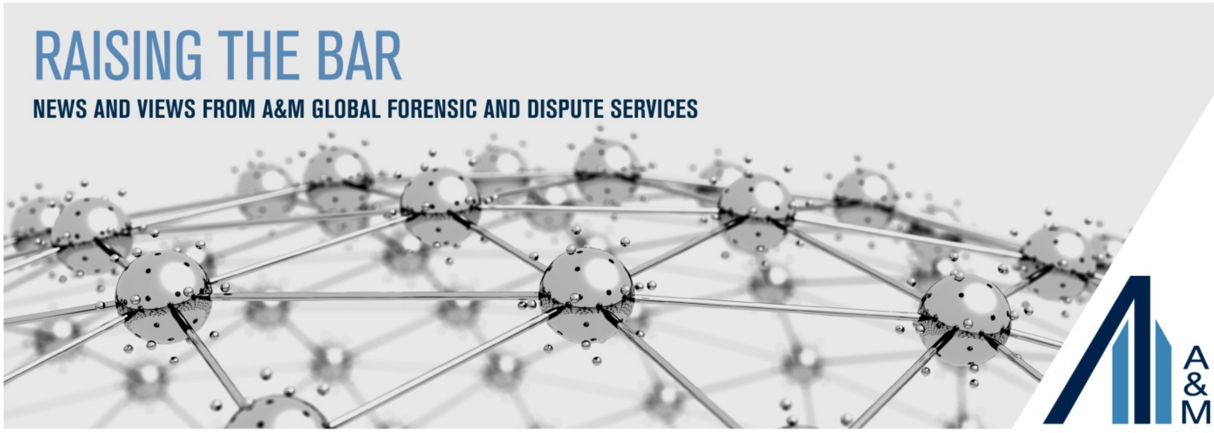

Dealer Fraud in the Automotive Industry

"It was the best of times, it was the worst of times . . ." –*A Tale of Two Cities*

Just as the seasonally adjusted annual rate (SAAR) for U.S. new car sales rose to a record high of 18.17 million at the end of September 2015,[1] Volkswagen reported its first quarterly loss in 15 years, due to costs related to the scandal over emissions testing of its turbodiesel vehicles.[2] So, as the U.S. auto industry rides high, the world's largest automaker (in the first half of 2015) suffers.[3]

From its inception over 100 years ago,[4] the automotive retail industry has encountered many types of risk, from manufacturing issues and changing consumer preferences at the manufacturer level to consolidation through the growth of public and private equity-owned dealer groups at the retail level. Throughout this century of change, one thing has remained constant in the retail dealer industry: A small group of unethical players has engaged in deceptive practices calculated to separate both manufacturers and consumers from their money. As early as 1920, Motor Age reported on a dealer who sold a used car to a buyer while representing that it was new.[5]

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[1] David Philips, "U.S. sales rise 16% on double-digit gains at Detroit 3, Nissan, Toyota, Honda. Deals, truck surge push SAAR to 10-year high of 18.17 million," *Automotive News*, October 1, 2015, http://www.autonews.com/article/20151001/RETAIL01/150929780/u-s-sales-rise-16-on-double-digit-gains-at-detroit-3-nissan-toyota.

[2] "VW Set to Post First Loss in More than 15 Years," *Automotive News*, October 27, 2015, http://europe.autonews.com/article/20151027/ANE/151029858/vw-set-to-post-first-loss-in-more-than-15-years. "VW slumps to third-quarter loss on emissions scandal," *Automotive News*, October 28, 2015. http://europe.autonews.com/article/20151028/ANE/151029826/vw-slumps-to-third-quarter-loss-on-emissions-scandal.

[3] Nathan Bomey, "VW Surpasses Toyota as World's Largest Automaker in First Half of 2015," *USA Today*, July 28, 2015, http://www.usatoday.com/story/money/2015/07/28/volkswagen-surpasses-toyota-worlds-largest-automaker-first-half-2015/30772509/.

[4] William E. Metzger established the first car dealership, a General Motors franchise, in 1898. Roger M. Quinland, "Has the Traditional Automobile Franchise System Run Out of Gas?" *Franchise Lawyer* 16, no. 3, Summer 2013, http://www.americanbar.org/publications/franchise_lawyer/2013/summer_2013/has_traditional_automobile_franchise_system_run_out_gas.html.

