

ARTICLES

SERVICE WARRANTY ASSOCIATIONS: REGULATING SERVICE CONTRACTS AS “INSURANCE” UNDER FLORIDA'S CHAPTER 634

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OVERVIEW

This Article analyzes the economic and legal rationale behind regulating service contracts as a form of insurance. Parts I and II present an introduction and overview of the service contract industry in general, and Part III takes a specific look at Florida's chapter 634. Parts IV through VI discuss a state's power to regulate insurance, the general distinction between “warranty” and “insurance,” how service agreements are distinguished from warranties, and how Florida has adopted these concepts in regulating warranty associations as a form of insurance under chapter 634. The need for consumer protection is exemplified by the case of *EWC Electronics*,¹ discussed in Part VII. Parts VIII and IX analyze the need for regulating warranty associations, and the costs imposed by such regulation. Part X presents a conclusion and recommendation.

I. INTRODUCTION

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1. *EWC Elecs. of Florida, Inc. v. Florida Dep't of Ins.*, No. 91-2037 (Fla. 1st Dist. Ct. App. 1991).

The "service contract" has become an increasingly common part of the purchase on a wide range of goods — from automobiles, to electronics, to new home structures. These agreements are known by a wide variety of names such as "warranty agreements," "extended warranties," "buyer protection plans," or "mechanical breakdown insurance," but are referred to as "service contracts" or "service agreements" throughout this Article. Service agreements generally promise to repair, replace, or indemnify the consumer against defects in product workmanship or material,² basically providing an extension of the original manufacturer's warranty. Florida law defines "service warranty" as: "[A]ny warranty, guaranty, extended warranty or extended guaranty, contract agreement, or other written promise to indemnify against the cost of repair or replacement of a consumer product in return for the payment of a segregated charge by the consumer."³

When purchasing a product, the rational consumer justifies the additional expenditure of purchasing a service contract based upon the probability that: (1) the covered product will at some time require additional repairs which are not covered by its original warranty; (2) the service contract will cover such repairs; and (3) the service contract costs less than the repairs will cost. There is, however, an additional risk the consumer takes when purchasing a service contract: the implicit assumption that the service contract provider will not only honor the service agreement, but will in fact still be in existence when the repair is needed. This assumption is probably the greatest risk in purchasing a service contract, yet is rarely, if ever, addressed by the service contract provider, or even considered by the consumer. The overall purpose of service contract regulation is to help minimize this hidden risk and to ensure the consumer's implicit assumption is realized.

As with any type of warranty or insurance, service contracts present tremendous potential for abuse and fraud. Several states have taken legislative action to regulate warranty associations (companies which sell service contracts) in an attempt to protect consum-

2. The Service Contract Industry Council (SCIC), the trade association for service agreement providers, defines service contract as "a contract or agreement given for consideration over and above the lease or purchase price of a product that extends the term of the service and/or repair provisions of the original manufacturer's warranty." SCIC INFORMATIONAL BROCHURE 3 (1992) [hereinafter SCIC BROCHURE].

3. FLA. STAT. § 634.401(14) (1995).

ers from fraud.⁴ Florida has taken particularly aggressive action, enacting chapter 634 of the Florida Statutes, which sets forth strict regulatory requirements for warranty associations.⁵ Florida has led the way in service agreement regulation: Chapter 634 was among the first major statutory acts specifically created to regulate service agreements and still stands as one of the most (if not *the* most) comprehensive and aggressive statutory schemes to this regard.⁶

II. THE SERVICE CONTRACT INDUSTRY

A. Background and History⁷

Warranties covering defective products have been offered by manufacturers and the dealers who sell those products for over a century.⁸ Automobile warranties were first introduced in the early 1960s and offered only by the car manufacturers, usually for twelve months or 12,000 miles.⁹ Automobile factory warranties expanded to five years/50,000 miles by 1967,¹⁰ but the scope of coverage and duration of the warranty period began to decline in the 1970s.¹¹ As consumers became dissatisfied with the auto makers' warranties, and the cost of auto repairs increased, the market responded with the emergence and rapid expansion of independent service contract providers. The major car manufacturers responded to the success of

4. See, e.g., ARIZ. REV. STAT. ANN. § 20-1096 (1991); COL. REV. STAT. § 42-13-101 (1992); MASS. GEN. LAWS ANN. ch. 175, § 149F (West 1992); MINN. STAT. § 65B.29 (1989); N.C. GEN. STAT. § 58-1 (1992); VA. CODE ANN. §§ 59.1-436, 38.2-2600 (Michie 1950); WASH. REV. CODE § 48.96 (1992).

5. 1959 Fla. Laws ch. 110 (codified at FLA. STAT. §§ 634.011-444 (1995)) [hereinafter chapter 634].

6. Inter-office Memorandum from Elise Matthes, Florida Dep't of Insurance 5 (Aug. 6, 1991) (stating, "No doubt we have the strongest statute in the country. . . .") [hereinafter Matthes].

7. For a more in-depth economic analysis of the service contract industry, see William C. Whitford, *Law and the Consumer Transaction: A Case Study of the Automobile Warranty*, 1968 WIS. L. REV. 1006.

8. Courts imposed the first express warranties requiring the seller to stand behind its representations as to the product's quality. See *Hawkins v. Pemberton*, 51 N.Y. 198 (1872).

9. JOHN APPLEMAN, *INSURANCE LAW AND PRACTICE WITH FORMS* §§ 10757-10758 (1967).

10. *Id.*

11. *Id.*; see also FEDERAL TRADE COMM'N: REPORT ON AUTOMOBILE WARRANTIES 14-20 (1970) [hereinafter FTC REPORT]; M.J. Trebilcock, *Manufacturers' Guarantees*, 18 MCGILL L.J. 1 (1972).

these independent service providers by expanding and improving their own service agreements. This resulted in an overall shakeout in the industry, driving many smaller independents out of business, and leaving the industry dominated by the major car makers and large service agreement providers.¹²

The automobile service agreement industry has continued to increase. Service contracts are now a major element of new vehicle sales, with virtually every new automobile and truck dealership in the country offering some type of service agreement.¹³ As dealer margins on automobiles decline, service contracts have become one of the dealers' most profitable activities,¹⁴ and continue to grow as dealers capitalize on consumers' lack of confidence in the reliability of cars.¹⁵ Automobile service agreements now account for over \$9 billion in sales every year,¹⁶ with about one-third of all new car buyers opting for some type of service agreement.¹⁷

A similar pattern occurred with "repair agreements" covering major household appliances. These agreements first emerged in the 1940s,¹⁸ and became a major force in the early 1970s as major manufacturers and retailers, such as RCA, Sears, General Electric, and Montgomery Ward, began to offer service programs covering most home appliances. The independent service agreement industry spread from the national retail giants to other smaller merchants, and gave birth to independent service agreement providers.¹⁹

Service agreements covering consumer products have grown rapidly over the past two decades and are currently offered by almost every retailer in the country. They cover a wide array of con-

12. Larry Light, *New Lemons From the Auto Lot*, BUSINESS WEEK, Dec. 3, 1990, at 148. From 1987-1990, the number of MVSACs sold by independent providers decreased by 200,000, while those sold by auto makers increased by 1.4 million. *Id.*

13. *Auto Service Contracts*, CONSUMER REPORTS, Oct., 1986, at 663 [hereinafter CONSUMER REPORTS].

