

US Senate Commerce Committee
Subcommittee on Consumer Affairs, Product Safety and Insurance
November 16, 2005 Hearing
“Protecting the Consumer from Flooded and Salvage Vehicle Fraud”
Testimony Of
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Mr. Chairman and Senators: Thank you for the invitation to testify today regarding ways to protect consumers from flooded and salvage vehicle fraud. My name is Rosemary Shahan, and I am the President of Consumers for Auto Reliability and Safety, or CARS, a non-profit auto safety and consumer advocacy organization based in Sacramento, California.

CARS is dedicated to preventing motor-vehicle related fatalities, injuries, and economic losses. Since 1979, I have worked at the state and federal levels on behalf of consumers on a range of auto-related issues. I appreciate the opportunity to highlight some of the worst problems posed by flooded and salvage vehicle fraud, and to make some recommendations for your consideration.

PROBLEM

Damaged vehicles pose a serious threat to the American public

Every year, millions of vehicles are in serious collisions, or in flood disasters. Most people assume that severely damaged vehicles are crushed, or sold solely for parts. In fact, many are destroyed. Many are taken apart and usable parts are recycled by professional and responsible recyclers. But every year millions of severely damaged autos are sent by insurers to auctions and then sold to unscrupulous auto dealers and rebuilders. They are then sold under false pretenses to car buyers. The deceptions artificially inflate profits for the unscrupulous insurers, auctions, rebuilders, and dealers who profit from perpetrating fraud, at the expense of the motoring public and honest businesses alike.

This is particularly troubling since shoddily rebuilt wrecks and flood cars pose a serious safety problem—to the owners and to all who share the roads with them. ¹

The problem of flooded and salvage vehicles goes far beyond title branding. At its core, the problem is systemic fraud---knowing and deliberate concealment of material facts. Fraud involving prior wreck or flood damage costs American consumers billions each year and also endangers lives.

Prior damage vehicles may not provide adequate protection in a subsequent crash. Air bags are sometimes not replaced. Some major franchised auto dealers have sold cars missing air bags or with shop rags where the air bags belong. This is a serious safety threat. Auto manufacturers have reconfigured seat belt designs so that seat belts work in tandem with the air bag as a safety system. Consequently, in a moderate-to-severe collision, a driver or passenger who is wearing a seat belt, but whose vehicle is missing an air bag, is prone to suffer and debilitating serious head, facial, or spinal cord injuries, or be killed.

Insurers part of the problem

Some insurers destroy vehicles that are nonrepairable and properly brand the titles of “salvage” autos, but others engage in fraud. The fraudsters send nonrepairable vehicles and salvage or flood cars to auctions, often with clean titles. In return, insurers recoup more than the vehicles are actually worth, given their damaged condition.

The nation’s largest auto insurer, State Farm, has a shameful record of violating state title-branding laws and failing to properly brand titles as ‘salvage.’ In 1998, State Farm settled a case brought by the Attorney General of Indiana. According to Indiana Attorney General Jeffrey Modisett, “State Farm sold, exchanged, or transferred salvage vehicles it had acquired without obtaining salvage titles...People who purchased these vehicles did so without knowledge of the damage, safety, reliability and true value of these vehicles.”²

That case reportedly came to light because “a car dealer in Greenfield, IN, made a startling discovery. After repairing what he thought was a relatively new Ford pickup, he routinely sent the manufacturer a bill for his warranty work. Ford refused to pay. It told the puzzled dealer that a records check found that the pickup had been in a wreck, an insurance company had declared it a total loss and had resold it. That voided the warranty....After a two-year investigation, State Farm admitted selling about 1, 400 totaled cars, trucks and sport-utility vehicles in Indiana---all without the required state salvage titles.”³

Earlier this year, State Farm settled yet another case, this time with 49 state attorneys general and the District of Columbia. The company publicly admitted that it had resold at least 30,000 totaled vehicles without salvage titles. State Farm reportedly conceded that “the number could turn out to be as high as 40,000.”⁴ A spokesperson for State Farm is quoted as saying “We don’t know whether it was an error, a mistake or malfeasance.”⁵

Owners of those salvage vehicles were not immediately notified. Over a year after State Farm notified the attorneys general, the owners received letters informing them their vehicles were “salvage.” The titles are belatedly being branded ‘salvage.’ Some owners have found that not only is their vehicle worth far less than they paid for it, but they face losing insurance coverage or having their coverage reduced due to the salvage history.

