Vehicle Service Contract Industry

How Consumers Lost Millions of Dollars

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Introduction

Consumer complaints to the BBB and law enforcement about the Vehicle Service Contract (VSC) industry began to soar in 2005. Sellers, providers and insurers went bankrupt or simply went out of business, leaving thousands of vehicle owners holding useless contracts for which they had paid millions of dollars. This study provides an in-depth look at the industry, which boomed and is still the source of numerous complaints and law enforcement actions. While this study focuses on Missouri and the St. Louis area because it is the hub of industry contract sales, the widespread elements of the industry necessitate their inclusion.

Sources

This study used the national and local BBB databases, a BBB survey of 2,802 consumers who had filed complaints with the BBB regarding VSC companies, with 660 responding or a response rate of 23.6 percent; documents filed in federal and state courts; media reports; provider and seller websites; Missouri attorney general's office; Missouri Department of Insurance, Financial Institutions and Professional Registration (DIFP or Department of Insurance); Missouri Revised Statutes; United States Code; trade associations; Federal Trade Commission (FTC); contracts offered by sellers; documents filed with state agencies; bankruptcy liquidator or receivership documents; PACER, the federal court tracking system; Case.net, the Missouri court tracking system; and the Government Accountability Office (GAO).

Definitions

While many in the industry call the contracts "extended auto warranties," the term is a misnomer, according to the FTC. A warranty is a promise that is included in the purchase price of an automobile or other product. A service contract must be paid for separately. The Missouri attorney general alleges in lawsuits that companies using the term "warranty" in their names are violating the law because the term misleads consumers into believing they are purchasing an extended warranty rather than a service contract. The St. Louis BBB database lists 45 VSC companies that use "warranty" in their names.

There are five major entities involved in the VSC process. The first, and sometimes the only entity with which consumers have contact, is the **seller**. The seller offers contracts that have been drawn up and issued by a **provider**. A contract may be administered by an **administrator**, although some providers may administer their own contracts. The providers/administrators are the entities that are obligated to perform under the contract, approving or denying repair bills or refunds.

The contracts often are backed by a policy issued by an **insurer**. An insurer is not necessary under the laws of many states, including Missouri, if other conditions are met—a funded reserve account or a net worth threshold ($100 million in Missouri). If the provider/administrator fails to meet its obligations, the consumer may file a claim with the insurer within a certain time frame.

The final participant is the **financing organization**, which collects payments on contracts that have been financed. This four- or five-tiered structure is confusing to consumers. A BBB survey asked consumers, "What company was the administrator or provider of the contract, that is, what was the name of the company on the contract itself (not the seller)?" Of those who responded to the question, 64 percent said they did not know and 18 percent said the financing company was the provider.

The complexity and national scope of the industry is illustrated by a complaint filed with the BBB: An **Alabama** consumer bought a contract from a **Missouri** seller issued by a provider in **North Carolina** and administered by an administrator in **Texas**. A **South Carolina** company insured the contract, which was financed through an **Illinois** company.

History

Service contracts offered by independent companies began evolving in the early 1980s. One of the earliest known VSC companies is an Ohio firm incorporated in 1984. The Ohio Department of Insurance was rebuffed in an effort to stop the company in 1991, but in 1993, the FTC alleged that the company

deceptively and unfairly promoted VSCs and misrepresented the terms for canceling the contracts. By 1997, the FTC was warning consumers about VSCs, pointing out many of the misleading tactics which were used broadly a few years later. The BBB in St. Louis issued its first warning regarding a VSC company in June 2002. Warnings that named nine companies followed. The industry boomed in the middle of the decade and prosecutions by law enforcement officials, primarily against sellers, increased late in the decade.

