department of Transportation shut it down under the Texas dealer franchise law.[65]

The Fifth Circuit held that Texas's auto dealer law did not discriminate against out-of-state commerce because "all car manufacturers, wherever domiciled, were similarly prohibited to engage in direct distribution."[66] As noted above, this same argument is one that Michigan could assert in its pending Tesla litigation. Whether it will receive a different reception in the Sixth Circuit is an open question. After all, in the Texas litigation, Ford was one of many auto manufacturers with a franchise dealer network both in and out of Texas, while in Michigan Tesla has no such network. Accordingly, Tesla could argue that, unlike the Fifth Circuit's Ford case, the Hune amendment was a death sentence for its ability to even compete in the Michigan market. Still, despite this distinguishing factor, the Fifth Circuit's precedent does not augur well for Tesla.

Tesla's rational basis arguments under the Fourteenth Amendment may not fare much better. Under rational basis review, where there is no suspect (usually discriminatory) classification under the equal protection clause, or where there is no fundamental constitutional right at issue under the due process clause, laws are presumed constitutional if they are rationally related to a legitimate government purpose. Note that there are two prongs of rational basis review: legitimate government purpose and rational relation.[67]

In this case, if the interest of the state of Michigan is to protect franchise dealers, then the Hune amendment is rationally related to that interest. The rational basis question then becomes: Is the protection of franchise dealers against companies such as Tesla a legitimate interest of a state government?

Generally, rational basis review exerts a light touch on state statutes that come before the courts. As the Supreme Court has stated, any state statute subject to rational basis review must be upheld if "any state of facts reasonably may be conceived to justify it."[68] Accordingly, states do not even need to credibly assert facts to support legislation subject to rational basis review (and the intent of the state legislators, no matter how protectionist, is irrelevant). Courts may search to conceive of "any state of facts" that could be used to support them—even if that state of facts is part of an entirely post hoc rationalization.[69]

"Courts may search for any facts that could support them—even if those facts are part of an entirely post hoc rationalization."

As Tesla sees it, the Hune amendment fails even that forgiving rational basis standard:

> By design, Section 445.1574 creates a monopoly in favor of franchised dealers with respect to selling and servicing new cars, and it excludes Tesla from the Michigan market because Tesla does not, and could not, use the dealer model. Section 445.1574 also protects Michigan's local vehicle manufacturers, which use the franchise model, from competition by Tesla. Thus, as applied to Tesla, Section 445.1574 is a purely protectionist measure that does not further

> "**Applying rational basis review, the Sixth Circuit found that protecting a discrete interest group from economic competition is not a legitimate governmental purpose.**"

any legitimate state interest, as the U.S. Constitution requires.

> *[The] original Section 445.1574 was enacted to ensure fairness in relationships between powerful manufacturers and their less-powerful, independent dealers. But applying the law to Tesla cannot further Section 445.1574's purpose because Tesla has never used a franchised dealership model.*
>
> Conversely, Section 445.1574 unquestionably harms consumers. Preventing a nonfranchising manufacturer such as Tesla from selling cars within the state of Michigan removes a competitor from the marketplace. Increasing competition enhances consumer choice and reduces prices, whereas reducing competition takes choice away from consumers and increases prices. Moreover, there has been no showing—nor could there be—that the dealer model is otherwise better for consumers.[70] (Emphasis added.)

In the Ford Fifth Circuit case, preventing car manufacturers from competing against auto dealers in selling cars was seen as a legitimate state interest—and the franchise dealer laws were rationally related to addressing that interest.[71] Tesla's rational basis challenge is likely to meet with the same response in the Sixth Circuit.

There are some cases, however, that might give Tesla a sliver of a chance in court. Those cases state that rational basis should not be a "get out of jail free" card for states and legislatures with nefarious intent that are unable to articulate legitimate government interests. As Crane points out, there are cases in various circuits where courts did not merely search for any conceivable rationale to defend state statutes. In these cases, courts actively scoured the record for legitimate government purposes and invalidated state statutes if no such purposes were found. Quoting the Ninth Circuit, Crane argues that since "economic protectionism for its own sake . . . cannot be said to be in furtherance of a legitimate government interest," courts can apply "rational basis with economic bite" in reviewing protectionist statutes. This more demanding rational basis review would take into account empirical data, statistical analysis, legislative motivations, and intent, and it would question how and whether the legislation in question increased the public good.[72]

Fortunately for Tesla, one of the cases in which courts have applied "rational basis with economic bite" came out of the Sixth Circuit, which includes the state of Michigan in its jurisdiction. In *Craigmiles v. Giles*, the Sixth Circuit invalidated a restrictive licensing scheme that prevented competition in the market for caskets.

