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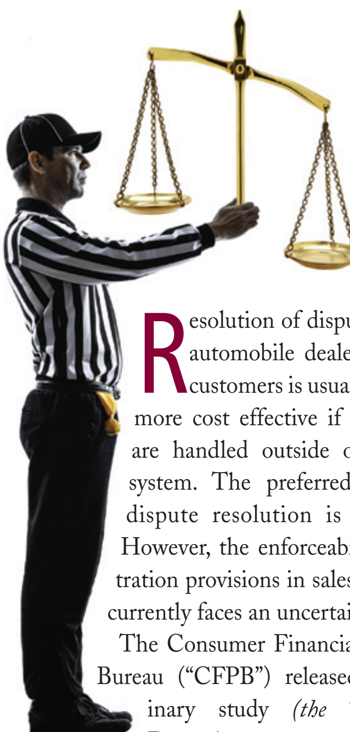
JUNE 2014

Members of the Automobile Dealers Association of Greater Philadelphia and the Greater Lehigh Valley Automobile Dealers Association

Arbitration Provisions in Sales Agreements Can Have Significant Benefits but Face an Uncertain Future

By Jonathan Samel, Esquire



Resolution of disputes between automobile dealers and their customers is usually faster and more cost effective if the disputes are handled outside of the court system. The preferred forum for dispute resolution is arbitration. However, the enforceability of arbitration provisions in sales agreements currently faces an uncertain future.

The Consumer Financial Protection Bureau ("CFPB") released a preliminary study *(the "Study")* on December 12, 2013 on the use of arbitration provisions contained in credit card, prepaid card and checking account contracts. The Study is only the first part of a broader examination of arbitration provisions required by the Dodd-Frank Act. In the 168-page Study, the CFPB examined arbitration provisions in different markets, the length and complexity of the provisions, the frequency and type of arbitration filings, and the frequency of class action waivers in arbitration clauses.

While the Study is not the final version that the CFPB will present to Congress, the findings in the Study have been cited as evidence that the CFPB supports the argument that arbitration provisions (particularly where such provisions are mandatory) suppress the legal rights of consumers, and that the CFPB may try by regulations to restrict the use of arbitration provisions in consumer contracts.

The use of arbitration provisions has been based on a national public policy that strongly favors alternative dispute resolution. As indicated in numerous United States Supreme Court decisions over the past several years, the Federal Arbitration Act endorses the enforcement of arbitration provisions.

One significant advantage of arbitration over a lawsuit in court is that the parties choose the decision-maker. The parties are better off having some control over the selection of the arbitrator. Another advantage is that parties can have more input in controlling the dispute resolution process, including the time and location of the hearing. Arbitrations also lack a public record, which provides privacy for the parties involved.

Discovery is the process whereby both sides collect information prior to trial by taking depositions and requesting documentation from the opposing party. In court proceedings, the discovery process can take many months. In arbitration, discovery is usually limited within a defined time frame and therefore less time-consuming and costly.

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USE CAUTION WITH ONLINE CUSTOMER DATA

Online data allows dealerships to target potential customers with ads on social media, and reach them in ways that reduce marketing costs. Benefits of tracking customers' online activity include seeing their shopping patterns and customizing content that is displayed to them.

Regulators are pushing rules that require businesses to inform shoppers when they are being tracked online. Certain jurisdictions are at the forefront, but there is a general sentiment that eventually stricter privacy laws will be adopted across the country. In January, California began requiring commercial websites to disclose to visitors whether personal data is tracked and whether third parties can view that data. Draft rules in Europe would require consent from the website visitor before the visitor's data can be shared. In July, Canada will have a new anti-spam law that imposes harsh fines for organizations that ignore the desires of recipients regarding electronic communications.

One Midwest dealership group decided to get out in front of the legislative trend. With 13 dealerships and operations in multiple states, the group feared it would become a big target if its jurisdictions adopt stricter privacy laws. The dealership group now proactively informs customers how it gathers and uses data. Its websites feature an online video explaining how to decline data tracking and opt out of emails. Its websites also have prominent displays of its consumer privacy policy.

The future of digital marketing will likely require businesses to be increasingly careful about their tracking practices, and to clearly notify customers of their rights not to be tracked. There may also be heavy penalties for violations. Dealerships that use online data should consider the goodwill that can be gained by being upfront and transparent to customers about data collection and sharing practices. A well-written consumer privacy policy is a good first step. Please contact one of our attorneys to discuss any privacy law related questions you may have. ■

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A review of the preliminary data cited in the CFPB Study indicates that the aggregate number of both small claims actions and consumer financial service related arbitrations was very small compared with the total consumer financial service market as a whole. In other words, the Study can also be interpreted as evidence that the current consumer system using arbitration is operating efficiently and fairly.

In order to obtain the benefits of arbitration, it is critical that the arbitration provisions used in a sales agreement be legally enforceable. A number of court decisions in different states have invalidated arbitration provisions in automobile sales agreements.

