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Pennsylvania's regulation of service contracts – Two significant developments

By Michael F. Consedine

SUMMARY

With the recent passage of a new Pennsylvania law and an unreported but important appellate decision, the regulation of service contracts in Pennsylvania and their treatment in insurance company insolvencies has become a little clearer in Pennsylvania – a state where there had previously been a number of questions related to service contract regulation.

Introduction

With the recent passage of a new Pennsylvania law and an unreported but important appellate decision, the regulation of service contracts in the Commonwealth and their treatment in insurance company insolvencies has become a little clearer. On October 7, 2010, Pennsylvania Governor Edward Rendell signed H.B. 1774 into law (the "Act"). The Act generally excludes "service contracts" from regulation as insurance. Unlike a number of other states, however, the Act does not set up a separate regulatory scheme for service contracts. In a separate but related development, on September 27, 2010 the Pennsylvania Commonwealth Court, an appellate level court, issued a memorandum opinion reversing a Notice of Determination arising out of the Reliance Insurance Company liquidation where the Liquidator had classified claims arising under an insurance policy covering service contracts risks as "reinsurance" and therefore assigned them general creditor status. The Commonwealth Court held that the Reliance-issued policies on their face were contracts of insurance and therefore any resulting claims should be afforded a higher priority of recovery as "policies for losses."

A. H.B. 1774 – Service Contracts Excluded from Regulation as Insurance

Pennsylvania has long posed somewhat of a legal quandary for issuers of service contracts and warranty products over whether such products might be regulated as insurance for two reasons. First, Pennsylvania does not have a statutory definition of insurance, but instead relies on a common law approach involving weighing various subjective criteria. Second, until last week, unlike a majority of other states, Pennsylvania had not implemented any statutory schemes specific to the regulation of service contracts and warranties.

Historically, the Pennsylvania Insurance Department ("PID") generally advised the service contract industry, by way of informal guidance letters, that warranties or service contracts, especially

those issued by the product manufacturers or sellers, covering manufacturing defects, poor workmanship, or improper service or installation were not insurance because they did not cover "fortuitous events" – one of the important common law elements of insurance in Pennsylvania. To the extent, however, a warranty or service contract, in particular those issued by third parties (i.e., not the manufacturer or seller), extended to outside perils, "acts of God," and other events over which neither the contract issuer nor the contractholder has control, then the PID warned that the "fortuitous event" criteria might be triggered and the product might qualify as insurance depending on the application of the other common law insurance elements. This approach resulted in a significant degree of uncertainty in the service contract and insurance industries and left companies grappling with the prospect of filing their products for formal PID review or marketing and selling potentially illegal insurance contracts.

With the passage of H.B. 1774 (the "Act") on October 7, 2010, some of the uncertainty regarding the regulation of service contracts in Pennsylvania has been resolved. Rather than regulating service contracts, the Act simply exempts the marketing, sale and administration of "service contracts" from regulation as insurance. The Act defines "service contract" as:

A contract or an agreement for a separately stated consideration for a specific duration to perform the service, repair, replacement or maintenance of property or indemnification for service, repair, replacement or maintenance, for the operational or structural failure due to a defect in materials, workmanship or normal wear and tear with or without additional provisions for incidental payment of indemnity under limited circumstances, including, but not limited to, towing, rental and emergency road service.

The definition then carves-out certain insurance company backed services as well as auto club coverages:

Service contracts may provide for the service, repair, replacement or maintenance of property for damage resulting from power surges or accidental damage from handling, provided however, that an insurance company providing coverage or payment for towing, rental, emergency road service or mechanical breakdown insurance shall not be considered to be providing a service contract; and further provided that automobile club coverage or payment of towing, rental or emergency road service shall not be considered a service contract and shall not be regulated as insurance.

While not a model of clarity, this language appears to provide that insurance company coverages for towing, roadside service, etc. (which are often included as benefits under the auto policy) will continue to be regulated as insurance, even if these services are offered on a stand-alone basis. Conversely, auto club coverages covering the same services will not be regulated as either insurance or service contracts.

