Your Neighborhood Gasoline Station - A Legal Issues Overview

by David Feldheim

Many people mistakenly view the oil industry as a highly monopolistic business, one in which there are vast conspiracies to limit the amount of gasoline sold and to fix the prices we pay at the pump. Nothing could be further from the truth. Gas station owners are engaged in a penny business, highly competitive at all levels of the supply chain, and characterized by multiple distribution channels from wellhead to pump.

I have been handling legal matters related to gas stations for over 35 years. Recently, it occurred to me that other attorneys might be interested in the legal issues associated with their friendly neighborhood service station.

Gas Business Basics: The Supply Chain

Let's start at the beginning. The gasoline you purchase at your neighborhood station began its life somewhere in the world as crude oil. By "somewhere in the world" I mean *anywhere* in the world. The search for crude is an expensive, high-stakes undertaking. Bidding for exploration rights is very competitive, based upon educated guesses and geological studies.

Once found, private companies, nation states, or some combination of the two produce the crude under licensing rights. Those licensing rights are also subject to competitive bidding. After it's extracted, the producer sometimes ships the crude to its own refineries for processing; other times, it's sold on the world open crude markets.

As we know all too well, the price of crude is subject to the laws of supply and demand. Daily prices are widely published and used as economic indicators. In addition, the price is subject to frequent and wild swings, often reacting to market forces having little to do with supply and demand (can you say *trader* and *speculator*?). In fact, a load of crude on an oil tanker on the open seas may change owners several times before it reaches its destination.

After crude is refined into gasoline, the product again moves along the supply chain on the way to its ultimate destination- the retailer. The gasoline may move by rail or truck from the refinery, but most likely (especially in huge quantities or if great distances are involved) it's shipped by barge or pipeline. Usually, the refiner delivers gasoline to terminals, where it's stored for truck distribution to retail outlets. Sometimes a refinery will have a terminal on-site for direct retailer distribution.

Gas Pricing Issues

There are two kinds of gasoline terminals: *branded* and *independent*. Branded terminals sell gasoline primarily to buyers affiliated with their particular brand, but they may also sell to unaffiliated buyers. Independent terminals sell gasoline to all comers.

Two kinds of buyers visit a gasoline terminal: dealers and distributors (wholesalers). Those dealers and distributors may be branded or unbranded, and that distinction affects the purchase price.

Where a supplier operates the terminal and the buyer is a dealer carrying the supplier's brand (for example, a Sunoco dealer buying gasoline at a Sunoco terminal), the dealer pays the "dealer tank wagon" (DTW) price. If a supplier operates the terminal and the buyer is a branded distributor for the supplier (a Sunoco distributor buying gasoline at a Sunoco terminal), the distributor pays Sunoco's standard "rack" price.

If the terminal is either independent (not affiliated with a particular brand) or a branded supplier selling to an unaffiliated distributor, the buyer pays the rack price. It's not unusual for an unbranded dealer to buy gasoline directly from a branded terminal.

Usually, the DTW price is higher than the rack price, and a branded dealer or branded distributor may pay more than an unbranded dealer or distributor. But that's not always true. Result? Pricing is frequently the subject of disputes and litigation among refiners, terminals, distributors, and dealers. While an independent operator may buy its gasoline from the terminal of its choice, a branded operator, whether a dealer or distributor, *must* purchase gasoline from the terminal its branded supplier designates.

Location, Location, Location!

David Feldheim

Service stations come in two flavors: company-operated and dealer-operated. When you see a Sheetz, Wawa, or Costco station, you know it's company-operated. The owner sets the retail gas price every day – and I mean <u>every</u> <u>day</u>. If you see a sign for one of the traditional brands (such as Sunoco, ExxonMobil, or Shell), the station could be either type. Most have independent dealer operators who make their own, independent decisions about pricing.

To be sure, supplier sales representatives coach these dealers on pricing. Complicated computer models play a role in driving this coaching, models intended to demonstrate to the dealer how to establish a price that will optimize the dealer's profits. Suppliers are also highly motivated to make sure the dealers price fuel in such a way to maximize the volume sold by the supplier to that location.

Further complicating the picture is the issue of who controls the real estate on which the service station is located. There are four possibilities. For one, the dealer might own the location. Second, the dealer could lease the station under a long-term arrangement with a third party. In another scenario, the supplier could own the location. Or, the supplier could have a long-term third party lease. You may be assured that the owners of many service stations you drive by are retirees living in Florida or Arizona, collecting monthly rent checks under leases their parents or grandparents negotiated many years ago.