Two statistics evidence this growth: Complaints at BBBs nationally escalated from an average of 57 in the years 2000 to 2004, and then spurted to 979 in 2005, growing each year to a peak of 7,643 in 2009, the last year for which complete data are available. Nearly three-fourths of the VSC companies in the St. Louis BBB database were formed after 2004. A fourth of those companies are now out of business. The earliest VSC company in the St. Louis BBB's service area appears to have been Consumer Automotive Consultants LLC, which was formed in 1995 and sold VSCs through allegedly misleading notifications in the mail. Employees reportedly left the company to start their own companies, and the St. Louis area soon became the hub of the VSC-selling industry.

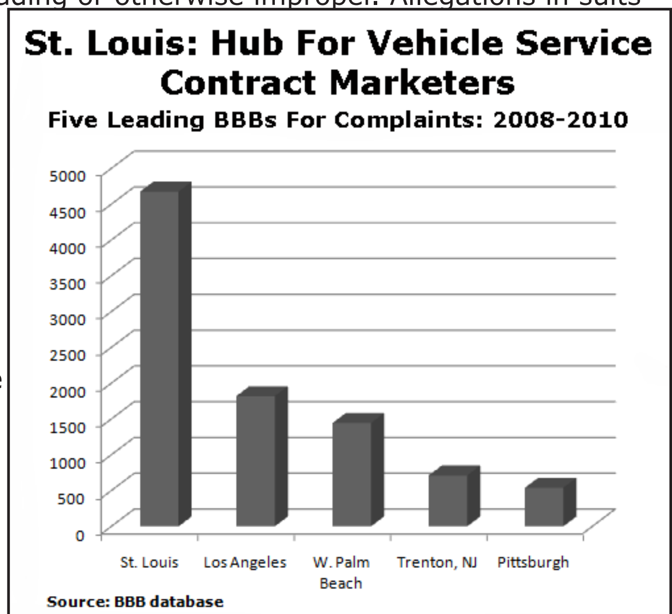
Turbulent Industry

The fast money available in the industry made it turbulent and highly competitive. Many lawsuits ensued:

- A provider sued several competitors alleging they bought links from search engines to steer potential customers to their own sites.
- Another provider sought to stop a competitor from using a similar name.
- A company sued former employees alleging they took materials with them to form their own company.
- Partners have sued each other.
- A wireless company sued telemarketers and sellers.
- Consumers have sued sellers and providers.
- Sellers and providers have sued insurance companies.
- Auto manufacturers have sued providers.
- A seller sued a financing company alleging that in forwarding money it had collected from purchasers, it kept $100 per contract of the amount due.
- Law enforcement agencies also sued service contract firms.
- Providers, sellers, and insurance companies have filed bankruptcy or been forced into receivership.

Sellers

Some call the St. Louis area the Silicon Valley of the VSC industry. In the three years ending in 2010, the St. Louis BBB closed 4,677 complaints regarding the industry, more than a fourth of the total closed nationally. The companies located in the St. Louis area are primarily sellers of contracts, the companies with which consumers first come in contact. Ninety-two percent of the respondents to the BBB survey said they felt the sales tactics used by sellers were misleading or otherwise improper. Allegations in suits filed by the Missouri attorney general support that assessment.



The typical purchaser of a contract, according to the survey, was 44 years old with a household income of $57,539. Fifty-five percent were male. Seventeen percent of those who bought contracts were 60 or older.

Providers set a price they want for a contract. Sellers can reap huge profits because they are usually free to mark up the price to whatever the consumer will pay. A contract that cost the seller $1,000, for example, may be sold to a consumer for $2,000 or more.

The average price paid by survey respondents who bought contracts was $2,146. Based on that, the estimated cost of contracts for complainants in the BBB database who bought contracts would total $7.8 million. However, many did not pay the full price. Twenty-six

percent of survey respondents simply did not pay the amount remaining on the contract. The average consumer who bought a contract paid $1,430, or the equivalent of $5.2 million for database complainants. Complainants also were stuck with $2.7 million in repair bills they thought were covered by the contract.

