STATE OF KANSAS

Office of the Attorney General

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Attorney General

February 14, 1978

ATTORNEY GENERAL OPINION NO. 78-68

Mr. Ron Todd
Assistant Commissioner
Kansas Insurance Department
1st Floor - State Office Building
Topeka, Kansas 66612

Re: Insurance--Motor Vehicles Service Contracts--Third-Party Lenders

Synopsis: A motor vehicle service contract, offered by a third-party lender to its debtor respecting a motor vehicle purchased with financing provided by such third-party lender, constitutes a contract of insurance subject to the Kansas insurance code.

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Dear Mr. Todd:

You advise that a question has arisen concerning the operation of a program proposed to be offered in Kansas by Consumer Protection Plan Insurance Agency, Inc., and regarding, particularly, whether the offering of an automobile service agreement plan by lending institutions to their motor vehicle loan customers constitutes the business of insurance.

Under the proposed plan, a lending institution would offer for sale to its customer a service agreement, providing for the repair of the motor vehicle, within the scope of the agreement, for a fixed annual cost. For example, under one agreement applicable to used vehicles, the lending institution, as vendor of the agreement, agrees to furnish repairs to the engine, transmission, rear axle assembly and differential, drive shaft and universal joints, brakes and water pump, for a period of one year or 12,000 miles.

Until the expiration of that period, the lending institution would provide repairs to the covered parts of the vehicle at no charge to the customer for parts and labor, save for a deductible charge, *e.g.*, $25, for each instance of repair under the plan. A separate plan, applicable to new vehicles, would cover a period of 5 years, or 50,000 miles, covering the parts described above, and in addition, the front suspension, steering, air-conditioning, electrical system, and substitute transportation, again with a deductible provision.

Consumer Protection Plan Insurance Agency, Inc., hereinafter referred to as Agency, proposes to offer this agreement through motor vehicle dealers, who would offer the agreement to their customers. With this much of the plan, no question is raised here. However, Agency also proposes that the plans be offered for sale by lending institutions to credit customers on motor vehicle loans.

In Opinion No. 76-372, this office considered the question whether the offering of a motor vehicle service contract, not dissimilar to that described above, directly by the motor vehicle dealer to the purchaser constituted a contract of insurance. We concluded that it did not.

In doing so, we relied in important part on *State ex rel. Londerholm v. Anderson*, 195 Kan. 649, 408 P.2d 864 (1965), in which the state challenged the operation of a pre-need burial plan on several grounds, among them that a so-called family protection provision in the purchase contract constituted a contract of insurance. Under this provision, the seller agreed that if the purchaser died during the life of the contract and before the full balance was paid, the balance due would be cancelled, and the seller would provide the services or goods due under the contract, provided a minimum portion of the total balance had been paid, and certain other conditions were satisfied. The court observed thus:

> "While the definition of insurance must perforce be a very broad one, it does not necessarily follow that every contract which contains some technical element of indemnity or insurance is an insurance contract for the purpose of state regulation.
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> In 44 C.J.S., Insurance, § 59, at page 528, we find this:
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> 'Whether a company is engaged in the insurance business depends . . . on the character of the business that it transacts . . .

> and whether the assumption of a risk, or some other matter to which it is related, is the principal object and purpose of the business.'
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> In *Jordan v. Group Health Ass'n*, 107 F.2d 239, the court in considering whether a group health association was conducting an insurance business said this:
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> 'That an incidental element of risk distribution or assumption may be present should not outweigh all other factors. If attention is focused only on that feature, the line between insurance or indemnity and other types of legal arrangement and economic function becomes faint, if not extinct. This is especially true when the contract is for the sale of goods or services on contingency. *But obviously it is not the purpose of the insurance statutes to regulate all arrangements for assumption or distribution of risk. That view would cause them to engulf practically all contracts, particularly* conditional sales and *contingent service agreements.* The fallacy is in looking only at the risk element, to the exclusion of all others present or their subordination to it. *The question turns, not on whether risk is involved or assumed, but on whether that or something else to which it is related in the particular plan is its principal object and purpose. . . .* "Care must be taken to distinguish mere contracts to render service on the happening of a contingency from true contracts of insurance. . . . The cases have failed to declare a satisfactory rule for distinguishing between the two types of agreements, but it would seem that the contract should not be classed as insurance if the paramount purpose in its formation was to be the rendition of the services rendered. . . . However, it should be insurance if the chief purpose of the agreement is the protection against the risk involved. . . ."'" [Emphasis supplied.]

Applying this analysis to the facts before it, the court concluded thus:

> "Upon the facts presented in this record we think the principal object and purpose of the business of defendants is basically that of selling cemetery lots, burial vaults and markers, and not that of assumption of risks; the latter being merely incidental to the former, or as the parties themselves put it, a 'sales gimmick' or an inducement to the potential customer to buy the merchandise." 195 Kan. at 663.

