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## Front Page Stories

### Tool Company Is Hit With \$5.3 Million Fraud Verdict

Four failed dealers of Snap-On tools who say they were defrauded out of their investments with the company have been awarded \$5.3 million, including \$5 million in punitive damages.

In a summary jury trial this month in Wake County Superior Court, the plaintiffs, who each put up about \$60,000 to become Snap-On dealers, said that they were promised a bright financial future. Instead, they alleged, they found themselves in financial ruin, victims of unrealistic sales forecasts and unprofitable routes.

#### ADVERTISEMENT

The plaintiffs also contended that Snap-On continued to mislead them about their chances for success, even when the company knew that their dealerships were rapidly going down the tubes.

Headquartered in Kenosha, Wis., Snap-On is a 'Fortune 500' corporation that distributes high quality tools and automotive diagnostic equipment through an independent dealer network. The plaintiffs' lawyers, Howard Twiggs and Donald Strickland of Raleigh, maintained that Snap-On had assembled an elaborate scam that enriched the company while leaving most dealers penniless.

'It's like a spider web,' Twiggs said. 'It's woven so that the prey can't see it. But once the prey gets caught up in it, there's no way out.'

The punitives awarded by the jury amounted to the profit Snap-On made on failed dealers in North and South Carolina during the past eight years. The jury also awarded about \$40,000 in loss of consortium to the wives of two plaintiffs.

The case was tried as a summary jury trial before Judge Robert A. Collier. Under terms of the agreement, neither party can appeal the judgment.

At a hearing last Tuesday, Judge Collier refused to set aside the verdict. The verdict was a test case for 17 other similar suits that are pending. It appeared that Judge Collier was ready to resolve the remaining cases by requiring Snap-On to pay additional compensatory damages.

## Corporate Structure

Snap-On was formed in 1920 and currently has 7,200 employees. The company markets its product line directly to the estimated 700,000 auto mechanics in the U.S. Dealers recruited by the company market more than 9,000 items directly to mechanics.

The company is divided into three divisions: eastern, central and western. Each division is broken down into regions, which are further subdivided into a total of 53 branches.

The branch that services North Carolina and South Carolina is in Charlotte. About 65 to 70 dealers operate out of that office. Personnel at each branch include a branch manager, a sales manager, and seven to eight field managers directly supervising six to eight dealers.

The company has marketed directly to mechanics for years. In the early 1980s, however, Snap-On launched an aggressive campaign to increase its sales, according to Strickland. First, the company saturated the country with more dealers by carving out new territories from existing ones, he said. For example, in a four-dealer area, Snap-On created a fifth dealership by taking a piece from each of the existing territories.

The company also pushed into new areas where no dealerships had previously existed, including parts of eastern North Carolina where each of the plaintiffs worked. Snap-On usually looked for geographic areas with 200 to 250 mechanics.

The result of that expansion effort: the number of dealers jumped substantially. So too did the corporation's sales and profits. Net profits rose from \$83 million in 1983 to \$114 million in 1984, and remained steady or climbed over the next five years.

The expansion into new markets meant steep profits for Snap-On. It also meant financial disaster for dealers in many areas, the plaintiffs' lawyers argued at trial.

'The way Snap-On recruited dealers was to tell them that all the territories were the same ' that when Snap-On created a territory, they adjusted it and made sure those territories were equivalent to other territories in the United States in regards to sales and income potential,' Strickland said. 'In other words, they said that the sales potential was just as good in Raleigh as it was in Brunswick County. That's just not true. That was one of the big frauds in the case.'

## Anatomy Of A Scam

Strickland and Twiggs said that overestimating the strength of some territories was one of many misrepresentations made by Snap-On in North Carolina. In fact, Twiggs and Strickland came up with a theme for their trial strategy: 'The anatomy of a scam.'

In opening arguments to the jury, they drew a complicated chart that detailed Snap-On's operating procedures:

**The Recruiting Process.** The company looked for hard working recruits with some mechanical background, such as Whiteville resident Greg Worthington, and promised them a rosy economic future, Strickland said (See related story, page 1).

'They would recruit dealers by essentially guaranteeing them that they were certain to achieve financial security,' he said.

Prospects were told that the company had a proven track record. While most recruits had little or no experience running a business, they were told that the field managers were themselves former dealers who could guide new recruits to success.

'The new recruits were told that if they would put their trust in the field manager and follow the proven program, they would make as much money as the top 10 percent of the national income brackets, along with doctors, lawyers and other professionals,' Strickland said.

**Misleading Sales.** 'Snap-On would give prospects income projections that grossly overestimated the sales that could be achieved,' Strickland said. 'If you could actually make \$2,000, they might say you could make \$5,000.'

'Prospects were also shown that the top 85 dealers made \$140,000 and were told, 'You can

make that, too, since all the territories are the same. You just have to be willing to work hard and follow the program. The sky's the limit. It's just up to you."

Bankrolling a dealership cost about \$60,000. Snap-On financed some prospective dealers but usually encouraged prospects to borrow money from their family and friends, Strickland said.

**Underestimating Expenses.** At the same time that it was inflating the potential income, Snap-On underestimated the business expenses that would be incurred, according to Strickland.