14. *GM is Offering Option of Extended Coverage on New Auto Repairs*, WALL ST. J., Feb. 2, 1979, at 3, col. 4. On an average, on a \$750 service contract (in 1979), the dealership commission averages \$500. Dealers may often make an even higher profit, such as a Chrysler dealer who regularly charged customers \$1,620 for service contracts which cost the dealer only \$125. *Id.*

15. CONSUMER REPORTS, *supra* note 13, at 664.

16. Light, *supra* note 12, at 148.

17. *Id.*

18. CONSUMER REPORTS, *supra* note 13, at 663.

19. These companies are known in the trade as "professional service agreement administrators." SCIC BROCHURE, *supra* note 2, at 1.

sumer goods from stereos and televisions to computers and fax machines.²⁰

B. General Industry Structure and Distribution

Service agreements are “written” like an insurance policy, either by the original manufacturer or retailer of the covered product, or by an independent third-party service contract provider known as a “warranty association.” The warranty association may sell its warranties directly to consumers, or indirectly through the retailers (“dealers”) where the product is sold.²¹ The service warranties are sometimes sold by warranty associations directly to retailers, but are more commonly sold through middleman distributors.²²

Most service contracts are sold to dealers on a “*consignment*” basis. The warranty association usually provides its dealers with blank application forms which the dealers use to sell service contracts to their customers, operating similarly to an insurance binder. The dealers retain their pre-determined commission, and remit the remaining balance, along with the completed form, to the warranty association. When repair work is needed, the dealer repairs the product, or sub-contracts the work to an independent repair facility, at no cost to the customer above the deductible, if any. The dealer then submits the bill to the warranty association for reimbursement.²³

In addition to consignments, service agreements may also be distributed through “*wholesaling*.” Rather than writing individual contracts for each covered purchase, as with consignments, the warranty association may “wholesale” generic unwritten contract forms *en masse* to its retailers or distributors, who then fill in the blanks and resell the contracts to the consumer at whatever price they can get. Wholesaling inherently entails more risk and more potential problems than consignment. In particular, wholesaling does not

20. SCIC BROCHURE, *supra* note 2, at 3; *see also Are Service Contracts Worth the Cost?*, 57 BETTER HOMES AND GARDENS, Oct. 1979, at 94.

21. By selling the service agreement, the dealer becomes an “insurance agent” in addition to a consumer good retailer.

22. The chain of distribution is thus: From warranty association, to distributor(s), to retailer, to the consumer.

23. In other instances, the customer may be required to pay the repair bill directly, and then seek reimbursement from the warranty association (similar to medical insurance).

provide the warranty association, or the state regulatory body, with an accurate number of outstanding service contracts, or the total extent of liability at any given time. Wholesaling is seldom ever seen in the automobile segment, as motor vehicle service contracts are written separately for each individual car. Wholesaling is still found with consumer products, but it has declined in usage, especially after the EWC Electronics fiasco.²⁴

III. FLORIDA'S CHAPTER 634: "WARRANTY ASSOCIATIONS"

Chapter 634 of the Florida Statutes regulates warranty associations under the authority of the Florida Department of Insurance ("DOI"). In creating chapter 634, the Florida Legislature recognized the need to regulate service contracts similar to other forms of "insurance," but also recognized that many service contract providers did not have the financial resources to meet the statutory requirements for property and casualty insurance companies.²⁵ Imposing such strict requirements would preclude most warranty associations from being financially able to enter the market, leaving Florida open only to the major manufacturers and large national insurers, and foreclosing the opportunity for most warranty associations to do business in the state.²⁶ The legislature reached a compromise with chapter 634, which protects the public by regulating warranty associations, yet is lenient enough to enable independent warranty associations to compete.

Three Types of Warranty Associations: Part I, II, & III

24. See *infra* text accompanying notes 131–48.

25. Interviews with Gary A. Mills, Financial Analyst, Bureau of Specialty Insurers, Florida DOI, in Tallahassee, Florida (Jan. 29, 1993 and Oct. 30, 1995) [hereinafter Mills]. The requirements for property and casualty (P&C) insurers are set forth in FLA. STAT. §§ 624.401–489 (1995).

26. Mills, *supra* note 25; see also Steven Cole Smith, *Long arm of the law strangles extended warranties*, AUTOWEEK, Feb. 15, 1988, at 27 (stating "[Warranty associations] don't suffer catastrophic losses like insurance companies do, so we don't need the same kind of reserves. About the worst we can expect is a \$1,700 claim for engine and transmission work. We don't have to worry about huge lawsuits or natural disasters." (quoting Bob Boughton, President of Griffin Systems, Inc.)).

Chapter 634 establishes three general categories of warranty associations and regulates each category under a separate section. Part I regulates “Motor Vehicle Service Agreement Companies,” Part II covers “Home Warranty Associations,” and Part III regulates “Service Warranty Associations.” While the specific requirements vary for each category, they all reflect the same underlying rationale behind all insurance and warranty regulation: protecting the consumer.

1. Part I — Motor Vehicle Service Agreement Companies

Part I²⁷ of chapter 634 regulates “Motor Vehicle Service Agreement Companies” (“MVSACs”) that offer service agreements on motor vehicles.²⁸ The statute defines a “Motor Vehicle Service Agreement” as “any contract or agreement indemnifying the service agreement holder . . . arising out of the ownership, operation and use of the motor vehicle against loss caused by failure of any mechanical or other component part, or any mechanical or other component part that does not function as it was originally intended.”²⁹ In order to do business in Florida, a MVSAC must comply with the strict requirements set forth in Part I, including posting an initial deposit³⁰ and maintaining a minimum net asset ratio³¹ and premium reserve.³² The chapter further requires the MVSAC to be a licensed insurance sales agent,³³ provides grounds for refusal, suspension, or revocation of a sales license,³⁴ and authorizes DOI to seek administrative penalties and injunctive relief for violations of the statute.³⁵ There are currently thirty-two MVSACs licensed to do business in

27. FLA. STAT. §§ 634.011–.281 (1995).

28. *See id.* § 634.011(8).

29. *Id.* § 634.011(7).

30. MVSACs must deposit \$100,000 – \$200,000 with DOI. *Id.* § 634.052(1).

31. MVSACs must maintain a ratio of gross written premiums to net assets of 10 to 1. *Id.* § 634.041(8)(a)(2).

32. MVSACs must also maintain an unearned premium reserve, equal to 50% of the unearned gross written premium of each service agreement. This requirement is waived, however, if the company has purchased contractual liability insurance for 100% of its claims exposure. *Id.* § 634.041(8)(a)(1).

33. *See id.* § 634.031(1) (the licensure requirement applies to the car dealer as a corporation, rather than the individual salespeople).

34. FLA. STAT. §§ 634.171–.201 (1995).

35. *Id.* §§ 634.151–.221.

Florida.³⁶

2. Part II — Home Warranty Associations

Part II³⁷ of chapter 634 regulates Home Warranty Associations (“HWAs”), which are defined as companies which sell agreements that: “[I]ndemnify the warranty holder against the cost of repair or replacement . . . of any structural component or appliance of a home, necessitated by wear and tear or an inherent defect of any such structural component or appliance or necessitated by the failure of an inspection to detect the likelihood of any such loss.”³⁸ HWAs sell service agreements for: (1) the physical structure of the home, usually a house or condominium; and/or (2) major appliances such as refrigerators or stoves which are sold with the home. When the service contract covers an appliance *included* with the sale of a home, it is considered an HWA and regulated under Part II. If, however, the service agreement is sold *independently*, and not incident to the sale of the home itself, it is considered a “service warranty,” and regulated by Part III.³⁹

Part II, now accompanied by chapter 4-199 of the Florida Administrative Code (“FAC”),⁴⁰ sets forth strict requirements for a company to do business as an HWA in Florida. The HWA is required to be a solvent United States corporation with competent and trustworthy management;⁴¹ deposit at least \$100,000 with DOI;⁴² maintain minimum unearned premium reserves;⁴³ conform the home warranty contracts to many specific requirements;⁴⁴ file biographical statements;⁴⁵ maintain a warranty register;⁴⁶ and file an annual statement and quarterly reports.⁴⁷ Part II further requires HWA

36. Mills, *supra* note 25.

37. FLA. STAT. § 634.301–.348 (1995).

38. *Id.* § 634.301(4)(c).

39. *See infra* text accompanying notes 51–65.

40. FLA. ADMIN. CODE ANN. r. 4-199 (1992) (filed with the Secretary of State on June 26, 1992, and became effective July 16, 1992).

41. FLA. STAT. § 634.404(2) (1995).

42. *See id.* § 634.405(1)(b).

43. *Id.* § 634.406(1); FLA. ADMIN. CODE ANN. r. 4-199.005 (1992).

44. FLA. ADMIN. CODE ANN. r. 4-199.005(2)(b) (1992).

45. *Id.* at r. 4-199.012.