Interestingly, the large branded suppliers have cycled through alternative real estate ownership philosophies over the years. Sometimes a large branded supplier's management will decide it's

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best to have as little capital as possible tied up in real estate, and the brand tells its real estate department to sell as many of its locations as possible at market rates. That doesn't mean there are fire sales or sales under duress, but nevertheless the goal is for the brand to own as little real estate as possible. When the next management team takes over, a different attitude might emerge, where the new ideal is to acquire "control" of as many locations as possible. It's a highly subjective consideration.

This issue of control is so important that every large gasoline marketer manages its branded locations according to whether it controls the site. If a franchisee or dealer owns the location or has a long-term lease with a third party, the franchisee or dealer has control of the location. Every brand has its own vocabulary for this distinction. At Sunoco, a dealer-controlled location is known as an "A" account and a company-controlled location is referred to as an "AA" site.

Other Control Issues

Control is a key concept for the distribution of motor fuels in the supply chain. If a supplier controls (owns or leases) a location, the supplier is assured that the location will operate under its brand. On the other hand, if a dealer owns or leases the location from a third party, that dealer is free to shop the location among suppliers to secure the best possible supply arrangement.

Take this example: A Dealer owns a location at the corner of Spruce and Goose. It's a desirable site, with excellent access and high traffic. This location moves in excess of two million gallons a year. Result? That dealer has power to seek the best possible deal from each of the branded suppliers who operate in that area, playing one off of another. The "best possible deal" could include more favorable pricing, a rebate on fuel costs if certain specified targets are met, and financial assistance with site improvements (such as repaved driving surfaces, building renovations, new signage and dispensers – maybe even new underground tanks!).

Federal Considerations

When a dealer chooses its supply source, its contract with the supplier to market motor fuels under a branded franchise name establishes a relationship governed by federal law, specifically the Petroleum Marketing Practices Act (PMPA). Congress enacted the PMPA in 1978 in an effort to provide some measure of protection to the dealers. Up to that time, service stations had operated at the mercy of the branded suppliers.

Before the PMPA existed, due to the gross disparity in bargaining power (think Exxon vs. Mom and Pop station owner), a branded supplier could choose almost at whim either to terminate or not to renew a dealer. This lopsided relationship ended many a dealer's lifetime investment and customer good will developed at a particular location.

Initially known as the "Dealer Day in Court" law, the PMPA was intended to level the playing field to the extent possible by prescribing certain criteria that must be met before a Dealer's franchise could be terminated or non-renewed. For example, a supplier/franchisor may no longer terminate a dealer in the middle of the term of its PMPA Franchise Agreement (usually three years) unless the franchisor can document the occurrence of at least one of four conditions:

- The dealer violated a reasonable and materially significant provision in the PMPA Franchise Agreement. Examples of these provisions: taking or giving bribes, failing to maintain business records, failing to file tax returns).
- The dealer failed to use good faith efforts to carry out the franchise: it didn't devote its primary efforts to the business, secretly transferred the franchise to a third party, or didn't stay open during mandatory hours of operation.
- An event relevant to the franchise relationship has happened making termination reasonable. This would include a misbranding of fuels, loss of the dealer's lease, theft, employing illegal immigrants, failing to operate for seven consecutive days, or death of the Dealer.
- The supplier decided to withdraw from the dealer's geographic marketplace.

Another PMPA protection for franchisees requires a franchisor to renew a dealer's franchise agreement at the end of its term unless the franchisor can prove grounds for non-renewal. Any of the grounds for termination of the agreement constitute a reason not to renew. Other acceptable non-renewal reasons include:

- The parties can't agree to the franchisor's good-faith changes or additions to the agreement. Examples include rent increases, location rebranding, adding a convenience store and self serve pumps to the location, or changing operating hours.
- The franchisor has received numerous bona fide customer complaints about the franchisee's operation of the station, such as complaints about cleanliness, unruly employees, unnecessary customer repairs, or inaccurate credit card charges.
- The dealer has failed to operate the station in a clean, safe, and healthful manner. This would include having junk cars or piles of used tires in view, filth at the location, and failure to keep restrooms clean.
- The franchisor has decided to convert the premises for use other than as a service station; to materially alter, add to or replace the premises; to sell the premises; or that renewal is economically unsound.

As you might imagine, each of these grounds has been the subject of considerable litigation during the 32 years since the PMPA's debut. Federal courts have dissected and interpreted virtually each clause and word of the law. In fact, a conference of hundreds of attorneys convenes each year in Washington, D.C., immediately before the Spring Meeting of the American Bar Association's Antitrust Section, to review the previous twelve months' updates to the law.