Hapless victims may also find the lender will call the entire loan due, on grounds the vehicle is not sufficient collateral for the loan. Under the new federal bankruptcy law, they may be held liable for the entire amount of the loan, based on the inflated price they paid, while in the past the amount could have been reduced to reflect the fair market value of the damaged vehicle. If the consumer is unable to pay the full loan, they may end up having the vehicle repossessed. For many people, that means they would lose their only means of transportation, and potentially lose their jobs.

Flood cars pose unique problems

The entire nation has witnessed national news coverage showing tens of thousands of new and used flooded cars resulting from the recent disasters in the Gulf region and Florida. They have garnered tremendous media attention, and rightfully so. Flood cars pose a unique set of hazards to consumers. Thanks to sophisticated, advanced safety technologies and the increasing computerization of automobile design, flood cars are even more hazardous than in the past. Virtually all of today’s cars have sensitive electronic components that control major systems, including the engine, brakes, and air bags. Those electronic components, immersed in water and contaminants such as silt and petroleum residues, will inevitably deteriorate and corrode, particularly if the vehicle was submerged in salt water, rendering the vehicles unreliable.

Compounding the problem: complicated electronic components tend to be the most expensive to replace. They are also not visible, but are usually enclosed, making their condition difficult to detect and easy to conceal. The temptation for unscrupulous rebuilders and dealers is to cut corners and simply do a cosmetic clean-up, replacing the carpeting and upholstery and leaving the compromised electronics untouched.

At one time, the typical vehicle could be submerged in water over the sill without compromising its safety. Those days are gone. Now, most passenger vehicles have electronic systems located under the seats. Flood damage to the point where vital electronic components are soaked in water makes today's vehicles totally unreliable. They will be plagued by a whole host of major electronic problems.

For example, the air bags may or may not inflate in a crash. If they do inflate, they may inflate too soon or too late. The anti-lock brakes may not work. In an emergency braking situation, on a rain-slicked road, a driver who has learned to slam on his or her anti-lock brakes may lose control and spin out. The engine may stall out intermittently, without warning, during driving in heavy traffic—an obvious safety hazard.

Over time, flood cars are also prone to develop mold and mildew that can cause serious health problems, particularly for people who suffer from allergies or asthma.

According to one news report, some insurers, such as Progressive, have been destroying many of their flood cars, but others, including State Farm, reportedly have failed to do the same.⁶ This raises the question: what possible legitimate purpose can there be for placing flooded vehicles back into the stream of commerce? This question takes on a certain urgency when it involves an unprecedented number of flood cars that were submerged in heavily contaminated salt water for days or weeks.

Self-insured entities

A complicating factor: some self-insured entities, including rental car companies, large auto dealers and auto dealer chains, may not be required to brand titles “salvage,” or “flood,” and since there is no claim filed, it is harder to trace and document the damage history.

New vehicles

Salvage and flood car fraud also involves new vehicles. For example, some auto dealerships had hundreds of new vehicles on their lots when the flood waters rose. If history is any guide, new car buyers from coast to coast will eventually end up saddled with problem-plagued “new” vehicles that were once submerged in flood waters. In some cases, the manufacturers will refuse to honor the warranties, citing the prior flood histories. Those histories will be known to the manufacturer, but not the buyer.

“Certified” damaged vehicles

Some rebuilt wrecks are even being sold by supposedly “reputable” dealers as “certified” used cars, and the dealers are charging a premium---with the representation made that the vehicles have passed a rigorous, 130+ or 150+ point inspection. Sometimes the vehicles are advertised “complete with factory/manufacture warranty.”