46. *Id.* at r. 4-199.005(3).

47. *Id.* at r. 4-199.012.

sales representatives to be licensed as insurance agents,⁴⁸ and specifies grounds for refusal, suspension or revocation of the license or appointment of salespeople and for the imposition of fines.⁴⁹ This myriad of requirements has apparently discouraged many HWAs from entering the Florida market, as only thirteen HWAs are currently licensed to do business in the state.⁵⁰

3. Part III — Service Warranty Associations

Chapter 634 originally had only two parts: Part I (MVSACs) and Part II (HWAs). Confusion resulted between warranties covering major appliances sold in conjunction with the sale of a home and independent service contracts on later-acquired household items.⁵¹ The legislature recognized the need to regulate service contracts that were not “incident to the sale of the home,” and thus created Part III to regulate companies that sell service contracts for consumer appliances and electronics such as televisions, personal computers, or telephones known as “Service Warranty Associations” (“SWAs”).⁵² Part III defines such “service warranties” as: “[A]ny warranty, guaranty, extended warranty or extended guaranty, contract agreement, or other written promise to indemnify against the cost of repair or replacement of a consumer product in return for the payment of a segregated charge by the consumer.”⁵³ Part III is intended to regulate companies whose primary “product” is the service contract itself, rather than retailers or manufacturers who may offer extended warranties on the products they sell. SWAs, which receive more than half of their total revenues from the sale of warranties, defined as “warranty sellers,”⁵⁴ are thus subject to much stricter regulations than are “warrantors,” which derive less than 50% of their revenues from the sale of warranties.⁵⁵ By October of 1995, over two hundred SWA licenses had been issued, but only eighty-six SWAs

48. FLA. STAT. § 634.317 (1995) (with limited exemptions for real estate offices).

49. *See id.* § 634.320.

50. Mills, *supra* note 25; Interviews with Loraine Farley, Insurance Examiner, Bureau of Specialty Insurers, HWA Division, Florida DOI, in Tallahassee, Florida (Jan. 29, 1993) [hereinafter Farley].

51. Farley, *supra* note 50.

52. *Id.*

53. FLA. STAT. § 634.401(14) (1995).

54. *Id.* § 634.401(15), (17).

55. *Id.* § 634.401(16).

were actively doing business in the state.⁵⁶

Chapter 634 sets forth strict requirements for SWAs (as with MVSACs and HWAs) to do business in Florida.⁵⁷ In addition to paying a yearly license fee of \$500,⁵⁸ Part III sets forth numerous financial requirements for an SWA, including minimum net assets,⁵⁹ reserve funds,⁶⁰ and deposits and bond requirements “to assure the faithful performance of its obligations.”⁶¹ In addition, the SWA must be a solvent United States corporation and licensed to do business in Florida,⁶² establish that its management is “competent and trustworthy,”⁶³ and file its articles of incorporation and bylaws with the State.⁶⁴ Part III also specifies grounds for suspension or revocation of a license and sets out procedures for these actions.⁶⁵

IV. REGULATING SERVICE AGREEMENTS AS “INSURANCE”

A fundamental issue concerning chapter 634, or any service agreement regulation, is whether service agreements should be regulated as “insurance.” In order for a state insurance department, such as Florida's DOI, to have proper authority to regulate warranty associations, two primary hurdles must be overcome: First, the state must have proper authority to regulate insurance. Second, service

56. Mills, *supra* note 25. This number has increased by only two over the past two years, as there were 84 SWAs doing business in early 1993. *Id.*; Interview with Donna Spikes, Insurance Examiner, Bureau of Specialty Insurers, SWA Division, Florida DOI (Feb. 25, 1993) [hereinafter Spikes].

57. In 1991, the Florida Legislature passed CS/HB 2089, which significantly revised the laws relating to warranty association. The bill strengthened the prior law regarding financial requirements, licensure of sales reps, and misleading and deceptive practices by both companies and agents. 1991 Fla. Laws ch. 106 (amending FLA. STAT. §§ 634.011–.405).

58. FLA. STAT. § 634.404(6)(b)(3) (1995).

59. *See id.* § 634.404(1)(b). Warrantors must maintain minimum net assets of at least \$25,000 and warranty sellers must maintain at least \$300,000. *Id.*

60. *See id.* § 634.406. The SWA must keep unearned premium reserve fund equal to 25% of gross written premium received from all contracts in force, 10% of which must be on deposit with the Treasurer. These reserve requirements are, however, waived if the SWA obtains a contractual liability policy from an authorized insurer covering 100% of its liability. *Id.*

61. FLA. STAT. § 634.405(1)(a)(2), (b) (1995) (setting forth deposit requirements of \$50,000 for warrantors, \$100,000 for warranty sellers).

62. *Id.* § 634.403.

63. *Id.* § 634.404(2).

64. *Id.* § 634.404(6)(b)(1).

65. *Id.* §§ 634.422–.444.

contracts must qualify as a form of “insurance,” and thus subject to DOI regulation and control. The first hurdle, as will be seen, is met with relative ease; but the second presents a far more difficult issue.

A. State's Power to Regulate Insurance

In order to exercise control over warranty associations, DOI must first have the authority to regulate the business of insurance in general. This obstacle is met fairly easily. The federal McCarran-Ferguson Insurance Regulatory Act of 1945 (the “McCarran Act”)⁶⁶ grants to the states unqualified power to regulate insurance companies and their methods of conducting the business of insurance.⁶⁷

The underlying purpose behind granting such authority to state governments is that insurance is not considered just a private business, but a matter of public concern, and therefore subject to regulation for the public good.⁶⁸ The state has wide discretion⁶⁹ in regulating insurance carriers as a legitimate exercise of its police powers, so long as such regulation is reasonable.⁷⁰ Under the McCarran Act, states not only have the direct authority to regulate insurance companies, but also realize two tangential benefits. First, the Act authorizes a state to regulate *any* industry, including warranty associations, which the state classifies as “insurance.”⁷¹ Second, it frees the state from possible Commerce Clause attacks on such regulation.⁷² Therefore, Florida's DOI clearly has authority to regulate warranty associations, *if* the industry is in fact a form of “insurance.”

66. McCarran-Ferguson Act, ch. 20, 59 Stat. 33 (1945) (codified as amended at 15 U.S.C. §§ 1011–1015 (1994)). Since the Act was passed in 1945, every state has broadened its insurance regulation. Robert B. Ely III, *Governmental Regulation of Insurance Marketing Practices*, 374 INS. L.J. 186, 189 (1954); see also R. RATHIAS, INSURANCE REGULATION AND ANTITRUST: THE EFFECT OF THE McCARRAN-FERGUSON ACT 5 (Ill. Dept. of Ins. 1979).

67. JOHN ALAN APPLEMAN & JEAN APPLEMAN, INSURANCE LAW AND PRACTICE § 10321, at 1 & n.1 (rev. ed. 1982) [hereinafter APPLEMAN].

68. *Id.* § 10321, at 3 & n.2. The McCarran Act further acts to exempt insurance companies from certain anti-trust requirements to help prevent excessive and destructive competition, such as allowing insurance companies to pool information. *Id.*

69. *Id.* § 10321, at 3 & n.3.

70. *Id.* § 10321, at 3 & nn.5–6.