In Tennessee in 1999, Rev. Nathaniel Craigmiles, noticing that funeral directors had been charging casket buyers exorbitant prices, decided to sell them himself at lower prices. Rather than compete on service or price, however, funeral directors relied on the Tennessee Funeral Directors and Embalmers Act to try to drive Craigmiles out of business.[73]

Under the Act, a person involved in "funeral directing," which apparently included the simple sale of caskets ("the selling of funeral merchandise"), must be licensed under state law. To be licensed, applicants may either complete a two-year apprenticeship with an undertaker or one year of apprenticeship plus one year of study. At the end of the two-year period, the applicant must take an exam. The bulk of the study and certification is focused on embalming and funeral directing—with very little of it focusing on the sale of caskets or funeral merchandise.[74]

Applying rational basis review, the Sixth Circuit found that "protecting a discrete interest group from economic competition is not a legitimate governmental purpose." While noting that licensed Tennessee funeral directors mark up casket prices from 250 percent to 600 percent, the Court found that requiring Craigmiles to undergo an expensive licensure requirement served no legitimate government

interest. Public safety was not implicated because Tennessee law, curiously, had no requirement that buried bodies be interred in caskets, allowing for homemade caskets or even no casket at all. And since Craigmiles was not asking for the right to prepare bodies for burial, there was no risk of spread of communicable disease. Accordingly, the Court saw the funeral directors' complaints as purely protectionist in nature and refused to find a legitimate state interest in preventing Craigmiles from selling caskets.[75]

Shortly after the publication of the *Craigmiles* decision, however, the Tenth Circuit, reviewing an almost identical licensing requirement, found in *Powers v. Harris* that "[i]ntrastate economic protectionism constitutes a legitimate state interest."[76] Accordingly, the Tenth Circuit upheld a ban on unlicensed casket sales. Despite the clear conflict with the Sixth Circuit, the Supreme Court refused to hear the appeal of the *Powers* case.

In 2004, the Ninth Circuit went even further in propping up economic discrimination as a legitimate government interest. In *Sagana v. Tenorio*, the Ninth Circuit held that clearly discriminatory labor laws that favored native resident workers satisfied rational basis review.[77] At issue in *Sagana* was a labor law that gave job preferences to residents of the Northern Mariana Islands (a territory of the United States that is subject to the Fourteenth Amendment). The Ninth Circuit found that such preferences were designed to "protect[] the wages and conditions of resident workers" and therefore served "reasonable, important [government] purposes."[78]

As *Powers* and *Sagana* show, cases where courts have taken an active role in striking down protectionist statutes under rational basis review are the exception and not the rule. The majority view of rational basis review is still, unfortunately, with the *Powers* and *Sagana* courts and not the *Craigmiles* court.[79]

Tesla's fans might hope that its rational basis and dormant commerce clause arguments would carry the day in the Michigan litigation. As the Ninth and Tenth Circuit Courts show, however, it is unlikely that Tesla's arguments, relying as they do on largely legal theories, will prevail in court.

What Tesla does have going for it, however, is that the *Craigmiles* case is a binding Sixth Circuit precedent, and the Fifth Circuit's *Ford* dormant commerce clause analysis is not binding in Michigan. Accordingly, Tesla has a slim chance of prevailing—but the challenge, as of now, is still daunting.

OTHER AVENUES?

The threat presented by startups and other innovators to market participants has caused the latter to pull more heavily on the levers of legislation and regulation to prevent open competition. This has a detrimental effect on new companies experimenting with transformational products (Tesla) or business models (Uber, Airbnb, Lyft) and causes consumers to lose out. Many of these new companies, such as Tesla, face long odds in court, given the generally deferential rational basis standard applied to state economic regulation.

