

Third Circuit Rules Texas Auto Dealer Incentive Programs Must Use Reliable Standards

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The Texas Third Court of Appeals has offered guidance on the use of dealer incentive programs (DIPs) under the Texas Occupations Code (TOC). In *Star Houston, Inc. v. Volvo Cars of North America, LLC* and the Board of the Texas Department of Motor Vehicles, *Star Houston, Inc. (Star)*, a local Volvo dealer, and *Volvo Car USA, LLC (Volvo)*, the brand's U.S. distributor, had a dispute over the termination of Star's local franchise. Star claimed Volvo's DIPs violated the TOC.

Star was a longtime, local Volvo dealer, operating under a 1970 franchise agreement. It performed poorly in sales for years, lagging other local Volvo dealers in the region and consistently refusing to adopt Volvo's suggestions for improvement of its sales and overall business. Volvo operated incentive programs for its franchised dealers, attaching bonus payments to certain actions. Star generally did not perform the incentivized actions. Thus, Star usually did not receive as much bonus money as the other dealers.

In 2016, Volvo notified Star that it was terminating their franchise relationship. Star contested the termination of its franchise in an administrative proceeding before the Texas Department of Motor Vehicles (DMV), which regulates vehicle-dealer franchises. Star sought relief from termination and also filed claims that Volvo's six DIPs each violated various TOC provisions. The six DIPs at issue were:

- Customer Service Index (CSI) and Service Satisfaction Index (SSI): two measures of customer satisfaction using survey results.
- Facility Investment and Support Initiative (FISI): conforming facilities to Volvo specifications.
- Volvo 360: buying, certifying, and selling "certified pre-owned" Volvos.
- Retailer Standards: submitting business plans, financial statements, training goals, etc.
- Factory Options/Package Bonus/Sales Mix: selling Volvo-brand options in new car sales.

Star lost on its protest of the franchise termination and on its challenges to four of the DIPs. The two DIPs that Star successfully challenged were the CSI and SSI programs (CSI/SSI). The DMV found these to violate the TOC because they were unreasonable and discriminatory.

Both parties appealed the DMV's final order to the Third Court of Appeals of Texas in Austin. Volvo challenged the ruling that CSI/SSI were unreasonable and discriminatory. Star maintained that each of the six DIPs violated the TOC.

In its consideration of Volvo's appeal of the DMV's ruling that CSI/SSI were unreasonable and discriminatory, the court analyzed two specific TOC sections: 2301.467(a)(1) (reasonability) and 2301.468 (discriminatory).

First, the court examined TOC section 2301.467(a)(1) regarding the question of whether the two DIPs were unreasonable. The statute prohibits distributors from "requir[ing] adherence to unreasonable sales or service standards." The court looked at each of these constituent parts of the statute:

- Sales or service standards. The court determined that the programs were related to "sales or service," and that they also qualified as "standards" that measured franchise performance.
- Adherence. Next, the court found that a distributor's calling for its dealer to meet standards for eligibility in incentive programs qualified as "requiring adherence."
- Reasonability. Last, the court decided that the surveys and scoring had various statistical flaws, and that it was "unreasonable" to tie flawed surveys to quantified customer happiness scores and bonus payments.

Based on this analysis, the court held that the two DIPs were unreasonable, in violation of TOC section 2301.467(a)(1).

Second, the court examined TOC section 2301.468 in deciding whether the two DIPs were discriminatory. That statute prohibits distributors from treating franchised dealers "differently," "unfairly," or "inequitably" when gauging their performance through formulas, computations, or other processes. In its analysis, the court found that by tying flawed surveys to quantified scores and bonus payments, the two programs treated dealers inequitably. It also noted that Star, as a low-volume seller, was vulnerable to large swings in CSI/SSI scores, where one bad survey disproportionately skewed a small sample size. Based on this reasoning, the court held that the two DIPs were discriminatory toward low-volume dealers, in violation of TOC section 2301.468.

The court also agreed with the DMV that the other four challenged DIPs did not violate the TOC. Volvo lacked control over Star to force its compliance, as substantially evident through Star's consistent refusal to follow Volvo's advice or requests. Thus, the four DIPs were not unreasonable. Star's poor sales record predated any of the DIPs, and those programs' qualification thresholds applied equally across the dealer community. Thus, the policies were not discriminatory toward low-volume sellers.

This opinion is important to note for Texas-based automobile dealership and franchise systems, particularly dealerships that sell in relatively low volumes. If a franchisor institutes a DIP that uses standards to measure sales or service, it should ensure that such a program relies on sound metrics

and statistical analysis as well as adequate sample sizes. Such programs might discriminate against smaller-volume dealers and, thus, violate the TOC.

Conversely, a franchisee that consistently ignores a franchisor's advice or requests for improvement, despite a longtime poor sales record that predates incentive initiatives, may not be able to maintain a claim against the franchisor for operating unreasonable or unfair incentive programs.

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