71. APPLEMAN, *supra* note 67, § 10323 n.13.

72. U.S. CONST. art. I, § 8, cl. 3; see *Group Life & Health Ins. Co. v. Royal Drug Co.*, 440 U.S. 205, 218 (1979).

B. Defining "Insurance"

As indicated above, the McCarran Act authorizes a state to regulate insurance. The more difficult issue, however, is determining what constitutes "insurance." Rather than attempting to establish a firm definition of "insurance," state regulators initially relied upon a basic "terminology" approach. If the agreement contained the term "insurance" in its text, it constituted a "contract of insurance," and was therefore subject to the state's insurance department regulations.⁷³ This terminology approach is perhaps the easiest way to define insurance, but, as with most "simple" solutions, left many unfilled gaps. The terminology approach has been consistently rejected by the courts⁷⁴ and has essentially been abandoned.⁷⁵

In lieu of the "terminology" approach, state agencies, and courts, have turned to establishing definitions for "insurance." An oft-cited definition of "insurance" was set forth by the court in *Griffin Systems, Inc. v. Washburn*,⁷⁶ which, coincidentally, involved service contracts. *Griffin* is instrumental because it provides clear guidance in distinguishing insurance contracts from warranty contracts. Griffin Systems, Inc. ("Griffin") sold "automobile parts indemnity plans, which provided to pay for repair or replacement of warranted automobile parts."⁷⁷ The Illinois Insurance Commissioner determined these plans constituted contracts of insurance;⁷⁸ and because Griffin was not an authorized insurance dealer, it was therefore engaging in the unauthorized selling of insurance.⁷⁹ The Commissioner then issued a cease and desist order,⁸⁰ which Griffin appealed, contending its indemnity plans were not "insurance policies," but rather *service contracts*, over which the Department of Insurance had no author-

73. 1 GEORGE J. COUCH, COUCH ON INSURANCE 2D, § 1:12, at 19 (rev. ed. 1984).

74. See, e.g., *People v. Roschli*, 9 N.E.2d 763, 764 (N.Y. 1937) (stating "[w]hat is in substance a contract of insurance cannot be changed into something else by giving it another name"); *Mein v. United States Car Testing Co.*, 184 N.E.2d 489, 493 (Ohio Ct. App. 1961).

75. COUCH, *supra* note 73, § 1:12, at 19.

76. 505 N.E.2d 1121, 1123 (Ill. App. Ct. 1987).

77. *Id.* at 1122.

78. *Id.* at 1123. The Commissioner determined that such a plan contained all the elements of "insurance," as the essence of the plan was to indemnify the customer and reimburse him for possible future loss. *Id.* at 1124.

79. *Id.* at 1122.

80. *Id.*

ity.⁸¹ The court, however, disagreed, ruling that such agreements were in fact contracts of insurance.⁸²

In reaching its conclusion, the *Griffin* court devised a four-prong test to define a contract of insurance: (1) contract for a specified period of time; (2) an insurable interest possessed by the insured; (3) consideration in the form of a premium paid by the insured to the insurer; and (4) an agreement by the insurer to indemnify the insured for pecuniary loss to the covered property resulting from specified perils.⁸³ The court applied these four criteria to determine that Griffin's so-called "service" contracts were, in fact, *insurance* policies.⁸⁴ The *Griffin* court noted that such indemnity agreements are based on insurance principles,⁸⁵ and therefore "constitute . . . insurance polic[ies]."⁸⁶

The Florida Legislature defines insurance as "a contract whereby one undertakes to indemnify another or pay or allow a specified amount or a determinable benefit upon determinable contingencies,"⁸⁷ and an "insurance policy" as a written contract or agreement for or effecting insurance "by whatever name called."⁸⁸ The legislature has further granted the DOI authority to regulate anything that resembles insurance.

C. Classifying Service Contracts as "Warranty" or "Insurance"

As discussed in Section A above, the McCarran Act authorizes the DOI to regulate insurance contracts in Florida⁸⁹ which qualify as one of "insurance" companies. Thus, the DOI has authority to regulate warranty associations if service contracts are considered a form of *insurance*, but not if such contracts are construed as *warranties*.

81. *Griffin*, 505 N.E.2d at 1125.

82. *Id.* at 1123.

83. *Id.* at 1123-24.

84. *Id.* at 1124-25.

85. *Id.* at 1125.

86. *Griffin*, 505 N.E.2d at 1125. The *Griffin* court specifically distinguished these service contracts from attorney retainer fees, which do not involve indemnity for losses. *Id.*; see *Group Life & Health Ins. Co. v. Royal Drug Co.*, 440 U.S. 205, 211 (1979) (noting that the primary element of insurance is "the spreading and underwriting of a policyholder's risk").

87. FLA. STAT. § 624.02 (1995); see, e.g., *Cozine v. Tullo*, 394 So. 2d 115, 116 (Fla. 1981).

88. FLA. STAT. § 627.402(1) (1995).

89. See *supra* text accompanying notes 67-72.

This issue has proved to be a major topic of debate, and finds industry members, legislatures, regulators, and courts wrestling over whether service agreements should be regulated as a form of warranty, insurance, or both.

Warranties are generally regulated by a state's *commerce* department, rather than insurance department, in accordance with Article II of the Uniform Commercial Code.⁹⁰ In addition to the state codes, warranties are also subject to federal regulation under the Magnuson-Moss Warranty Act (the Magnuson Act).⁹¹ The Magnuson Act vests the Federal Trade Commission with the authority to regulate service contracts, which are defined as "contract[s] in writing to perform, over a fixed period of time or for a specified duration, services relating to the maintenance or repair (or both) of a consumer product;"⁹² and further provides for a federal cause of action for breach of a warranty.⁹³

V. DISTINGUISHING SERVICE CONTRACTS FROM WARRANTIES

Establishing a bright line distinction between insurance and warranty proves quite elusive, as many aspects of insurance and warranty overlap. This general distinction becomes even more confusing when applied specifically to warranty associations under chapter 634 of the Florida Statutes, as the terms "service contract" and "warranty" are often used interchangeably. Service contracts (as a form of insurance) may, however, be differentiated from warran-

90. Florida has adopted the UCC in chapters 670-680 of the Florida Statutes. Warranties related to sales of goods are specifically addressed in Florida Statutes §§ 672.312-.318 (1995).

91. 15 U.S.C. §§ 2301-2312 (1994). For additional analysis of the Warranty Act, see Kathleen F. Brickley, *The Magnuson-Moss Act — An Analysis of the Efficacy of Federal Warranty Regulation as a Consumer Protection Tool*, 18 SANTA CLARA L.R. 73 (1978); Arthur L. Harold, *Service Contracts, Insurance Agreements, and Tying Arrangements Under the Magnuson-Moss Warranty Act*, in WARRANTIES IN THE SALE OF GOODS 1977, at 211 (PLI Com. L. & Practice Course Handbook Series No. 169, 1977); Christopher Smith, *Service Contracts Under the Magnuson-Moss Warranty Act*, in WARRANTIES IN THE SALE OF BUSINESS EQUIPMENT & CONSUMER PRODUCTS 1985, at 185 (PLI Com. L. & Practice Course Handbook Series No. 346, 1985); Ware, *Strict Liability for Defects in Consumer Services: A Defense Approach*, 20 FOR THE DEFENSE 3 (1979).

92. 15 U.S.C. § 2301(8) (1994). The Magnuson Act also provides a definition of "warranty," which includes several elements not incorporated in "service contract." *Id.* § 2301(6).

93. *Id.* § 2310(d)(1) (1994).

ties by five essential factors: consideration, indemnity, independence from the sale, third party involvement, and scope of control.

1) *Separate Consideration*: Service contracts generally entail additional costs above and beyond the purchase price of the product, whereas warranties are generally given at no additional cost. Thus, if a consumer pays additional consideration for the service agreement beyond the purchase price of the product, the agreement will most likely be considered a service contract, rather than a warranty. The primary distinction here is consumer choice. Because a warranty is "included" in the price of the covered product, the consumer has no choice but to "purchase" the warranty with the product. A service contract, on the other hand, is offered as an option which the consumer may choose to purchase or do without. The FTC has interpreted a warranty as an agreement which "must be conveyed at the time of the sale of a consumer product and the consumer must not give any consideration beyond the purchase price of the consumer product in order to benefit from the agreement."⁹⁴ The products offered by warranty associations and regulated by chapter 634 do require consideration in *addition to* the purchase price of the good, and are therefore considered service contracts, rather than warranties.

2) *Indemnity*: The second major distinction between service contracts and product warranties is indemnity, wherein a party agrees to reimburse "another upon the occurrence of an anticipated loss."⁹⁵ Florida courts have defined insurance as "a mere contract of indemnity against contingent loss,"⁹⁶ and both the courts and the statutes have long held indemnity to be a central element of insurance.⁹⁷ Service contracts exceed the scope of warranties because they

94. 16 C.F.R. § 700.11(b) (1995) (emphasis added).