The safest and surest way that Tesla and other innovators can prevent market incumbents from improperly using government to inhibit competition is through the courts. The widespread adoption of a more rigorous and demanding rational basis test will require a concerted effort from multiple market entrants over a number of years and across multiple states and federal Circuit Courts. Such an effort will require extensive time and investment. In that light, the Tesla litigation against Michigan can be seen as the first step on the thousand-mile journey to a more sensible rational basis test.

If Tesla and its brethren will carry a heavy burden in litigation, are there other avenues by which Tesla could attain relief? If Tesla finds the road to market competition blocked at the courthouse and state capitol doors, might they find it open with the new administration or in the halls of Congress? Should Tesla, rather than putting all of its eggs in the litigation and local lobbying basket, turn to Washington in order to open markets closed by state politicians?

"The threat presented by startups and other innovators has caused market participants to pull more heavily on the levers of legislation and regulation to prevent open competition."

These questions identify an interesting tension between free-market economics and federalism. Where state legislatures are captured by rent-seeking incumbent market participants, should the federal government consider using its power to pry open markets to competition? Is it wise to override general federalist principles in order to open markets on a state level—or would such interference do more long-term harm than good? These questions are beyond the scope of this analysis, but they are worth considering in an era where those who profess an affinity for free markets and deregulation control the federal executive and legislative branches.

It is worth noting that one option for Tesla (if it does indeed lose its lawsuit in Michigan) is to do nothing. If surrounding states allow for the direct sale of Tesla vehicles to consumers, Michiganders might cross state lines to buy a Tesla. In this alternative scenario, out-of-state services could be created to allow for the sale and transportation of Tesla cars to Michigan buyers. These services would add a completely unnecessary transactions cost to the sale of a Tesla. Unfortunately, given the Michigan state legislature's behavior, it is probably too late to avoid unnecessary transactions costs for Michigan EV car buyers.[80] Additionally, other new market entrants may not have the resources to adopt such a laissez faire approach.

CONCLUSION

In the end, there is already an avenue for disruptive market entrants. The surest remedy for states overstepping their bounds lies not in new federal statutory or regulatory schemes but in courts applying more rigorous rational basis review. If courts adopted the rigorous rational-basis analysis of *Craigmiles* (instead of the looser and more traditional rational basis standard seen in *Powers* and *Sagana*), companies such as Tesla, Uber, and Airbnb would stand a fighting chance of enriching consumers with new services, products, and goods—and legislatures could focus their efforts on governance for the benefit of all citizens instead of the established few market incumbents.

NOTES

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49. Ibid. In an FAQ page on its website, the National Association of Auto Dealers asks the question, "Don't franchise laws limit competition?" It responds: "State laws do not give existing dealers the unilateral right to block the addition of new dealers. Rather, state laws typically give existing dealers the ability to challenge as economically unjustified the proposed addition of a new dealer in the existing dealer's immediate neighborhood. But, for the dealer to prevail, the new outlet must be shown to, in fact, be unjustified. These rights are appropriate given the enormous, multi-million dollar financial commitment dealers invest in their communities to build and run their dealerships. And, in any event, consumers can still easily shop at the same brand dealers in nearby markets." It would appear that the shorter answer to that question is simply, "Yes."

50. Michigan Compiled Laws Section 445.1574(i).

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52. *Tesla Motors, Inc. v. Johnson et al.*, ¶¶ 33–36.

53. Daniel A. Crane, "Tesla, Dealer Franchise Laws, and the Politics of Crony Capitalism," *Iowa Law Review* 101, no. 2 (2016): 573–607, https://ssrn.com/abstract=2566436.

54. Some libertarians may argue that Tesla is not the most sympathetic victim of government coercion, given that its business model relies, in part, on federal and state subsidies that make the effective cost of its vehicles cheaper for prospective buyers. While it is certainly true that Tesla benefits from government incentives for EV, so, too, do its Michigan tormentors GM and Ford. In the game of government subsidies, bailouts, and incentives, no automaker is clean. Accordingly, it may just be best to take Tesla's Michigan litigation on its merits despite the company's previous reliance on government money.

55. *Tesla Motors, Inc. v. Johnson et al.*, ¶ 28.

