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ATTORNEY GENERAL OPINION NO. 80- 8

The Honorable William W. Bunten
State Representative, 54th District
Box 278
Rossville, Kansas 66533

Re: Insurance--Motor Vehicle Service Contracts--
Contracts of Insurance and Warranty Distinguished

Synopsis: Pursuant to K.S.A. 40-201 et seq., it is unlawful to conduct the business of selling insurance without the license required by law. Under certain conditions the sale of extended coverage automobile warranties or service contracts may constitute the business of selling insurance. The terms and effect of each motor vehicle service contract or warranty must be examined individually to determine whether it is in the nature of an insurance contract.

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Dear Representative Bunten:

You request the opinion of this office regarding extended coverage automobile warranties and ask whether such warranties constitute insurance under Kansas law, thus requiring any person selling such warranties to be licensed in accord with state insurance laws. As you note in your request, a prior Attorney General Opinion (No. 76-372) has approved a particular version of such warranty (otherwise referred to as a motor vehicle service contract) as not constituting the sale of insurance by an unlicensed party. We hereby reaffirm the above-cited opinion but limit its application to the unique contractual arrangements analyzed therein. For the reasons stated below, certain other extended coverage automobile warranties or service contracts may constitute the sale of insurance and

such sale by unlicensed persons would be unlawful. For example, see Attorney General Opinion No. 78-68 (attached), declaring an alleged warranty contract (similar to the contract considered in Attorney General Opinion No. 76-362) to be insurance under Kansas law where the identity of the seller of the contract was different from that of the seller of the goods. We note that you do not inquire about a specific service contract or warranty, nor do you identify any persons illegally selling such "warranties." Therefore, we compose our opinion so as to identify the characteristic differences between permissible and impermissible conduct in the sale of extended coverage automobile warranties.

At the outset it must be observed that neither the sale of insurance nor the making of a mechanical warranty is per se unlawful. It is only when a service contract which legally constitutes insurance is sold by an unlicensed person that the problem herein arises. The business of selling insurance is a regulated industry in Kansas. Pursuant to K.S.A. 40-201, the term "insurance company" applies to "all corporations, companies, associations, societies, persons or partnerships writing contracts of insurance, indemnity or suretyship upon any type of risk or loss." K.S.A. 40-214 provides that it is unlawful for any insurance company "to transact the business of insurance" in Kansas unless the company has been properly authorized by the Commissioner of Insurance.

Persons selling warranties or service contracts, not constituting insurance, remain unregulated under Kansas law unless such persons violate consumer protection laws, fraud statutes or similar general provisions proscribing certain commercial activities. Thus, extended-coverage automobile warranties, not constituting a contract of insurance, are permissible, as are warranties on service contracts constituting insurance when offered by a licensed insurance company. Only warranties or service contracts coming within the meaning of insurance and offered by an unlicensed company are prohibited.

In distinguishing between a contract of insurance and a warranty or service contract, the Kansas statutes and case law have added little clarity. It is clear, however, that the name by which the contract is called is not determinative. The courts will look to the character of the promise and the nature of the circumstances or contingencies giving rise to performance agreed upon. See 43 Am. Jur. 2d Insurance, §4 (1969).

Although Kansas statutes do not define insurance (but do define "insurance company," supra), "[t]he term insurance has been judicially defined as any contract whereby one party promises for a consideration to indemnify the other against certain risks." State ex rel. Londerholm v. Anderson, 195 Kan. 649, 662 (1965). A recognized authority has stated that there are normally five elements present in an insurance contract, namely:

1. An insurable interest;

2. A risk of loss;

3. An assumption of the risk by the insurer;

4. A general scheme to distribute the loss among the larger group of persons bearing similar risks;

5. The payment of a premium for the assumption of risk.

See W. Vance, Handbook on Insurance, §§1 and 2 (2nd ed. 1930); 63 A.L.R. 711, 713 (1929); 100 A.L.R. 1449, 1450 (1936); 119 A.L.R. 1241, 1242 (1939).

However, every contract indemnifying or providing some measure of protection from loss or damage resulting upon specified contingencies may not necessarily be insurance. For example, where a manufacturer or seller offers indemnity to all purchasers for defects in his or her products and the indemnity is included in the purchase price as inducement for the purchase, the indemnity is normally considered a warranty and not insurance.

A "warranty" is defined by Kansas case law as "'[a]ny distinct assertion or affirmation as to the quality or character of the thing to be sold, made by the seller during the negotiations for the sale, which it may reasonably be supposed was intended to induce the purchase and was relied on by the purchaser.'" Cochrell v. Henderson, 81 Kan. 335, 338 (1909).

K.S.A. 84-2-313(a)(a) provides: "Express warranties by the seller are created as follows: (a) Any affirmation of fact or promise made by the seller to the buyer which relates to the goods and becomes part of the basis of the bargain creates an express warranty that the goods shall conform to the affirmation or promise."

In Attorney General Opinion No. 76-372, a previous Kansas Attorney General relied upon case law from this and other jurisdictions utilizing three separate tests to distinguish a contract of insurance from a warranty. Id. at 6. First, "the principal object and purpose" of the seller of the contract must be identified. If the assumption of some future risk is determined to be merely incidental to that purpose, the contract is not likely to be considered as insurance. See State ex rel. Londerholm v. Anderson, supra; also California Physicians' Service v. Garrison, 28 Cal. 2d 790, 172 P.2d 4 (1946).