In addition, we cited a number of cases which dealt primarily with the distinction between warranty and a contract of insurance, a question which is not in issue here.

Thus, we concluded that the "principal object and purpose" of the motor vehicle dealer was not the assumption of risk, but the sale of motor vehicles, and that the service agreement was merely an attractive commercial merchandising device which carried an implicit representation by the dealer of the soundness of the vehicle through the dealer's apparent willingness to "stand behind" the vehicle, and to assume, for a given sum, the risks of certain mechanical failures.

The question arises whether that same agreement becomes an insurance contract when it is offered by the lending institution itself which is extending credit for the purchase of the vehicle to be covered thereby. Acting pursuant to the Magnuson-Moss Warranty--Federal Trade Commission Improvement Act, 15 U.S.C. §§ 2301 *et seq.*, the Commission has adopted a rule requiring that in all indirect loans, *i.e.*, installment sales contracts which are initiated by a seller and negotiated to a lender, and many direct purchase money loans contain a notice to the consumer thus:

> "Any holder of this consumer credit contract is subject to all claims and defenses which the debtor could assert against the seller of goods or services obtained pursuant hereto or with the proceeds hereof. Recovery hereunder by the debtor shall not exceed amounts paid by the debtor hereunder."

Thus, the purchaser is permitted to raise against the third-party financer sale-related defenses regarding the product which the purchaser could have asserted against the dealer. As a result, it is argued that the lender has exactly the same commercial interest in offering the service agreement to its credit customers that the dealer has in offering the agreement to its purchasers, because the lender has the same commercial interest in assuring that warranties and representations regarding the product are satisfied. By offering the agreement covering a vehicle purchased by a buyer through credit extended by the lender, the lender seeks to assure that the purchaser will not default due to mechanical failure of the vehicle, frustration with a dealer's inability or unwillingness to repair the vehicle, or the likelihood that the purchaser will face repair costs which are so disproportionate to the outstanding balance on the loan that the purchaser merely abandons the vehicle to the lender. And to the extent that the service agreement program is presented and merchandised as an attractive and sound proposition, it also becomes an inducement to prospective customers to utilize the services of a particular lender rather than those of another.

We are concerned here with a service agreement proposed to be issued by a lending institution which has made a loan to a party for the purchase of a vehicle from a dealer or other party, referred to herein as a third-party lender. In the case of a new vehicle, *e.g.*, the seller of the vehicle, or its manufacturer, is under an affirmative obligation to the purchaser to honor the warranty accompanying the vehicle. The third-party lender is under no such obligation. As a result of modification of the holder-in-due-course doctrine, the lending institution which purchases a promissory note from a dealer, received by that dealer from the purchaser of a vehicle, has some commercial self-interest in encouraging the seller to honor its warranty obligations, or to assure otherwise that the purchaser's complaints regarding the vehicle are attended to with sufficient diligence that the purchaser lacks valid grounds to assert as a defense for nonpayment against the holder of the note. It is suggested that a proposed rule of the Federal Trade Commission will place all third-party lenders in precisely that same position, *i.e.*, will permit the purchaser of the vehicle, *e.g.*, to assert against the third party lender all defenses the purchaser could assert against the seller.

In Opinion No. 76-372, we concluded that an automobile service agreement, sometimes described as a contingent service agreement, when sold directly by the dealer to the purchaser, did not constitute a contract of insurance, following a number of cases which have upheld analogous agreements when offered by the seller as an integral part of the merchandising and sale of goods. Here, however, the plan is proposed to be offered by a party entirely unrelated to the commercial transaction itself, and whose sole dealing is with the purchaser as a financer of the transaction. When such a plan is offered by the seller, as, *e.g.*, an automobile dealer, the courts have viewed the purpose of the agreement as one not merely to assume a described risk, but also to promote the underlying sale of merchandise itself, and to demonstrate, albeit implicitly, the seller's confidence in the product by its willingness to offer and stand behind its obligations regarding the product. Where the plan is offered by a third-party lender, it has no such commercial or mercantile purpose whatever. The third-party lender has no commercial interest in the product itself, but only a commercial interest in forestalling its debtor from asserting against it any defenses which any rule of the Federal Trade Commission has made or will make available to the purchaser to assert against its financer. Strictly speaking, the commercial interest of the third-party lender is limited to assuring that its debtor remains legally obligated to honor the terms of his or her note. This interest is completely remote from that of commercial or mercantile context in which such agreements have been traditionally upheld, and upon which we relied in the earlier opinion. The offering of such an agreement for sale by a thirdparty lender to its debtor concerning the merchandise which is the subject of the credit transaction, where, as here, the lender has no legal or commercial interest in the merchandise itself, and no relationship to the merchandising transaction itself, constitutes, in my judgment, the offering of a contract of insurance.

Yours truly,

Curt Schneider

CURT T. SCHNEIDER
Attorney General

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