The tactic used by sellers that has gained the most attention, both from the public and law enforcement officials, is robo-calling. The FTC charged that one company made "hundreds of millions" of robo-calls, and a court document states that an employee bragged that his company could call every telephone number in the country within three hours.

In September 2009 the FTC began enforcing a rule that prohibits telemarketers from making robo-calls to consumers unless the consumers have agreed in writing to receive the calls. Under the new rule, violators face penalties of up to $16,000 per call. The rule and its enforcement seem to have diminished that tactic. Other tactics used by sellers (which the Missouri attorney general alleged in suits were misleading and in violation of the law) included:

- Selling what are called "product warranties" or "additive contracts," which required the consumer to place oil or another additive in his or her car to make the service contract valid. After the consumer did so and found the contract was very limited, no refund was available because the product had been used. The contracts were deemed to be insurance contracts by the Missouri attorney general and the Department of Insurance. Some sellers were charged with unlawfully engaging in the insurance business.
- Telling consumers their warranties had expired or were about to expire.
- Creating a sense of urgency by saying the offer was only good that day.
- Using the take-away scheme in which the consumer doesn't qualify for the offer but an exception will be made in his or her case.
- Selling contracts of "limited value" because they contained numerous exclusions and conditions.
- Promising "bumper-to-bumper" coverage, which didn't exist in the contracts.

The largest seller of vehicle service contracts nationally was Wentzville, Mo.-based US Fidelis Corp., also known as Dealer Services and National Auto Warranty Services. In the three years ending Dec. 31, 2010, consumers filed 1,672 complaints against the company with the BBB.

Attorneys general of 42 states joined forces in an investigation of US Fidelis and California-based Credexx, which did business as Auto One Warranty. Several attorneys general, including Missouri's, initiated legal actions. US Fidelis, which earned its owners a lavish lifestyle with multi-million-dollar homes, cars and properties, filed for bankruptcy protection on March 1, 2010. The case is pending and many of the luxury items have been sold to satisfy creditors.

While the new robo-calling rule has virtually blocked one avenue for sellers to reach prospects, 28 percent of survey respondents said their first contact with a company was in response to media advertising, the same percentage that said their first contact was a telephone call. Thirty-one percent said they responded to a mail solicitation. The most effective advertising was through TV or radio ads. Of those who bought contracts, 35 percent said their first contact with the company was through TV or radio ads, 29 percent said it was through a mail solicitation, while 26 percent said their first contact was through a telephone call. Only five percent said their first contact was through Internet advertising. After contacting or being contacted by the company, 74 percent bought contracts.

Providers/Administrators

While the St. Louis area may be the hub of the selling aspect of VSCs, providers and administrators, who are responsible for paying claims, are scattered across the country. Most sellers have several providers whose contracts they offer to the public, often eight or more.

Providers of the contracts often have agreements with six or more sellers. For example, nine sellers sued by the Missouri attorney general used 44 providers/administrators.

Missouri law requires providers to register with the Department of Insurance, which regulates the industry. Several suits filed by the Missouri attorney general allege that sellers offered contracts issued by providers who were not registered. There are 81 active providers of VSCs registered with the Department, more

than 30 of which are auto dealers or manufacturers. Seventy-five or 93 percent of the active providers guarantee the contracts with reimbursement insurance policies. The other six back their contracts with a funded reserve account or by showing a net worth of at least $100 million.

Insurers

The requirement that VSC contracts be insured or otherwise safeguarded to protect consumers has a twist. Consumers appear to have little knowledge of this safety net designed to protect them. In the survey, 84 percent did not know the name of the company that insured the contract, if it was insured. Some of the contracts have been insured by risk retention groups (RRGs). In 1986, Congress passed the Liability Risk Retention Act, which allowed certain groups which found regular insurance very expensive, e.g. malpractice insurance for professionals, to form RRGs to which individuals or companies contributed and were issued policies covering their risks: in effect, group self-insurance. Several VSC providers formed RRGs and posted the policies issued by the groups as security for the contracts they issued. Many RRGs are formed in states with relatively lax insurance laws, and other states in which an RRG may practice are prohibited by law from exercising their usual vigilance over this type of company.