But—manufacturers will not honor warranties on prior damage vehicles, certainly not for area repaired, and sometimes for entire vehicle. Nor will consumers who paid extra for an extended service contract be able to have necessary repairs covered, since prior wreck and flood damage are excluded under the contracts.

This is a triple whammy for consumers. Consumers pay extra for “certified” used cars, pay extra for factory or OEM [original equipment manufacturer] warranties, and pay extra for extended service contracts, in order to be protected. Then when problems arise, they discover not only did they pay thousands more than the Blue Book price when the vehicle is actually worth thousands less, but the warranty is void and the contract won’t cover repairs. It’s a very rude surprise to be forced to incur unexpected, unanticipated repair costs---if the vehicle is repairable. Some are beyond repair.

California recently enacted landmark legislation, the Car Buyers Bill of Rights, signed into law by Governor Schwarzenegger, to curb various forms of auto fraud, including sales of previously damaged vehicles as “certified” used cars. The impetus for the “certified” provision came from numerous cases where consumers paid thousands extra to buy cars that had been “certified,” only to find they were grossly unsafe to drive, due to prior damage that had been shoddily repaired and was concealed at the time of sale.

California’s law, which will take effect next July, expressly forbids the sale of used vehicles with ANY frame damage as “certified.”⁷

Salvage and flood car perpetrators target victims

Who is targeted for sales of rebuilt wrecks and flood cars? While even highly sophisticated, well-educated consumers sometimes fall prey to auto salvage fraud, some dealers have shown a propensity to target particularly vulnerable individuals. Due to their inexperience buying cars, teenagers and students buying their first vehicles are often targeted. Other targets: recent immigrants, and members of our armed forces, especially enlisted personnel.⁸

The armed forces themselves have documented the harm that ensues from used car fraud, noting that such frauds can compromise the troops’ ability to perform their duties, even “to the point of endangering themselves, their unit, and the mission itself.”⁹ According to experts, unscrupulous dealers prey on military families.¹⁰ Recently, representatives of the armed forces testified at a hearing in California that auto-related scams, including rebuilt wrecks being sold as “certified” used cars, are the worst consumer-related problems troops stationed in California face.¹¹

To make matters worse, some auto dealerships are disregarding the Servicemembers Civil Relief Act, intended by Congress to protect all active-duty families from foreclosures, evictions, and other financial consequences of military service.¹²

RECOMMENDATIONS

Designate vehicles non-repairable and retire VINs

Severely damaged vehicles and flood cars that have been submerged in salt water should be declared non-repairable and destroyed. The Vehicle Identification Numbers, or VINs, should be permanently retired to curb fraud and to reduce the incidence of VIN-switching, which contributes to vehicle theft, carjackings, and other related crimes.

National databases present opportunities, challenges

For vehicles that are suitable for repair and resale as safe, reliable transportation, full disclosure to sellers and consumers alike is needed.

With the advent of CLUE¹³ and other vast electronic databases, insurers, manufacturers, lenders,

dealers, and other entities have access to relevant data that is sometimes withheld from consumers, or is not provided in a timely fashion. The challenge policy makers face is how to make that information accessible to prospective buyers in an efficient, cost-effective, meaningful way.

While improved title branding will assist as an important enforcement tool, title branding is of limited usefulness in curbing salvage fraud. One reason: consumers usually do not see the titles until after a sale is consummated. It may be years later, when the lien is paid, that they finally see the title for the first time.

Also, thanks to computer technology, it is now quite easy for unscrupulous sellers to counterfeit titles, so even if states were to adopt uniform standards, and carry forward other states' title brands, auto salvage fraud involving vehicles with false clean titles would continue to occur.

However, a national electronic database with relevant information holds promise for curbing fraud. Prior to sale, prospective buyers should have access to the same information about the vehicle's history as the insurers, manufacturers, or other entities that already enjoy access. (Of course, the prior owner(s) personal information should be kept private.) Vehicle owners, who are entrusting their personal safety, and their family's safety, to the reliable operation of the vehicle, should not be the last to find out their vehicle's damage history.