56. Ibid., ¶ 30. Tesla's used-vehicle dealer license and registration for vehicle repair are still pending.

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62. *Tesla Motors, Inc. v. Johnson et al.*, ¶¶ 47–49. As a side note, it is also worth noting that most antitrust remedies available to Tesla under the Sherman Act are unavailable in this case because of the state action doctrine. The state action doctrine, born of the Supreme Court opinion in *Parker v. Brown*, 317 U.S. 341 (1943), states that the Sherman Act cannot be used to preempt state statutes or regulations. The *Parker* Court found no evidence that Congress intended to interfere with or preempt state laws in prohibiting anti-competitive behavior under the Sherman Act. The passage of state legislation such as the Hune amendment is classic "state action" under the Sherman Antitrust Act. Accordingly, Tesla rightly declines to assert the Sherman Act in its complaint.

63. See, for example, *Dean Milk Co. v. City of Madison, Wisconsin*, 340 U.S. 349 (1951) (states and localities may not discriminate against out-of-state commerce even if health and safety are at issue; health and safety regulations are subject to the dormant commerce clause and must use the least restrictive means of accomplishing their aims).

64. Crane, "Tesla, Dealer Franchise Laws, and the Politics of Crony Capitalism."

65. Ibid., p.21

66. Ibid., p. 37 (citing *Ford Motor Co. v. Texas Dept. of Transp.*, 264 F.3d 493 at 502 (5th Cir. 2001)).

67. One might say that protecting American citizens from harm is a legitimate government purpose—but that doing so by requiring them to eat Fruit Loops every third Sunday of the year is not rationally related to that interest. Conversely, one may argue that a policy of requiring all cars to be painted periwinkle is not rationally related to the legitimate government interest of keeping highway travel safe (assuming there are no persuasive scientific studies that show that a uniformly colored periwinkle fleet of cars is safer than cars of multiple colors). See, for example, *United States Dept. of Agriculture v. Moreno*, 413 U.S. 528 (1972) (even accepting the government's argument that preventing food-stamp abuse is a legitimate government interest, prohibiting households containing one or more unrelated members from receiving food stamps at all is not rationally related to that interest).

68. *McGowan v. Maryland*, 366 U.S. 420 p. 426 (1961).

69. *Lindsley v. Natural Carbonic Gas Co.*, 220 U.S. 61 (1911).

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71. *Ford Motor Co. v. Texas Dept. of Transp.*, 264 F.3d 493 at 502 (5th Cir. 2001).

72. Crane, "Tesla, Dealer Franchise Laws, and the Politics of Crony Capitalism" (quoting *Merrifield v. Lockyer*, 547 F.3d 978, 991 n. 15 (9th Cir. 2008) and citing *St. Joseph Abbey v. Castille*, 712 F.3d 215 (5th Cir. 2014) and *Craigmiles v. Giles*, 312 F.3d 220 (6th Cir. 2002)).

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74. *Craigmiles v. Giles*, 312 F.3d 220 (6th Cir. 2002).

75. Ibid.

76. *Powers v. Harris*, 379 F.3d 1208, 1221 (10th Cir. 2004), *cert. denied*, 125 S.Ct. 1638 (2005). In reviewing the *Powers* and *Sagana* cases, I owe a debt of gratitude to the following sources by Timothy Sandefur, which both contain excellent discussions of each case: Timothy Sandefur, "A Private Auction of Opportunities," *Regulation* 29 (Spring 2006): 52–56, https://object.cato.org/sites/cato.org/files/serials/files/regulation/2006/3/v29n1-6.pdf; and Timothy Sandefur, "Is Economic Exclusion a Legitimate State Interest?

Four Recent Cases Test the Boundaries," *William and Mary Bill of Rights Journal* 14, no. 3 (2006): 1034–35, http://scholarship.law.wm.edu/cgi/viewcontent.cgi?article=1190&context=wmborj.

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78. Ibid., at 741.

79. For a counterpoint on *Craigmiles*, see generally: Brianne J. Gorod, "Does Lochner Live?: The Disturbing Implications of *Craigmiles v. Giles*," *Yale Law and Policy Review* 21, no. 2 (2003): 537–45.

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