95. BLACK'S LAW DICTIONARY 529 (6th ed. 1991); see *Seaboard Coast Line R.R. v. Smith*, 359 So. 2d 427, 428 (Fla. 1978) (defining indemnity as "a collateral contract or assurance by which one person engages to secure another against an anticipated loss"); *Stuart v. Hertz Corp.*, 351 So. 2d 703, 705 (Fla. 1977) (citing 41 AM. JUR. 2D *Indemnity* § 1 (1995)) ("Indemnity has been defined as a right which inures to a person who has discharged a duty which is owed by him but which, as between himself and another, should have been discharged by the other.").

96. *Brock v. Hardie*, 154 So. 690, 697 (Fla. 1934).

97. *Id.*; see *Franklin Life Ins. Co. v. Tharpe*, 178 So. 300, 302 (Fla. 1938); *First Commerce Realty Investors v. Peninsular Title Ins. Co.*, 355 So. 2d 510, 511 (Fla. 1st Dist. Ct. App. 1978). The Insurance Code defines insurance as "a contract whereby one undertakes to *indemnify* another . . . upon determinable contingencies." FLA. STAT. § 624.02 (1995) (emphasis added). Chapter 634 defines a MVSA as "any contract or agree-

not only “warrant” against product defects themselves, but also promise to *indemnify* the holder against repair costs due to breakdown or failure of the covered product or parts. The service contract is therefore properly classified and regulated as a form of insurance under the “indemnity” test.

3) *Independence from the Sale*: The third major distinction between warranty and insurance revolves around whether the agreement is made incident to the contract of sale. A warranty is *part of* the initial sale of the covered product. It is made by the seller contemporaneously with and as a part of the sale,⁹⁸ assumes or necessarily implies the existence of a sale,⁹⁹ and cannot exist without an accompanying sale.¹⁰⁰ A service agreement, conversely, is an *independent* agreement, not considered incident to the initial contract of sale. The contract is not part of the manufacturer's or retailer's original product warranty,¹⁰¹ and may be issued completely separately from the initial sale of the covered product.¹⁰² The Florida Legislature has interpreted a warranty to be incident to the contract of sale,¹⁰³ thereby further buttressing the conclusion that service contracts are properly regulated as insurance.

An interesting question arises as to whether a service contract could be considered a “product” in and of itself, thus giving rise to additional legal remedies to consumers. To illustrate, assume a retailer sells service contracts written by an independent warranty association, the warranty association goes bankrupt, and the dealer then refuses to honor the contract. The remedies available to the

ment *indemnifying* the service agreement holder . . . against loss . . .” *Id.* § 634.011(7) (emphasis added).

98. BLACK'S LAW DICTIONARY 1095 (6th ed. 1991). A warranty is considered part of the “basis of the bargain” of the initial sale. UCC § 2-313.

99. *Whitehead v. Rizon E. Ass'n*, 425 So. 2d 627, 629 (Fla. 4th Dist. Ct. App. 1983).

100. *Marini v. Town & Country Plaza Merchants Ass'n, Inc.*, 314 So. 2d 180, 181 (Fla. 1st Dist. Ct. App. 1975).

101. APPLEMAN, *supra* note 67, § 7001; *Guaranty Warranty Corp. v. State ex rel. Humphrey*, 533 P.2d 87 (Ariz. 1975).

102. Even service contracts which are sold by the original retailer as an “option” to the initial product purchase are not actually part of the original sale, but rather an *additional* product.

103. *See, e.g.*, The Motor Vehicle Sales Warranty Act, defining motor vehicle warranties to mean “any written warranty issued by the manufacturer . . . *in connection with the sale* of a motor vehicle to a consumer . . .” FLA. STAT. § 681.102(16) (1995) (emphasis added); Florida's UCC specifies that an express warranty “relates to the goods and becomes *part of the basis of the bargain*. . . .” FLA. STAT. § 672.313(1)(a) (1995) (emphasis added).

consumer against the dealer might include recovery of the unearned premium, and perhaps a breach of contract action. Classifying the service contract as a separate *product*, however, could open additional remedies, as the consumer could now claim the dealer sold a “defective product.” This argument has not yet found its way to the courts, although it does present interesting possibilities.

4) *Third Party Issuer*: The fourth distinction between warranties and service contracts is that a warranty is issued by the *manufacturer or seller* of the covered product, whereas service agreements may be written by independent entities, without any involvement by the manufacturer. A warranty must, in fact, be made by a “supplier” of the covered product under both Florida law and the Magnuson-Moss Act.¹⁰⁴ Service contracts are not so restricted, and may be offered by suppliers as well as “nonsuppliers.”¹⁰⁵ The *Griffin* court relied upon this factor in distinguishing warranties (issued by the company which *manufactures or sells* the product)¹⁰⁶ from service agreement (issued by a third party).¹⁰⁷ Service contracts regulated under chapter 634 clearly fall into the “third party issues” category, and are thus distinguished from product warranties.

5) *Outside Control*: The fifth major distinction is the extent of the manufacturer's or retailer's *control* over the product. A warranty provides protection against defects that are within the control of the manufacturer or seller. A service contract, on the other hand, also insures against loss caused by factors unrelated to defects in the article itself and beyond the control of the manufacturer or seller.¹⁰⁸ The Florida Legislature has adopted this distinction. For example, a breach of warranty requires that the covered failure be caused by some defect in the product itself, but this requirement does not apply to chapter 634 service agreements.¹⁰⁹

The United States Supreme Court also used this factor to dis-

104. 15 U.S.C. § 2301(4) (1994).

105. 16 C.F.R. § 700.11(b) (1995).

106. *Griffin Sys., Inc. v. Washburn*, 505 N.E.2d 1121, 1124 (Ill. App. Ct. 1987) (emphasis added); see *supra* notes 76–86 and accompanying text.

107. *Griffin*, 505 N.E.2d at 1125.

108. 44 C.J.S. *Insurance* § 2b (1993).

109. See, e.g., FLA. STAT. § 634.011(7) (1995) (defining a Motor Vehicle Service Agreement, which does not require the failure to be caused by some defect in the product itself, which is required in proving cases of warranty); see also *Group Life & Health Ins. Co. v. Royal Drug. Co.*, 440 U.S. 205, 211 (1979); *infra* note 108 and accompanying text.

tinguish warranties from insurance in *Group Life & Health Insurance Co. v. Royal Drug Co.*,¹¹⁰ wherein the Court concluded “warranties promise to indemnify against defects *in the article sold*, while insurance indemnifies against loss or damage resulting from perils *outside of and unrelated to* defects in the article itself.”¹¹¹ The Florida Attorney General has concurred with this conclusion, noting “if the contractual obligation is to correct defective materials and workmanship, the instrument is a warranty, but if the contract is to correct loss or damages due to any cause, then it is a contract of insurance.”¹¹² Service agreements under chapter 634 protect against loss caused by elements beyond the manufacture of the product, and are thus properly classified as insurance.

VI. REGULATING WARRANTY ASSOCIATIONS AS “INSURANCE” UNDER CHAPTER 634

As indicated in Part V, service contracts can be distinguished from product warranties in general. But does chapter 634 specifically make such a distinction? The Florida Legislature clearly intended warranty associations to be regulated as insurance entities, as evidenced by the fact that chapter 634 was added to the state's *insurance* code,¹¹³ rather than to the commercial code which regulates product warranties.¹¹⁴ In addition, the plain language of chapter 634 clearly indicates the intent to classify warranty associations as a “type of insurance,”¹¹⁵ requiring separate insurance licensure.¹¹⁶

Under Florida law, warranty associations are considered a type

110. 440 U.S. 205 (1979).

111. *Id.* at 211 (emphasis added); see 1950 Op. Fla. Att’y Gen. 250.

112. 1957 Op. Fla. Att’y Gen. 171; see 1956 Op. Fla. Att’y Gen. 280; 1956 Op. Fla. Att’y Gen. 203; 1955 Op. Fla. Att’y Gen. 43; 1952 Op. Fla. Att’y Gen. 294; 1950 Op. Fla. Att’y Gen. 250.