The most effective way to provide vehicle history information in a timely fashion to all prospective purchasers and bridge the Digital Divide is to require relevant information from a national database be displayed on vehicles themselves.

A precedent to consider: after extensive research into effective means of disclosing vehicle safety information to the public, the National Academy of Sciences issued a report recommending that the relevant information be provided on a separate sticker on the vehicle itself.¹⁴ The National Highway Traffic Administration sought comments on that approach, and adopted the Academy's recommendation, requiring on-vehicle safety ratings disclosures on all new vehicles.

Federal Trade Commission Used Car Buyers Guide

For used vehicles, an on-vehicle Buyer's Guide already exists. Since 1985, the Federal Trade Commission has required that all licensed auto dealers must post a Buyers Guide on each used vehicle sold to retail consumers. The Guide includes information about warranty coverage and warnings aimed at informing consumers about common pitfalls involved in purchasing used cars. Dealers must provide consumers with the Buyers Guide as part of the sale or lease transaction.

Requiring the disclosure of vehicle history information would also help address the inherent deception that occurs when a vehicle is advertised and sold with a supposed warranty that is actually void due to prior damage. Currently, the Buyers Guide on relatively new damaged vehicles usually states that the vehicle is being sold with the remainder of the manufacturer's factory warranty. However, if the warranty is void due to prior damage, that should be fully disclosed prior to sale, along with the prior damage history. Otherwise, buyers are being misled into believing they are obtaining vital protections that prove to be illusory.

Enforcement and remedies for victims

In order to discourage scamsters from engaging in auto salvage fraud, it is important for any federal legislation to provide for remedies and penalties that are at least as strong as under the Federal Odometer Act. That act provides for victims to obtain multiple damages and attorneys fees, and also provides criminal penalties. Salvage and flood car fraud is even more serious than odometer fraud, since it clearly impacts the motoring public's safety, and should invoke commensurate sanctions.

Any federal statute should create a floor and not a ceiling for states, allowing states to provide stronger protection. This non-preemptive effect is particularly important since some states may find they are being targeted, and need to take stronger steps to avoid becoming dumping grounds for salvage and flood car frauds.

Ease of enforcement: providing damage information on the Used Car Buyers Guide would provide law enforcement agencies with a relatively simple, cost-effective, uniform method for monitoring disclosures and ensuring compliance. Rather than attempting to delve into whether or when the prior damage disclosure was made during complicated sales or lease transactions, law enforcement officials could simply monitor and spot-check the Buyers Guides on open display.

CONCLUSION

Thank you again, Senators, for the opportunity to testify. I appreciate the Senate's interest in examining this serious form of fraud, and I welcome the opportunity to work with you and the Subcommittee Counsel to develop positive, effective ways to protect the public from flooded car and salvage fraud.

Attachments:

1. Federal Trade Commission Used Car Buyers Guide from a so-called "certified" BMW. The buyer, who works as a landscaper, paid over \$30,000 for the BMW. When he test-drove it, the traffic was congested and he was unable to drive more than about 35 mph. As soon as he drove it home, and got to speeds over 60 mph, it shook violently. A subsequent expert inspection found that the vehicle had sustained major damage in a crash. The repairs were woefully inadequate and shoddy. As a result, the frame was bent and the suspension was shot. It would take thousands more dollars to fix it so that it was safe to drive. BMW refused to honor the "Full factory warranty, 4 years or 50,000 miles" touted on the Buyers Guide due to the prior damage. The buyer had also purchased an extended service contract. The holder of the service contract excluded coverage for repairs due to the prior damage.

The dealer refused to refund the purchase price. The BMW sat unused in the owner's driveway for over a year, while he drove an old truck and continued making \$500 per month in car payments, pending resolution of a lawsuit.

2. CARFAX Vehicle History Report for the same BMW, reporting "no severe accidents reported to DMV, Guaranteed!" This report was presented by the dealership to the buyer prior to sale.