An arbitration provision must pass the tests of substantive and procedural fairness. If a court determines that the terms of an arbitration provision are unfair, or that the negotiation process between dealer and customer was inequitable or fraudulent, then the court will invalidate the arbitration provision.

Courts have found arbitration provisions unenforceable where the terms were so unfair that no reasonable person would agree to them, and no honest and fair person would propose them. The agreement to arbitrate cannot be so one-sided, after considering all of the facts and circumstances, that the customer is denied any opportunity for a meaningful choice. For example, in a recent court case, an arbitration provision which required the customer to submit all claims to an arbitrator, but allowed the dealer to take any claim immediately to court, was deemed unenforceable.

A sales agreement containing an arbitration provision must also be explained, negotiated and signed with fairness in mind. For example, in another recent court case, where the salesperson never showed or explained the arbitration provision to the customer, and "misrepresented what the language meant, the court easily found the agreement unenforceable. Further, if the sales contract is offered to the customer on a standardized form in a "take it or leave it" manner, without affording the buyer an opportunity to negotiate, the agreement to arbitrate will likely be held to be invalid if challenged.

Elements of the CFBP Study may be useful to automobile dealers when reviewing the current arbitration provisions in their agreements. In the Study, the CFBP examined whether the arbitration clause (i) provides consumers with a period to reject the arbitration clause, (ii) contains a small claims "carve-out" excusing consumers with disputes eligible for small claims court from the obligation to arbitrate, (iii) delegates enforceability decisions to the arbitrator, (iv) prohibits class action proceedings, or (v) limits the recovery of punitive or other damages. A minority of the contracts reviewed in the Study provided consumers with a defined period of time to opt out of, or reject the arbitration clause. 90% of the contracts reviewed contained arbitration provisions that barred consumers from initiating or participating in class action proceedings.

Although it remains to be seen how the CFPB will proceed and how automobile dealers will ultimately be affected, it makes sense to follow a balanced and even-handed approach when drafting arbitration provisions. Keep the following procedural and substantive guidelines in mind with respect to your arbitration provision:

If you need assistance in developing an appropriate arbitration clause, please feel free to contact our office. One thing is clear, dispute resolution between dealers and customers will continue to evolve as more arbitration provisions are challenged, as new regulations are put in place, and as new court decisions are rendered. It is important that all dealers stay informed of the current law with respect to dispute resolution generally, and arbitration in particular. ■

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PROCEDURAL GUIDELINES:

- In printing a sales agreement, make sure to use **boldface** type and **CAPITAL** letters for the arbitration provision.
- Be sure your sales personnel understand and explain the arbitration provision to each and every customer, regardless of their impression of the customer's level of business savvy.
- Provide a place for the customer to initial or sign next to the arbitration provision to acknowledge his or her understanding and consent to the provision.
- Do your best to use plain language in drafting the arbitration provision; courts are more likely to enforce provisions that are clear and easily readable, even if the customer did not read the agreement.

SUBSTANTIVE GUIDELINES:

- Do not require the customer to accept arbitration, but rather give the customer the option at the time of signing to reject the arbitration clause.
- Provide options to the customer with respect to a particular type of arbitration forum or arbitration organization.
- Include a small claims "carve-out" which excludes disputes eligible for small claims court from the arbitration clause.
- Do not require the "loser" to pay the legal fees of the "winner" of the arbitration proceedings.
- Try to keep arbitration fees for customers reasonable, as arbitration is designed to be less expensive for both parties involved in the dispute.
- Do not require the confidentiality of the arbitration proceedings and its resolution.

Recent Tax Law Changes Make Income Tax Planning *More Important Than Ever*

One universal and challenging objective in wealth preservation planning is reducing taxes. Recent tax law changes have in many cases shifted the focus of such planning from estate and gift tax reduction to income tax reduction.

On January 1, 2013, Congress passed the American Taxpayer Relief Act of 2012 (ATRA) which, among other things, increased certain income tax rates. ATRA established a new top rate for ordinary income of 39.6% (up from 35%) for taxpayers with taxable income in excess of $400,000 for single individuals, $450,000 for married couples filing jointly, and only $12,150 for estates and trusts in 2014. In addition, the top long term capital gain and qualified dividend tax rate was increased from 15% to 20% for taxpayers in the above mentioned highest ordinary income tax bracket.

The Patient Protection and Affordable Care Act ("PPACA") which was originally enacted in 2010 established a new 3.8% surtax on investment income which first became effective in 2013. For purposes of this tax, investment income includes interest, dividends, rent, royalties, capital gain and passive activity income. This additional tax applies to taxpayers with an adjusted gross income in excess of $200,000 for single individuals, and $250,000 for married couples filing jointly. For estates and trusts, this tax applies to the lesser of (i) undistributed net investment income or (ii) the excess of adjusted gross income over the amount at which the top income tax bracket for trusts and estates begins (only $12,150 in 2014). Considering this additional 3.8% tax, for taxpayers in the highest bracket, their effective ordinary federal income tax rate (not considering state income tax rates) can be as high as 43.4%, and the top long term capital gain and qualified dividend tax rate is now effectively almost 24%.