113. FLA. STAT. § 624.01 (1995) designates chapters 624, 632, 634, 637, 639, 642, 648, and 651 as the “Florida Insurance Code.”

114. Express and implied warranties of sale are covered in Florida's UCC, chapter 672. Motor vehicle sales warranties are covered in the Motor Vehicle Sales Warranty Act, Florida Statutes, chapter 681.

115. For example, Part I specifies that a MVSAC may not “transact *any insurance business other than that of motor vehicle service agreement . . .* or otherwise to engage in any *other* type of insurance” FLA. STAT. § 634.231 (1995) (emphasis added).

116. *Id.* § 634.231. A company currently licensed to sell insurance (i.e., life insurance) would therefore still be required to obtain a *separate* license in order to operate as a MVSAC.

of limited purpose insurer, known as “Specialty Insurers.”¹¹⁷ As with other insurers, warranty associations are regulated by DOI and must comply with similar requirements and regulations.¹¹⁸ Both warranty associations and other insurers must, for example, obtain a certificate of authority or license;¹¹⁹ file articles of incorporation and bylaws;¹²⁰ maintain minimum capital,¹²¹ net assets,¹²² and reserve requirements;¹²³ deposit funds with DOI;¹²⁴ and file annual and quarterly financial reports.¹²⁵ In addition, DOI has authority to subject warranty associations to periodic examinations¹²⁶ and delinquency proceedings¹²⁷ in the same manner as applied to insurers, and may also suspend or revoke sales representative licenses¹²⁸ in accordance with the procedures set forth in the Insurance Field Representatives and Operations Law.¹²⁹ This consistency in the regulatory scheme clearly indicates the legislature's intent to regulate warranty associations as “insurance” in Florida.

Although Florida case law has not specifically addressed the issue of whether warranty associations are considered a warranty or insurance product, the Florida Attorney General has issued a series of opinions in this regard, distinguishing a service contract from a warranty, and further determining that a warranty is not an insurance contract.¹³⁰

VII. EWC: SHOWING THE NEED FOR WARRANTY ASSOCIATION REGULATION

The primary purpose behind chapter 634, or any such regulation of warranty associations, is to help protect consumers from

117. *Id.* § 628.4615.

118. Florida Statutes, chapter 624 sets forth the general requirements for “insurers.”

119. FLA. STAT. §§ 624.401, 634.031 (1995).

120. *Id.* § 634.061.

121. *Id.* §§ 624.407, 634.041(7).

122. *Id.* §§ 625.301 – .340, 634.011, .041, .045, .081(5), .301, .308, .3077, .401, .404, .406, .4065.

123. FLA. STAT. §§ 625.051, 634.041(8) (1995).

124. *Id.* §§ 624.411, 634.052.

125. *Id.* §§ 624.424, 634.041.

126. *Id.* §§ 624.444, 634.141, .314, .416.

127. *Id.* § 634.253.

128. FLA. STAT. §§ 634.081, .095, .320, .321, .422, .423, 626.611, .621 (1995).

129. *Id.* §§ 626.011–.99 (licensing procedures), .621, .641, .651, 634.309, .424.

130. *See supra* note 112.

getting stuck with worthless service contracts, by imposing requirements to help ensure that the warranty associations will remain in existence. The need for such protection was clearly illustrated by the case involving EWC Electronics, Inc. (“EWC”).¹³¹ The EWC fiasco represents not only the leading case which DOI has pursued under chapter 634, but also perhaps the most significant warranty association failure in the country, and therefore warrants further discussion.

EWC sold service agreements covering a vast array of consumer electronics and appliances,¹³² and fast became one of the nation's largest service contract providers. EWC captured its tremendous foothold in the market primarily by using two unsavory tactics: (1) “wholesaling” its service contracts,¹³³ and (2) predatory pricing (selling its service agreements to retailers at extremely low prices).¹³⁴ This unrealistically low pricing tactic can enable a firm such as EWC to gain strong initial market penetration, but generates insufficient revenues to fund repairs for inevitable product failures, thus proving economically unfeasible in the long-run. The end result is that consumers and/or retailers are not reimbursed for their covered losses and are left with worthless service contracts. Predatory pricing also has the negative effect of driving legitimate service warranty providers, unable to compete with such unrealistically low prices, out of business.

Economic reality eventually caught up with EWC, as its unrealistically low prices proved insufficient to fund the inevitable reimbursement claims for warranted product failures. As dealers and repair facilities sought reimbursement for repair charges, EWC began denying reimbursement and renegeing on its contractual obligations. EWC's failure to reimburse its dealers became so rampant, in fact, that the National Electronics Service Dealers Association issued a “Special Member Alert” in February, 1991 entitled, “NO-

131. *EWC Elecs. of Florida, Inc. v. Department of Ins.*, No. 91-2037 (Fla. 1st Dist. Ct. App. 1991).

132. Such agreements are governed under Part III (“Service Associations” of chapter 634).

133. *See supra* text accompanying note 24.

134. The average EWC service contracts was sold by EWC to its service contracts to its distributors for \$30, who then sold it to the retailer for \$40, who then retailed it to consumers at \$100–\$500. Matthes, *supra* note 6.

TICE: Use Caution With EWC.”¹³⁵

The Florida DOI became involved when an October 1990 audit of EWC Electronics of Florida, Inc. (“EWCF”), a wholly-owned subsidiary of EWC, revealed many chapter 634 violations, including findings that EWCF failed to maintain a proper warranty register¹³⁶ and sufficient net assets to comply with its ratio requirements;¹³⁷ and also failed to include in its 1990 Annual Report sufficient information on premiums received.¹³⁸ In addition, EWCF had registered over 85,000 service contracts at a sales price of only one dollar, or even zero dollars.¹³⁹

Prompted by its further finding that EWCF had liquidated its unearned premium reserves, DOI suspended EWCF's license in June of 1991, and then sought and received an Immediate Final Order to suspend the license permanently.¹⁴⁰ By the time DOI took action, however, the damage had already been done. EWCF left over 290,000 outstanding service contracts in Florida, for which Florida residents paid over \$100 million.¹⁴¹ In July, 1991 EWC filed for bankruptcy¹⁴² and subsequently folded, leaving nearly a million worthless service contracts outstanding with debts totalling over \$60 million.¹⁴³

EWC is perhaps the most vivid example of warranty association

135. Wallace Harrison, *Service Dealers Who Trusted EWC Get Screwed Twice*, PROFESSIONAL ELECTRONICS, May/June 1992, at 4 [hereinafter, Harrison]. The article specifically advised service providers to “be especially cautious in dealing with EWC, due to their current delay in service reimbursements and inadequate response to inquires for information on their financial solvency.”

136. Immediate Final Order, Tom Gallagher, Commissioner, DOI, June 21, 1991, Case No. 91-L-331BP, at 2, 3 (para. 7, 10) [hereinafter IFO].

137. *Id.* at para. 13. Florida Statutes § 634.406(4) requires the SWA to maintain a ratio of gross written premium to net assets of 5:1. A cash infusion of \$1.4 million was needed to bring EWCF to compliance. IFO, *supra* note 136, at para. 13.

138. *Id.* at para. 15. The DOI was therefore unable to ascertain whether the financial requirements set forth in FLA. STAT. § 634.406 had been satisfied, in accordance with § 634.425(1).

139. IFO, *supra* note 136, at para. 8.

140. *Id.* The IFO was issued June 21, 1991.

141. EWCF received \$25–\$30 million in premiums for these service contracts.

142. The actual bankruptcy was filed by EWC's parent company, EWC Electronics, Inc. [EWCI], an Oklahoma corporation. Mr. Baird Trice was President and 100% stockholder of EWCI.