3. Blank Federal Trade Commission Used Car Buyers Guide

(Footnotes)

¹ State of California: *Report to the Legislature: A Study of Auto Body Repair Problems with Findings and Recommendations* (July 1, 1994). “According to a 1984 DCA/BAR [Department of Consumer Affairs Bureau of Automotive Repair] study of unibody repairs, the ability of improperly repaired unibody vehicles (ninety-five percent of today’s passenger cars are of unibody design) to withstand a second crash is significantly compromised and would result in serious injury and death to the occupants.... Finding: More than 70,000 structurally damaged and 150,000 salvaged vehicles are returned to our streets and highways every year without a safety inspection, and they pose a potential hazard to all of California’s twenty million unsuspecting motorists.”

² “Attorney General Modisett, State Farm settle salvage motor vehicle title case,” News Release, State of Indiana Office of the Attorney General, July 28, 1998.

³ State Farm violated agreement on selling totaled cars,” *St. Louis Post-Dispatch*, January 24, 2005.

⁴ Ibid.

⁵ Ibid.

⁶ “What insurers are doing,” *Automotive News*, October 31, 2005.

⁷ AB 68 (Montañez), Statutes of 2005.

⁸ *In Harm’s Way—at Home: Consumer Scams and the Direct Targeting of America’s Military and Veterans*,” Report by National Consumer Law Center, May 2003. “Automobile-related scams: Cars are a big source of financial trouble for service people. The Navy-Marine Corps Relief Society, for instance, gives the largest single portion of its cash aid to military families—nearly a quarter of all its aid—for car-repair assistance.... military legal assistance officials in the San Diego region told NCLC that high-priced used car sales are ‘the single largest consumer [contract] problem that we see here in Legal Assistance.’”

⁹ *Financial Fitness: The Importance of Financial Fitness to the United States Marine Corps’ Mission. A Final Report*. Prepared for and funded by The United States Marine Corps, prepared by The Financial Fitness Evaluation Team, University of California, Riverside. August 2000: “We found widespread agreement that when Marines have pressing financial problems, their performance in the field can be significantly compromised, even to the point of endangering themselves, their unit, and the mission itself... Buying cars causes more problems than any other single financial factor.”

¹⁰ “Scamsters preying on military families,” *Los Angeles Times*, April 2, 2003. “Operating just outside the gates of major bases, some car repair shops and dealerships prey on military families, particularly when a husband has been shipped out of the country, said Karen Varcoe, a consumer economics specialist at UC Riverside who has written academic studies on the financial problems of military personnel.”

¹¹ “After car breaks down, Iraq vet wages new battle—with dealer.” *Sacramento Bee*, April 14, 2005: “Last month, the Assembly Committee on Banking and Finance heard testimony about financial scams aimed at members of the military. John Irons, director of the Navy-Marine Corps Relief Society in San Diego, told lawmakers his informal survey of Navy lawyers found ‘the number one issue they are confronted with is used car dealers who are taking advantage of military personnel.’ Among the alleged problems: sale of ‘certified’ junkers....” [Note: Active duty representatives of the U.S. Armed Forces also testified that they had conducted their own informal surveys and reached the same conclusions.]

¹² “Creditors Press Troops Despite Relief Act,” *New York Times*, March 28, 2005.

¹³ CLUE is a registered trademark of ChoicePoint Asset Company.

¹⁴ As part of the Department of Transportation and Related Agencies Appropriations Act, 1995 (P.L. 103-331; September 30, 1994), Congress provided NHTSA funds “for a study to be conducted by the National Academy of Sciences (NAS) of motor vehicle safety consumer information needs and the most cost effective methods of communicating this information.” The NAS study was completed and released to the public on March 26, 1996. It is titled “Shopping for Safety - Providing Consumer Automotive Safety Information,” TRB Special Report 248. Based on its findings, the study makes recommendations to NHTSA on ways to improve automobile safety information for consumers.