A familiarity with the PMPA is essential to any lawyer representing the buyer or seller of a parcel of real estate containing a branded service station. If the landowner has leased the parcel to a branded gasoline marketer who in turn has leased or franchised the location to a dealer, the owner need not be concerned with the PMPA. There are also no PMPA issues if the service station is company-owned and operated.

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However, if the parcel owner is the branded supplier or franchisor with a PMPA agreement granting a dealer the right to operate a branded service station on that property, the owner may not sell the location unless it satisfies PMPA requirements, and the Dealer's rights to operate a franchise at that location may not be terminated or non-renewed without meeting one or more of the PMPA's grounds for termination or non-renewal. If a non-renewal is based on a decision to sell the property, the franchisor is required to give the franchisee a right of first refusal.

Environmental Considerations

The purchase and sale of a service station property is unique among most real estate transactions in one more area: the history of petroleum product storage and sale from the location and any resulting environmental contamination. There was a time when purchase and sale agreements did not address environmental issues, or at most, there was a single paragraph. That era is long gone.

Today, environmental costs and risks often drive the economics of a service station deal. At times, cleanup costs may exceed the commercial value of a particular location. If you have driven by a closed and abandoned service station in your neighborhood and wondered why there's no activity there, the most likely reason is that the owner can't afford to sell the parcel because of the environmental cleanup costs.

Let's start with the customary way of handling environmental responsibilities in a sale: the parties adopt a "your watch/my watch" protocol, allocating responsibilities between the parties for contamination on the property. Under this scenario, the seller is generally responsible for existing levels of contamination on the site up to the closing date, including the responsibility to restore the site to permissible contamination levels, and the buyer is responsible for any contamination that occurs after the Closing.

To establish a baseline of existing contamination levels, the parties conduct investigations. The easiest and least expensive inquiry is called a Phase I Report, consisting of mostly visual inspections, review of records and perhaps one or two pokes in the ground. While this might suffice for most commercial properties, it is inadequate for a former or current service station.

The more comprehensive (and more expensive) inquiry is the Phase II Report. This investigation includes drilling holes and taking water and soil samples. The testing company will initially drill holes at scientifically determined locations on the parcel; it may decide to drill additional holes if it finds contamination and must determine the degree of its spread.

Independent third party contractors usually conduct the investigation and prepare the Phase I and Phase II reports. The property owner may solicit bids from several contractors before awarding the work. Who pays the costs of the work is a matter of negotiation between the buyer and the seller, as is control over contractor selection.

It's important to understand that, if the investigation detects contamination, the parcel owner is required to report the findings to the state environmental agency for the parcel location. In Pennsylvania, that would be the Pennsylvania Department of Environmental Protection (DEP). Filing these reports triggers DEP supervision and regulation, including the requirement that the property owner submit a plan for cleaning up the parcel to permissible levels.

Pennsylvania and some other states have "spill funds" that will reimburse the costs of the cleanup. Others, including New Jersey, have no such fund and the property owner is 100% responsible for cleanup costs. Pennsylvania is among the states that will work with the owner to identify the acceptable levels of soil and water contamination to complete the remediation.

Upon attainment of acceptable contamination levels in Pennsylvania, DEP will grant the owner "Relief From Liability," sometimes referred to as a No Further Action (NFA) letter. Other states, such as New York, make it difficult, if not impossible, to understand the state's goal and get an idea of when to expect the clean up will be completed.

Recently, Pennsylvania introduced an additional variable to this process: an Environmental Covenant. With this new wrinkle, DEP has the authority to require the owner to record a deed restriction that runs with the land, such as a prohibition of use of the property for potable water.

It's not unusual for the seller's cleanup responsibility and active remediation work to extend beyond the sale closing date. In this situation, the seller should require the buyer to sign an agreement to permit the seller access to the property to conduct remediation on the parcel beyond the closing date. The buyer will usually agree to this, unless the location of the monitoring wells and clean up equipment significantly interferes with the proposed use of the station (I have seen architects relocate the site of a fast food structure on the footprint of a highly desirable property specifically to accommodate environmental cleanup requirements). All buyers should insist that the seller agree to minimize the degree to which the clean up activities interfere with the operation of the buyer's business.

It's also not unusual for the buyer to insist that the seller place a portion of the sale price into an escrow account to ensure funding of the seller's cleanup responsibilities. The amount of the escrow is often subject to intense and spirited negotiation, as is the manner in which the cleanup bills are submitted for approval and funds are disbursed from the escrow.

Though this article is quite long, I have only skimmed the surface of a very interesting subject. I hope I have heightened your awareness of the many legal intricacies associated with the ownership, operation, and sale of your friendly neighborhood gasoline service station. Happy Motoring!

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