143. Harrison, *supra* note 135. By July 1991, over 1,500 service companies and 300 consumers had claims against EWC. In Total, EWC took in \$25–30 million, retailers sold over \$100 million in EWC service contracts, and EWC's distributors took in \$10 million. *Id.*

failure, but is certainly not the only case. ComponentGuard, a New York marketer of extended service plans on a variety of consumer products, filed chapter 11 in May 1992;¹⁴⁴ Autotech Services went bankrupt in 1988, leaving thousands of customers stuck with worthless contracts;¹⁴⁵ American National Warranty (ANW) declared bankruptcy in 1988, cancelling over 33,000 customer contracts;¹⁴⁶ and United Dealer Groups, which sold "Carlife" contracts through 1,300 dealers in thirty-nine states, went bankrupt in 1981, leaving approximately 40,000 worthless service contracts.¹⁴⁷

The case of EWC, further buttressed by these other examples, shows the need for statutory regulation of warranty associations. EWC's tactics amounted to outright and deliberate fraud. A warranty association that artificially "lowballs" its service contract prices as EWC did is destined to fail. However, the company can hide this fact from the public, keeping its cash income flowing by selling more and more service contracts, which it never plans to honor. As Elise Matthes, a DOJ attorney who worked on the EWCF litigation, observed, "We have had several warranty companies fail. We will have more. Stronger legislation is needed and it doesn't get passed. We can educate the consumer or we can continue to let them get ripped off while criminals siphon hundreds of millions of dollars from this state."¹⁴⁸

VIII. ANALYSIS: THE NEED FOR AND BENEFITS OF REGULATION

A primary consideration when analyzing chapter 634, or any such regulatory scheme, is whether such government regulation is in fact really needed. Such an analysis should take into account where the free market has failed, the general goals and objectives of the regulation, and whether the regulation accomplishes these goals.

144. Wallace Harrison, *ComponentGuard Files chapter 11 Bankruptcy*, PROFESSIONAL ELECTRONICS, May/June 1992, at 11-14.

145. Light, *supra* note 12, at 148.

146. Smith, *supra* note 26. The Texas State Board of Insurance shut down ANW for the unlawful selling of insurance without a license, ruling that ANW was not selling a service contract, but an insurance policy. *Id.*

147. CONSUMER REPORTS, *supra* note 13, at 663, 666.

148. Matthes, *supra* note 6, at 5-6. Much of EWC's funds were siphoned off to banks in the Cayman Islands. *Id.* at 4.

The goals and benefits of regulation must then be weighed against its costs and disadvantages, and against the costs of non-regulation, to determine whether or not the regulatory scheme is economically and socially justified.

A. Overall Goals of Regulating Warranty Associations

The underlying policy behind insurance regulation in general is to protect the public from surrendering its money for questionable or worthless "insurance policies."¹⁴⁹ This general goal applies equally to the specific regulation of warranty associations. Insurance policies, including service contracts, represent a promise to perform in the future, rather than a "current," tangible product or service, and therefore require specific attention.¹⁵⁰ The selling of service contracts presents tremendous opportunities for abuse and fraud, and the vague language employed in service contracts further increases the opportunity for claim denial.¹⁵¹ The overall decline of consumer confidence in the quality of products, combined with the reduced scope of warranty coverage offered by manufacturers, increasing repair costs, increased awareness and prevalence of the service contract concept,¹⁵² and increased marketing and sales efforts to sell service contracts have all resulted in increasing consumer pressure to purchase service contracts.¹⁵³ Obtaining a service contract covering a car or computer is not perceived as a "necessity" such as medical or life insurance; still, the tremendous quantity and prominence of service contracts in today's economy heightens the need for

149. See generally APPLEMAN, *supra* note 67, at § 8632; ROBERT E. KEETON, BASIC TEXT ON INSURANCE LAW § 8.2(a), at 543-45 (1971); Jan Hellner, *The Scope of Insurance Regulation: What is Insurance for Purposes of Regulation?*, 12 AM. J. COMP. L. 494 (1963); Spencer L. Kimball, *The Purpose of Insurance Regulation: A Preliminary Inquiry in the Theory of Insurance Law*, 45 MINN. L. REV. 471, 480-81 (1961).

150. See Jean Braucher, *An Informal Resolution Model of Consumer Product Warranty Law*, 1985 WIS. L. REV. 1405, 1405.

151. EWC, for example, routinely denied service repair claims. See *supra* notes 131-38; see also *Repair Insurance Is Seen as Option Offered by GM*, WALL ST. J., Jan. 31, 1979, at 2, col. 2.

152. Many mail-order companies such as Sharper Image, Damark, and DAK now sell extended warranty plans; credit card companies may offer an extended warranty on products purchased with their credit card; and even local telephone companies now offer "line repair" plans.

153. See *supra* text accompanying notes 13-17, 20.

regulation.¹⁵⁴

B. Market Failures: Types of Harm Which Regulation May Prevent

The underlying objective of warranty association regulation is to prevent, or at least to lower the likelihood of, several different types of harm, including:

1. *Warranty Association Insolvency* — The primary purpose behind regulation is to reduce the likelihood that a warranty association will fail and leave its customers holding worthless service contracts. This scenario was painfully evidenced by millions of Americans, including several hundred thousand Floridians, when EWC went out of business.¹⁵⁵ State regulation attempts to prevent such harm by establishing financial stability requirements to help ensure that warranty associations will be able to meet their future obligations.

2. *Ensure Adequate Funds to Pay Claims* — In the event the warranty association does fail, the secondary objective of regulation is to lessen the negative impact of the company's failure. Deposits, reserves, and independent insurance coverage may be required in order to compensate the service contract holders for their covered repair claims. Service contracts represent a promise for future performance, and warranty associations must maintain adequate funds “[t]o assure the faithful performance of [their] obligations.”¹⁵⁶

Assuring performance of future obligations is an underlying policy behind regulation of property and casualty insurers (“P&Cs”). Critics of regulation, such as chapter 634, would argue that service contract providers should not be subject to the same requirements as P&Cs because the potential liability is much less. Admittedly, the *individual* claims will generally be lower for a warranty association than for a P&C, as the cost to repair a car or a stereo is far less than to replace a house or a heart. However, a warranty association's

154. See JON S. HANSON, NATIONAL ASS'N OF INS. COMM'RS, MONITORING COMPETITION: A MEANS OF REGULATING THE PROPERTY AND LIABILITY INSURANCE BUSINESS, 93, 95-96 (1974).

155. See *supra* text accompanying notes 131-38.

156. FLA. STAT. § 634.052(1) (1995). MVSACs must deposit \$200,000 with DOI. SWAs must deposit \$50,000 if a warrantor or \$100,000 if a warranty sellers. *Id.* § 634.405(1), (5).

total claim liability may be even greater than a P&C's, due to the sheer quantity of service contracts outstanding and the frequency of repair and replacement. The likelihood of a car or stereo breaking down, for example, is far greater than a house being struck by a tornado or destroyed by fire; and the frequency of repeat occurrences increases exponentially. To-wit: it is not uncommon for a car or copy machine to break down repeatedly, but it's extremely unlikely that a house would be struck twice by a tornado.

3. *Provide Missing Information* — Another need for regulation of warranty associations is to help compensate for the lack of information available to consumers under the free market. The public generally has very little access to information about service contracts or warranty associations. Even when available, the cost and effort of obtaining such information is not economically feasible, nor is such data readily interpreted by most people. In addition, actuarial studies, which are common in P&C insurance, do not even exist for most service contract goods due to the virtually endless variety of different products, manufacturers, and models. Constantly changing technology and frequent model replacement of consumer goods further contribute to the lack of data. By the time data on the expected useful life and repair frequency of a product can be assembled and disseminated, that item may already be outdated and replaced with newer models. Without such adequate information on the risk of product breakdown or on the warranty association itself, the consumer cannot place an accurate value on the service contract.¹⁵⁷ State regulation helps to compensate for this information gap by assuring that a warranty association meets at least minimal financial standards.