RRGs pose a special problem for consumers. Most states, including Missouri, have guaranty funds to help pay the claims of policyholders against financially impaired insurance companies. But policyholders of a financially troubled RRG are prohibited by law from accessing a guaranty fund. The CNA National Warranty Corp. notes on its website that consumers should ask whether a VSC is insured by an RRG before buying it. "If so, we advise you to keep shopping. This form of insurance, while suitable for some purposes, has not yet established a proven track record for the long-term payment of service contract claims."

When a provider runs into financial trouble, it may wind up in bankruptcy court or receivership. The company that insured the contracts may as well, or vice versa. Two major cases of this nature had an impact on consumers across the country, including Missouri. Capital Assurance Risk Retention Group, which had eight VSC providers as members, was placed in receivership by a court in North Carolina in October 2007 because of the financial condition of Ultimate Warranty Corp., an Ohio-based VSC provider that insured its contracts through Capital Assurance. Six months later, a U.S. District Court placed Ultimate, which had over 137,000 contracts in effect at the time, in receivership. Most contracts stated that if Ultimate couldn't pay claims then Capital Assurance would. However, Ultimate had an 80 percent ownership interest in Capital Assurance. In effect, the provider was insuring itself. The receiver for both Capital Assurance and Ultimate says on its website that it does not know when or how much will be paid to creditors including consumers.

Thirteen companies in the St. Louis area sold Ultimate contracts, with 21,567 of the contracts active at the time Ultimate was placed in receivership. There were 1,980 unpaid claims on those contracts totaling $641,495. Through an agreement with the Capital Assurance receiver, some sellers would pay the authorized repair bills of holders of Ultimate contracts and then would file a claim for reimbursement from the Capital Assurance receivership estate. Seventeen months later, the number of active contracts sold by St. Louis area companies dropped to 10,850, but unpaid claims increased to 2,657 and totaled $1,034,312.

The case liquidating National Warranty Insurance Risk Retention Group, headquartered in Lincoln, Neb., is pending in a Cayman Islands bankruptcy court, where the company officially is domiciled. When the company failed, the GAO said it left "behind thousands of customers with largely worthless vehicle service contracts. National Warranty insured at least 600,000 contracts worth 'tens of millions of dollars.'" Last May, the liquidator said that creditors with approved claims would receive an interim distribution of 31 cents on the dollar.

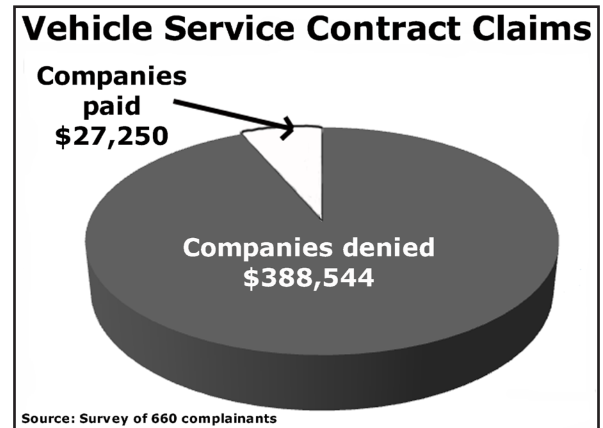
A GAO report in 2005 noted that there is a question of whether RRGs should be allowed to insure VSCs at all "because of the potential direct damage to consumers." At one time, US Fidelis had its own risk retention group domiciled in Montana.