The Act, while providing some clarity on the regulation of service contracts in Pennsylvania, still leaves unanswered questions. First, the Act does not follow the National Association of Insurance Commissioner's Model Service Contract Act ("Model Act") in establishing a separate regulatory framework for the marketing and sale of service contracts. The Act simply exempts service contracts from regulation as insurance, leaving still in question how such products will be regulated in Pennsylvania, if at all, and what agency, if any, has jurisdiction over the sale of such products. Second, the Act does not contain any guidance to service contract providers on how such products should be written and designed. For example, the Model Act prohibits service contract providers from using any terminology suggesting that the contract is one of insurance. The Act contains no such restrictions giving rise to the possibility of unscrupulous practices. Finally, the Act appears to put insurance companies offering free-standing services, such as emergency roadside assistance, at a disadvantage because these insurer-backed products appear not to get the benefit of the exemption.

The Act does not require the PID to promulgate regulations, although the PID may still decide to issue regulations or provide additional clarification through informal guidance. Any regulations or guidance, however, is limited to the substance of the Act and the PID may not impose requirements beyond those set forth in the law.

B. Treatment of Service Contracts in Insurance Company Liquidations

In an interesting but unreported memorandum opinion by President Judge Leadbetter of the Commonwealth Court of Pennsylvania, the court overturned the Liquidator's classification of claims arising out of Reliance Insurance Company (in Liquidation) issued policies covering service contract risks. See Robert L. Pratter v. Reliance Insurance Company; In Re: Objection of Warrantech Consumer Products Services, Inc., No. 269 M.D. 2001 (Pa. Cmwlth.

September 27, 2010) (Opinion Not Reported).

Warrantech, and a number of related companies, designed, marketed and administered an array of service agreements for automobiles, electronics, home appliances and other items, which often supplemented or extended the manufacturer's warranty. Beginning in 1999, Warrantech purchased two types of insurance policies from Reliance under which Reliance agreed to reimburse Warrantech or, in the event of Warrantech's default, the service contractholder for amounts paid under the Warrantech issued service contracts. After Reliance was placed into liquidation in 2001, Warrantech filed proofs of claims under the policies seeking priority level (b), i.e., policyholder claimant status.

The Liquidator issued a Notice of Determination ("NOD") assigning the claims a priority level (e), general creditor status, virtually assuring that Warrantech would receive little, if any, payment from the Reliance estate. In defense of its classification, the Liquidator argued that the service contracts themselves had the attributes of an insurance policy and therefore Reliance's obligations were more in the nature of reinsurance and not insurance. The matter was assigned to a referee who issued a Report and Recommendation in favor of the Liquidator. The Referee concluded that "class (b) priority should be for claims under policies that 'compensate individuals for losses that stem from the chance occurrences of life and do not compensate businesses for the calculated commercial risk covered by reinsurance agreements'." Warrantech appealed the Referee's decision to the Commonwealth Court.

In an issue of first impression, the Commonwealth Court reversed the Referee's decision and found in favor of Warrantech. The court held that the Reliance policies on their face were clearly policies of insurance and not reinsurance. It observed that while Warrantech's service contracts had some of the qualities of insurance under Pennsylvania's common law definition, "the same could be said of any form of contractual warranty or indemnification, and to hold that all such contracts should be treated as policies of insurance for purposes of the Act would be an absurd result." The court also rejected the Liquidator's argument that the Reliance contracts could not be treated as insurance because they lacked the common law element of fortuity since they covered liability assumed under a contract. The court held that "fortuity, however, is equally attendant to a contract of reinsurance as to a contract of insurance, and thus provides no genuine basis for distinguishing between the two." Ultimately the court concluded as follows:

[T]he policies at issue here are not only labeled, structured and regulated as insurance policies but functioned as insurance policies, covering losses incurred if and when liability arose under the warranty/service contracts. If the policies at issue here are not considered insurance "policies for losses," then it is difficult to see why all claims under policies covering the risk of commercial or contractual loss would not similarly be excluded from priority level (b).

The Commonwealth Court's opinion reverses what could have been a potentially dangerous precedent in which a Pennsylvania liquidator could recharacterize contracts that on their face appear to be policies of insurance and were previously regulated as such as something else, thus impacting potential recovery in a liquidation. As the court noted, the Liquidator's logic could have been extended to other types of commercial or contractual exposures that are covered under an insurance policy. Additionally, the passage of the Act should further minimize a Pennsylvania liquidator from taking a similar position in the future because service contracts are now clearly classified as not insurance.

Conclusion

Issuers of service contracts in Pennsylvania now have a better understanding of the regulatory landscape governing such products. As noted, however, significant questions still remain because the Act does not create a new regulatory framework; it simply removes such products from regulation as insurance. It is still unclear what regulations may be used to fill that legal vacuum. We will continue to monitor changes in this area and report further on any material developments.

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