Prospective dealers were shown charts and graphs that showed an inflated profit margin of 35 percent. Prospects were told business expenses would run about \$20,000. In fact, they usually ran anywhere from \$35,000 to \$40,000. Payments on the truck and the bank note were as high as \$2,000 a month. New dealers usually bought \$40,000 in tools as inventory on their trucks. Snap-On required up-front payment for most tool purchases.

**Dealers As Bankers.** Once dealers got into their new territories, they started living off their borrowed capital. And they soon realized that they had to finance the tool purchases by the mechanic customers.

'The dealer in essence becomes the banker for mechanics who are poor credit risks to begin with,' Strickland said. 'Dealers were encouraged to sell tools to those mechanics regardless of their credit rating. In fact, Snap-On would deny credit on their extended credit program. But the field manager would encourage the dealers to sell tools to those very people that Snap-On would deny credit to. The field manager would assure them they would help them collect the accounts if they went bad, or track down people if they moved.'

Dealers were required by Snap-On to make weekly tool purchases, Strickland said.

'You've got a dealer who has been advised to put his inventory on the street,' Strickland said. 'He does that, and all of a sudden he has an accounts receivable of \$20,000 to \$30,000 of his inventory. He doesn't charge any interest on that money because Snap-On encourages him not to. Pretty soon, he has so much capital on the street that his inventory starts getting depleted, and then he can't make as many sales. That's when the downward spiral starts. And the amount of capital they have in the business will determine how long they will survive. But eventually, about 90 percent of all dealers get caught in this cycle and lose money.'

**Misleading Managers.** New recruits were not told one important fact about the field managers that were directly supervising them, Strickland said.

'Each field manager gets paid 100 percent commission on the tools the dealers buy. The more dealers that the field manager can put into business, the more tools he can get the dealers to buy, the more money he makes.'

Said Twiggs, 'The field manager might call a dealer on a Thursday night and say, 'How much money do you have in your account? Your tools are really down. Don't you think we ought to take \$2,000 of the \$2,400 you have and put that back into tools?' The field manager would keep pushing the dealers to make more tool purchases. So the dealer's making a lot of sales. But he's taking any profit he might be making and buying more tools.'

'There was also another subtle thing going on,' Twiggs said. 'When a dealer's inventory gets low and his cash flow is getting low, the dealer should be told, 'Be careful with the tools you put out on the street. Collect the outstanding money first.' Instead, the dealers were told to borrow more money and to put more tools out on the street. The dealers, not knowing any better, followed that advice.'

**Personal Failures.** When dealers failed, they might have as much as \$30,000 in uncollected bills on the street, the records show. Those accounts receivable were sold to the replacement dealer at 75 percent of the face value.

'The only way the prior dealer would get any money for those outstanding bills was if the new dealer paid something for them,' Strickland said. 'So the prior dealer had a built-in incentive not to tell the new dealer about the problems.'

Also, Snap-On told failed dealers that they were the only person that had gone under, even though dozens of dealers have failed in North Carolina in the past eight years, according to Twiggs.

'Snap-On's position at trial was that any dealer who failed was at fault because they didn't work hard enough.'

The plaintiffs' lawyers say that only five to 10 dealers in North Carolina are currently doing well.

'The top dealer in North Carolina was making over \$100,000,' Twiggs said. 'The income of the next top dealer in North Carolina dropped substantially from that top dealer, to about \$45,000 to \$50,000 a year. But those dealers operated under better circumstances than those of the average dealer. Both had been in business for at least a decade, predating the market saturation scheme implemented in the mid 1980s. Both were in big markets, and both owned their own trucks, saving them about \$2,000 a month in business expenses.'

Internal Memos. Snap-On was often aware that dealers were failing in their business. Nevertheless, they often kept them going while they searched for a new recruit, internal Snap-On memos show.

For example, in the case of Whiteville dealer Greg Worthington, an internal memo instructed the field manager to find a replacement for 'the quickly failing Worthington.' That memo was sent a year before Worthington's dealership was terminated.

'It was clear that once the dealer started going downhill, the company would start recruiting somebody,' Strickland said. 'If they could get somebody, they would shut down the first guy and bring in the new one with \$65,000 and make another immediate \$40,000 tool sale.'

#### **Punitive**

At trial, the plaintiffs' lawyers showed that 90 percent of 140 dealerships that terminated at the Charlotte branch in a six year period did so because of financial failure. Those failed dealers purchased \$27 million in tools from Snap-On during their employment. Since the company's profit margin is about 21 percent, Snap-On's net profit before taxes was \$5.6 million. The jury took 90 percent of the profit and awarded it as punitive damages.

'The message the jury sent is that if you make money by fraud and deception you will not be allowed to keep it,' Strickland said. 'One argument I made in the closing arguments was, 'If a bank robber robbed a bank of \$100,000, and you took \$50,000 away from him, have you deterred him from future conduct?' The jury, by taking away all their ill-gotten gains, was saying that you cannot profit by wrongdoing in North Carolina.'

'The system works,' Strickland said. 'Punitive damages in this case did exactly what they are designed to do - deter wrongdoing.'

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