Contracts & Denial of Repairs

The Missouri attorney general's office says some providers' contracts are of "minimal value because the service contract actually contains numerous exclusions, limitations and conditions, and providers deny claims for the cost of repairs without a reasonable investigation." One contract listed 87 parts of the

vehicle that were not covered by the contract. In some contracts, if a covered part were damaged by a defective non-covered part, the repair of the covered part would be excluded.
Some contracts required the owner to have maintenance done as recommended by the vehicle's manufacturer and to provide receipts of work done, including oil changes, in order to file a claim. In the purchaser's signature block of the contracts, there often was a notation "by phone."

In the BBB survey, 93 percent of respondents said the company refused to pay for repair claims they thought were covered by their contracts. Asked what reasons the company gave for not covering the repair, 60 percent said the company told them the repair was not covered by the contract, 17 percent said they were told that they could not provide proper maintenance documents and 16 percent said the company classified the defect as a pre-existing condition. The average amount spent for those repairs was $1,480, and totaled $2.7 million when applied to all complainants in the BBB database who incurred the same problem.



Reasons for denying claims in many instances were questionable and even frivolous, according to the Missouri attorney general, which noted the following examples in its suits:

- A consumer's claim was denied by one provider because the certified mechanic's maintenance records were handwritten and not printed by computer.
- Another consumer's claim was denied when the claims department stated they could not pay the claim because they did not have the original paperwork, only copies.
- An inspector for a provider denied a claim because he said damage was due to off-roading even though the consumer was 67 years old and never went off-roading.
- One consumer's claim to repair the water pump for $958.91 was denied because the customer changes his own oil and the contract requires that work be done by a state licensed mechanic.

Trade Associations

Several trade associations have been formed by individuals in the VSC industry, often in response to increasing state regulation of the industry. The associations seem to have had little effect on policing the industry.

Concern for the consumer is questionable in at least one group, which hosted a conference that included a presentation: "Controlling the Bad Guys: How To Deal With Players that Abuse the System." The subject matter of the presentation was explained: "How can administrators deal with such players who submit fraudulent claims and indicate a lower mileage to validate a claim?" The "bad guys" are the consumers.

The Service Contract Industry Council (SCIC), which deals with the entire service contract industry, was formed in 1988 in response to "the increasingly cumbersome patchwork of regulation of the industry being carried out on a state-by-state basis." SCIC moved from monitoring state and national legislative activities to a more proactive role of developing regulatory standards appropriate for the industry and consumers. The Florida Service Agreement Association, incorporated in 1990, was formed in response to legislation governing the industry. Its focus is on Florida only and includes the wider service contract industry.

The Vehicle Service Contract Administrators Conference, a loosely knit group, has held annual conferences for those in the industry since 2005. The Vehicle Protection Association (VPA), formed in 2008, has developed a Code of Conduct for its members and certifies those companies that adhere to the code. Three companies that have been certified have been sued by the Missouri attorney general.

Law Enforcement

An article in the August 2008 issue of *Warranty Week,* a trade publication, carried the headline: "Existing laws are not much of a deterrent and the lawsuits are merely a cost of doing business." Beginning in March 2008, the Missouri attorney general sued 13 companies and 20 individuals that sold vehicle service

contracts, obtaining assurances of voluntary compliance or consent judgments in seven of the cases. But four of the companies that promised not to violate the laws and paid a total of $76,925 in penalties and restitution were sued a few months later when violations allegedly continued. The suits against six companies are 13 to 14 months old and two are 36 months old with no settlement. The attorney general has obtained $276,925 in restitution and penalties in all of the suits. In four of the suits, 12 individuals named as defendants engaged in the alleged violations in "conscious disregard of the law." No individual controlling the companies or named as a defendant in any of the suits has been criminally prosecuted.

While the FTC obtained multi-million-dollar settlements against a few telemarketers for violations of the new robo-calling rule, it broke new ground in filing criminal charges in the U.S. District Court in East St. Louis against two Florida men who allegedly reaped $40 million through the sale of VSCs.