4. *Protect Retailers and Service Repair Facilities* — When a warranty association fails, it harms not only the consumers who purchased contracts, but also the dealers and repair facilities who are owed reimbursement from the warranty association. Dealers and repair facilities usually receive reimbursement for their repair charges directly from the warranty association. When the warranty association goes out of business, it obviously leaves many indepen-

157. In addition, the cost, quality, and coverage of the service contract may vary from policy to policy and from seller to seller, leaving the consumer even further confused.

dent businesses with uncollected bills.¹⁵⁸ In fact, the economic harm falls far more on the dealer than the consumer. While an individual consumer may lose the cost of his service contract, the dealer may have dozens, perhaps hundreds, of outstanding repair bills, and therefore take a much greater “hit” than any one consumer. Note that under chapter 634, a retailer who sells service contracts of an independent warranty association is *not* held liable to the consumer if the warranty association goes bankrupt, and is not required to honor the contract or even refund the purchase price of the contract.¹⁵⁹ However, the dealer may have already undertaken or subcontracted for many repairs before he learns of the warranty association's failure. Also, many retailers may continue to honor the service contracts, regardless of the lack of legal obligation to do so, in order to maintain customer goodwill and return purchases. The warranty association's loss is thus shifted to the retailer, who ends up “eating” the cost of repair without being reimbursed.

5. *Protect the Industry* — The harm of a warranty association's failure is felt by the entire industry through lost sales. When a customer gets “burned” by a worthless service contract, he is far less likely to purchase another service agreement — for that same item or for *any* product. Lower consumer confidence in service contract providers decreases the overall demand of their product, thereby resulting in lost sales throughout the entire economic chain of distribution, including warranty associations, distributors, retailers, and service facilities. The industry is further harmed when a warranty association's unsavory tactics drive honest, legitimate companies out of business. EWC's predatory pricing, for example, forced many legitimate warranty associations, who were unable to compete against EWC's unrealistically low prices, out of business.

6. *Other Benefits of Regulation* — State regulation may also provide for rate control, which can serve to keep dealer profits reasonable and consumer prices affordable. Rate control also provides the regulatory agency with accurate gross written premium figures for the service contract provider and seller. Without such rate control, the warranty association or retailer could claim it simply “gave”

158. When EWC folded, it left over 1,500 service repair facilities with several hundred thousand outstanding claims. *See supra* text accompanying notes 140–41.

159. The retailer is, however, required to reimburse the consumer for any *unearned* premium (commission) remaining on the contract.

the service contract for free or for one dollar with the product purchase (as EWC regularly did).¹⁶⁰ Additional benefits of state regulation include quicker resolution of consumer complaints through local administration and supervision, and dispersion of a threat of federal regulation.

Several factors contribute to the need for strong protection specifically in Florida: the sheer number of people in Florida (the third most populated state); the constantly increasing population growth in the state; the large number (in both quantity and percentage) of elderly residents, who are not only most likely to purchase insurance products, but also the easiest “marks” for salespeople; and the heavy incidence of fraud and scams occurring in the state. Florida's tough chapter 634 has helped to keep out many questionable warranty associations from entering the Florida market, particularly those who lack the financial stability or who do not wish to disclose their officers' personal background.¹⁶¹

IX. ANALYSIS: COSTS AND CRITICISMS OF REGULATION

Imposing regulations over the warranty association industry provides many benefits, as discussed above. These benefits must, however, be weighed against the disadvantages of state regulation — primarily its restriction on the free market and the costs incurred by such government involvement. The primary criticisms of such regulation, especially chapter 634, include:

1. *Increased Costs* — Complying with regulatory requirements imposes additional costs upon warranty associations, who must raise capital to meet their deposit and reserve obligations, prepare and file quarterly statements, etc. These costs are ultimately passed on to the consumers in the form of higher service contract prices.

2. *Barriers to Entry* — The strict requirements set forth by chapter 634 may prevent certain companies, especially smaller firms who cannot meet these financial requirements, from entering the Florida market. This decrease in competition leads to a smaller,

160. See *supra* text accompanying note 139.

161. Spikes, *supra* note 56. DOI will recommend denial of license if the warranty association's officers or directors have felony convictions or judgments against them. These strict standards of chapter 634 have saved many Florida residents from being harmed by ComponentGuard's failure because the DOI denied ComponentGuard's application to enter the Florida market. See *supra* text accompanying note 143.

more concentrated market pool of large companies. As a result, consumer choice of suppliers is limited. In addition, an oligopolistic market may develop, thereby leading to decreased price competition and ultimately resulting in higher consumer prices.

3. *Increased State Burden* — Regulating warranty associations under the insurance code increases the burden on an already understaffed state insurance department, thus diminishing the state's capacity to regulate other, more essential "necessities" such as health and life insurance. This burden is particularly felt in Florida, as chapter 634 further increases the complexity of an already confused Insurance Code which now encompasses eighteen chapters and nearly 600 pages.¹⁶²

4. *Additional State Costs* — Additional state regulation requires more government employees and resources. The result is an increase in state costs, which is ultimately passed on to the public in the form of higher taxes, a diminished level of government services, or both.¹⁶³

5. *Ineffective* — State regulation such as chapter 634 is often ineffective and fails to accomplish its primary goal. This is evidenced by the number of warranty associations which have gone bankrupt (most notably EWC) and the lack of adequate funds available to reimburse the insured customers despite state regulations.¹⁶⁴ In addition, because the retailer is not held liable if the warranty association fails,¹⁶⁵ the consumer can still end up getting stuck with a worthless service contract despite all of chapter 634's precautions.

6. *Inadequate Disclosure* — Another criticism of chapter 634 is that it should impose stricter disclosure requirements upon service contracts and their sellers. For example, items covered by the service contract may *already* be included in the manufacturer's warranty, or may even be required by law. The consumer, with limited access to such knowledge, thus pays for such unnecessary "coverage."

162. See *supra* note 113.

163. As of 1992, state insurance departments collectively employed over 8,300 people, and spent \$450 million each year to regulate insurers. Fred Perlmutter & Frank Russo, *Regulating at a Snail's Pace*, BEST'S REVIEW, Dec. 1992, at 24. These numbers have undoubtedly increased since 1992.

164. See KEETON, *supra* note 149, § 8.4(b).

165. See *supra* text accompanying note 158.

X. CONCLUSION AND RECOMMENDATION

A. CONCLUSION: Warranty Associations Are “Insurance”

Service contracts, and the warranty associations which provide such contracts, are properly classified and regulated as “insurance” under chapter 634. Service contracts do in some ways resemble a type of warranty, but are clearly differentiated from product warranties and more properly fit the *economic* definition of insurance. They provide the means for a consumer to pay a current, certain price to protect against the risk of a future, unknown cost; and the cost of such risks is spread out among all the contract holders.

Service contracts also fit the *legal* definition of insurance, as they contain all the fundamental legal elements of insurance: indemnity, separate consideration, independence from the purchase of the product, third-party involvement, and coverage extending beyond the control of the manufacturer. The Florida Legislature clearly contemplated warranty associations to be regulated as insurers: chapter 634 was added to the state's Insurance Code, under the control of the Department of Insurance, with requirements and regulation closely paralleling those of insurance companies. Florida's Attorney General and numerous courts including the United States Supreme Court have interpreted service agreements to constitute a form of insurance. Florida's DOI does, therefore, have clear authority to regulate service contracts and warranty associations as a form of “insurance” under chapter 634.

B. RECOMMENDATION: Increased Retailer Liability

Warranty association regulation properly falls within the realm of a state's insurance department. Although this holds true from a legal standpoint, it may not necessarily be the most economically efficient way to reach the objective of protecting the public. Rather than increasing the burden upon warranty associations, a more effective solution would be to impose increased responsibility upon the *retailers* of the service contracts.

Retailers make a substantial profit from selling service contracts, and may sell thousands of contracts every year. The retailer therefore has a far greater incentive than the consumer, who may only purchase a few service contracts over a lifetime, to investigate the service contract provider and be assured of its financial stability.

The retailer also has ready access to far more information than the consumer about the risks and value of a service contract and its underwriter. Despite the tremendous vested interest a retailer has in the warranty association, the retailer is not held liable to the consumer if the warranty association fails.¹⁶⁶ If, however, retailers are held ultimately responsible for the “products” (*i.e.*, the service contracts) they sell, they will demand greater assurance of future performance by their suppliers, the warranty associations. The ultimate purpose of warranty association regulation is to ensure that consumers will be able to realize the benefit of their bargain when a repair is eventually needed. Holding the retailers responsible for the products they sell could accomplish this goal more effectively than increasing Insurance Code regulations upon warranty associations.

166. *See supra* text accompanying note 159.