While income taxes have increased, particularly for estates and trusts, the imposition offederal estate and gift taxes on individuals has been significantly reduced. ATRA made permanent the $5 million estate and gift tax exemption that was first introduced in 2011. The exemption is indexed for inflation, and in 2014, an individual can shield up to a total amount of $5.34 million of assets either transferred during lifetime or at death from federal estate and gift taxes. ATRA also made permanent the portability feature, which now allows a surviving spouse to use his or her deceased spouse's unused exemption. This gives a married couple the ability to protect up to $10.68 million in 2014 from estate and gift taxes. The use of all or a portion of the exemption for gifts made during each person's lifetime will correspondingly reduce the amount that is available to shelter assets from estate tax after that person's death. ATRA increased the top marginal estate and gift tax rate from 35% to 40% to the extent the total value of assets gifted and passed upon death exceeds the available estate and gift tax exemption.

As a result of the recent changes to the estate and gift tax law, planning for these taxes is no longer relevant for most people. Less than one percent of estates are now subject to these taxes. However, this does not alleviate the need for proper and careful estate planning for everyone to assure that property is preserved and passes to the appropriate beneficiaries in the appropriate manner.

Income tax planning, however, is now more important than ever for many more people, including those with modest estates. In many cases, this planning focuses on the adjusted basis of a person's assets.

The adjusted basis is the original cost of an asset which is then adjusted for various tax-related items. Such adjustments include increases for the cost of improvements to property, increases for purchase and selling costs, and decreases for depreciation and amortization, where applicable. In addition, the basis in stock, partnership interests and other ownership interests in certain closely held businesses is adjusted up and down annually based on the amount of any distributions made from the business to the owners, taxable income or losses of the business passed through from the business to the owners, and certain other tax events occurring in the business during the year.

Under the tax law, the amount realized from a sale of an asset is generally an amount equal to the total consideration given for that asset, less the seller's adjusted basis in the asset. If the difference is positive, then the amount realized is a gain. If the difference is negative, the amount realized is a loss. Therefore, taxable gain upon the sale of an asset can be reduced if that asset has a high adjusted basis at the time of sale.

For lifetime gifting of an asset, the general rule is that the adjusted basis of

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the person making the gift (the "donor") carries over to the person receiving the gift (the "donee"), subject to certain exceptions. One exception to the general rule is that if the basis is greater than the fair market value of the asset at the time of the gift, then for the purpose of determining loss on the future sale of the asset, the basis must be adjusted to the fair market value at the time of the gift. The effect of these rules is that any unrealized gain in the gifted asset will be taxed to the donee when the asset is sold, but unrealized losses are lost to both the donor and donee. The donor's accumulated depreciation, where applicable, on a gifted asset carries over to the donee.

Upon death, the general rule for basis is different. The basis of property which is inherited gets "stepped up" to the then current fair market value of such property on the date of death (subject to certain exceptions). This increase in basis can reduce or eliminate capital gain tax liability on subsequent sale transactions by heirs, and can also provide heirs with a larger basis for depreciation and amortization deductions going forward.

For example, assume that a father who is seriously ill owns rental real estate worth $500,000 which has an adjusted basis of zero as a result of depreciation of the property over the years. He is thinking about gifting the property to his son. This plan would not be a good idea. If he follows through with the gift, the father's zero basis in the property will carry over to his son. On the other hand, if the father holds on to the property until his death, and passes the property to his son under his will, the son will receive a new "stepped up" basis in the property equal to the fair market value at the time of father's death. A stepped up basis will give the son the ability to receive valuable depreciation deductions against his income if he holds on to the property, or will allow the son to sell the property after father's death with little or no capital gain tax liability.

It is important to obtain detailed documentation of the basis of assets, to store this information in a safe place and to provide the information to family members and advisors. The sale of any asset can occur many years after the asset was received by gift or by inheritance. Without proper records, the tax consequences of the sale cannot be properly be determined or reported.

For many years the focus in planning has often been to minimize asset values to reduce estate and gift taxes. Now, many taxpayers will instead focus on maximizing the value of their assets to reduce future income taxes by keeping the adjusted basis of assets as high as possible. The recent income tax law changes will likely make professional appraisals more important for documenting basis, particularly for closely held business interests which do not have an easily determinable fair market value.

Individuals who are no longer subject to estate and gift taxes may have current estate plans that are focused on saving estate and gift taxes, and are not designed to obtain a stepped up basis to save income taxes. Existing plans should be reviewed and updated as soon as possible to be consistent with the new tax law. ■

We can work with you to review and update your current estate plan and to assure that proper provisions are in place to meet your needs and goals. Wealth preservation planning can involve a number of areas of law, including, estate planning, taxation, business law, litigation, asset protection planning, real estate law and divorce law. HRMM&L takes a multi-disciplinary approach to wealth preservation planning involving attorneys with expertise in a number of different areas of law. Please contact our office if you have any questions or want to learn more about our capabilities in this area.

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