In a related court document, the FTC described its attempt to stop a practice of "deceptive and abusive tactics of a seller of purported extended automobile 'warranties,' which lies about who it is and what it sells, and brazenly violates a panoply of federal laws in virtually every one of the millions of telemarketing calls it makes each week."

Missouri Attorney General Chris Koster convened a task force of industry, legislative, enforcement and consumer representatives in March 2010 to gather information and consider legislation. Michelle L. Corey, BBB president and CEO, participated. Koster issued a report with recommendations following two task force meetings.

In May 2011, Missouri joined the ranks of states that have enacted new laws regulating the VSC industry. Many of Koster's recommendations for legislative action are included in the new law enacted by the Missouri Legislature. A major change requires licensing of "producers" (sellers), including both business entities and individuals, who are exempt from most regulations under current laws. The law also:

- Sets new standards for delivery of contracts purchased by consumers.
- Sets restrictions regarding the moral turpitude of sellers.
- Requires providers to maintain records of all producers authorized to sell their products.
- Sets specifications regarding a "free look" period within which a purchaser could cancel the contract with a 100 percent refund.
- Defines fraud and deception committed in the act of selling.

Koster also recommended changes in the Department of Insurance's regulations governing the VSC industry. One that has drawn objections from the industry is a requirement that sellers engaging in telephone sales be required to disclose 12 items including what's covered in the contract and what isn't, who the providers and administrators are and their home states, the free-look period, cancellation procedures with the right to a refund, and how claims are handled.

The BBB posed several questions to the Department of Insurance but had no response after several weeks.

Conclusions

Lax oversight of the VSC industry has created a national scam that has been evolving for at least 25 years, costing consumers millions of dollars. Laws protecting consumers have been drawn up or more widely enforced only in recent years. Even now, punishment for those who have reaped millions rarely includes criminal prosecution of individuals. Prosecution of providers and administrators is rare.

Some owners of companies that bilked consumers lived lavish lifestyles until their companies quit doing business or declared bankruptcy. The owners of US Fidelis are one example. The petition to place Ohio-based Ultimate Warranty in receivership states: "It appears that most of the funds . . . were dissipated by defendants on such things as loans to directors, officers and affiliates, purchase of properties in Panama, extravagant travel for directors and officers (e.g. Las Vegas), exorbitant salaries, and other payments other than the payment of contract holders' claims."

In a press release, the FTC almost gloated over a $2.3 million settlement because the company owner would have to "give up his Mercedes." Greed, left unchecked, diminishes the well-being of consumers.

The brief spurt in prosecution of law violators in the past few years, enactment of new laws and the virtual halt to robo-calling may herald a new beginning and reformation of the industry. Some in the industry appear to be fearful. The legal advisor for a recently formed trade group, Vehicle Protection Association, was quoted as saying, “We’re running out of time. If we don’t move quickly, the industry’s going to be shut down.” But also, without effective enforcement, sellers, providers, administrators and insurers may continue to find ways to evade the laws.

Recommendations

Base on this study’s findings, the BBB recommends the following:

- That state and federal authorities be more vigilant and vigorous in prosecuting violators of consumer protection laws governing the VSC industry, including criminal prosecutions of the more egregious offenders.
- That Congress amend the Liability Risk Retention Act of 1986 to preclude risk retention groups from insuring VSCs, as suggested by regulators in several states in response to a Government Accountability Office survey.
- That an Assurance of Voluntary Compliance being considered as satisfactory settlement of a suit be the exception rather than the rule.
- That the Missouri Department of Insurance consider regulations such as those recommended by the Missouri attorney general.
- That the Missouri Department of Insurance consider regulations requiring that before any payment is made, a VSC must be signed by the purchaser and returned before it becomes valid and that telephone “signatures” be prohibited.
- That the Missouri Department of Insurance consider a regulation that would prohibit providers from insuring their contracts with policies from RRGs in which they or affiliated entities are members.

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