[5] Wellington Gustin, "A Lesson on the Sales Contract," *Motor Age* 38, no. 14, September 30, 1920, 46. Accessed at https://books.google.com/books?id=AjcfAQAAMAAJ&pg=RA10-PA52&lpg=RA10-PA52&dq=1920+%22A+Lesson+on+the+Sales+Contract%22&source=bl&ots=CfgSUlWh7P&sig=uEM4PDi_ZPWBa

The typical U.S. auto dealer earns its revenue through three departments: new vehicles (57.6 percent), used vehicles (31.0 percent), and parts and service (11.4 percent).[6] The vehicle lines sold by a dealer have a very significant impact on earnings and profitability, but, on average, net profits before taxes for dealers total only about 2 percent of total sales.[7] Because these margins are tight, and have always been tight, the small minority of dealers who partake in creative and sometimes fraudulent practices can cause significant harm to both consumers and manufacturers. Most fraudulent dealer practices fall into two categories: those against consumers and those against manufacturers and lenders.

Tasked with the principal mission of protecting consumers, the Federal Trade Commission (FTC) has taken a renewed interest in the questionable acts of dealers. Through Operation Steer Clear, unveiled in January 2014, and Operation Ruse Control, unveiled in March 2015, the FTC has taken enforcement action in 197 cases.[8] Some of the most egregious and common fraudulent practices include the following:

> Deceptive Advertising: Dealers commonly advertise sales, leases or financing that lure buyers to the dealership with the intention of conducting aggressive sales tactics to sell them something different and more expensive than what was advertised.
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> Add-on Product or Services Fraud: Services such as undercoating, extended service, road service and biweekly payment programs are frequently included in vehicle purchases. Many of these add-ons provide dealers with significant margins. However, the add-ons are either not disclosed adequately or fail to provide the promised benefit.
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> Failure to Disclose Material Facts about a Vehicle: Dealers have a duty to inform the buyer of material facts about a vehicle. Such disclosures include whether the vehicle is a “lemon law” buyback, prior rental, salvage, or has been in an accident that required major repair work such as for frame or suspension damage.
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> Spot Delivery: A dealer allows a buyer, typically of poor credit, to take delivery of a vehicle prior to completing financing. In many cases, the buyer’s original financing request is denied due to poor credit. The dealer then requires the buyer to pay additional fees and higher interest in order to keep the vehicle.
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> Vehicle Trade-Ins: Dealers often undervalue and underpay for an unsuspecting consumer’s trade-in vehicle. This causes the consumer to pay more for the overall transaction, due to the undervalued trade-in, and also provides the dealer with an additional source of profit when it subsequently disposes of the trade-in vehicle in a separate transaction.
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> Loan Application Fraud: Dealers have been known to submit false information to finance companies and banks in order to close sales. Many of these cases involve inflation of a consumer’s income so that the consumer can purchase a car he or she cannot afford.

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[6] National Automotive Dealers Association, “NADA Data 2014 Annual Financial Profile of American’s Franchised New-Car Dealerships,” 5, https://www.nada.org/WorkArea/DownloadAsset.aspx?id=21474839497.

[7] Ibid., 3.

[8] “Feds broaden crackdown on dealership fraud”, Automotive News, March 26, 2015.

Odometer Fraud: In 2002, the National Highway Traffic Safety Administration determined that more than 450,000 vehicles are sold each year with false odometer readings, costing American consumers more than $1 billion annually.

When it comes to fraudulent practices against manufacturers and lenders, dishonest dealers mainly focus on vehicle allocation, incentives and rebates, and warranty reimbursements. Many of their common practices include the following:

Backdating or Predating Contracts: Manufacturers offer incentives and rebates to dealers for vehicles sales. Often, these incentives and rebates are measured against monthly or quarterly sales targets. Thus, dealers are incentivized to change contract dates so as to meet or exceed periodic goals in order to maximize their incentives and rebates. Additionally, such practices can create significant variances for warranty periods, harming both the manufacturer and consumer.

Vehicle Allocation Fraud: In the market for limited production and exotic sports cars, dealers are often provided limited production slots based on past performance and future projections. Thus, buyers are often required to wait for long periods of time before taking delivery of vehicles. In order to maximize their production slots, dealers are known to creative fictitious customers in order to secure additional production slots from manufacturers. This practice often leads to misallocation of vehicles and at times results in excess unsold inventory in some markets and no inventory in others.

Warranty Fraud: As dealers' service departments contribute the most to their bottom line due to the high margins on repair work, dealers have been known to submit false warranty claims to manufacturers for work that was never performed.

Selling Out of Trust: It is common practice for dealers to pay for new and used vehicles with funds borrowed from a lender. The lender charges interest and claims the vehicle as collateral. Once the vehicle is sold by the dealer, the proceeds are used to repay the lender. However, in some cases dealers use the proceeds from the sale for purposes other than repaying the lender. This leaves the lender without a secured collateral that may be seized in the event of an unpaid loan.

In such a highly competitive environment where profitability pressures are significant, dealers often rationalize and exploit questionable and fraudulent practices at the expense of consumers and manufacturers. But as the Volkswagen case shows, exposure of fraud can result in dramatic losses, both tangible and intangible, for the perpetrator. That is a rational outcome in a market economy – one that dishonest dealers should bear in mind.