Second, the nature of the risk assumed must be considered. If the object of the contract is to protect against damage or loss from both defects in merchandise and extraneous causes, the contract is more akin to insurance than mere warranty. See State ex rel. Duffy v. Western Auto Supply Co., 134 Ohio St. 163, 16 N.E.2d 256 (1938).

Third, it must be decided whether the contract for indemnity is a commercial device designed to encourage the confidence of the potential customer as to the quality of the product, and, as such, is merely a merchandising method incidental to the sale of the product. If the contract is separate and unrelated to the primary transaction, then it is likely to be characterized as a contract of insurance. See State ex rel. Herbert v. Standard Oil Co., 138 Ohio St. 376, 35 N.E.2d 437 (1941), and Attorney General Opinion No. 78-68, supra.

We note, in connection with the third test, the definition of warranty as used in the federal Magnuson-Moss Warranty--Federal Trade Commission Improvement Act, which regulates service contracts where such contracts are not regulated as "insurance" by the various states. The Act declares:

> "A written warranty must be 'part of the basis of the bargain.' This means that it must be conveyed at the time of sale of the consumer product and the consumer must not give any consideration beyond the purchase of the consumer product in order to benefit from the agreement."
> 15 U.S.C.A. §2301(6) (1979 Supp.)

The "basis of the bargain" language as used in the federal law to define warranty reinforces our belief that the connection between the sale of goods and the contract of indemnity is a crucial characteristic in distinguishing insurance from warranties.

Although in this context the law will not presume that parties intended to enter into an illegal or unenforceable contract [Anstine v. Lake Darling Ranch, 305 Minn. 243, 233 N.W.2d 723 (1975)], each contract must be viewed as a whole [Guaranteed Warranty Corp. Inc. v. State ex rel. Humphrey, 23 Ariz.App. 327, 533 P.2d 87 (1975) and People ex rel. Roddis v. Calif. Mutual Assn., 68 Cal.2d 677, 441 P.2d 97 (1968)], and the determination is to be made on the facts of each case [Electronic Realty Associates, Inc. v. Lennon, 94 Misc.2d 249, 404 N.Y.S.2d 283 (1978); Transportation Guar. Co. v. Jellins, 29 Cal.2d 242, 174 P.2d 625 (1946)].

Thus, in order to determine whether a given contract is an express warranty or a contract for insurance, the following facts must be discovered and compared to the elements commonly necessary for insurance and those elements that characterize an express warranty:

1) Identity of the seller of the contract. Is the seller of the product (in this instance, an automobile) the same company or person as the seller of the contract? If the seller of the service contract is not the seller of the product which is the subject of the contract, this fact indicates the existence of an insurance contract instead of a warranty. See Attorney General Opinion No. 78-68, supra; Electronic Realty Associates, Inc. v. Lennon, supra.

2) Additional consideration. Was the contract part of the purchase price or was it entered into separately? Where additional consideration is paid for a given product for an optional service contract or the service contract is purchased separately, the contract may suggest the creation of an insurance relationship. However, this factor is rarely, if ever, determinative. See Attorney General Opinion No. 76-362. In addition, the corollary that the absence of additional consideration indicates the existence of a warranty is not determinative either. See Ollendorff Watch Co. v. Pink, 279 N.Y. 32, 17 N.E.2d 672 (1932).

3) Time of contracting. Was the contract entered into contemporaneously with the sale of the product? A separate contract to provide future services upon the occurrence of specified contingencies entered into after the completion of the principal sale implies the existence of something other than a warranty since the service contract was not incidental to the sale of the product.

4) Scope of risks covered by the contract. Does the coverage include only mechanical defects of the product or additional contingencies giving rise to loss or damage? Where the contingencies giving rise to the promised performance pursuant to the contract are limited to problems arising from defects in materials or workmanship of the product sold, the contract is more likely to be considered a warranty. State ex rel. Duffy v. Western Auto Supply Co., supra. When the contingencies giving rise to performance go beyond such mechanical defects and provide coverage for extraneous causes for loss or damage, the contract is more likely to be characterized as a contract of insurance. State ex rel. Herbert v. Standard Oil Co., supra.

5) Basis of the bargain. Is there evidence that the contract of indemnity was a contributing factor in the customer's decision to purchase the product? Evidence that the service contract was an inducement to the purchase of a particular product from a particular seller indicates the creation of a warranty rather than a policy of insurance. The optional service benefits become a partial basis of the sale of the product. See K.S.A. 84-2-313(1)(a).

6) Regular Service. Does the contract require regular maintenance and inspection services for the product sold, indicating the purchase of such services as well as protection from specified contingencies? Regular inspection and service provisions, not contingent upon loss or damage, indicate the existence of a contract for services or an express warranty.

Having ascertained the above-referenced elements of the contract and the transaction, the three tests outlined in Attorney General Opinion No. 76-362, supra, may be applied to determine the true nature of the contractual agreement and thereby determine whether licensing of the service contract seller is required by Kansas insurance laws.

In summary, pursuant to K.S.A. 40-201 et seq., it is unlawful to conduct the business of selling insurance without the license required by law. Under certain conditions the sale of extended coverage automobile warranties or service contracts may constitute the business of selling insurance. The terms and effect of each motor vehicle service contract or warranty must be examined individually to determine whether it is in the nature of an insurance contract.

Very truly yours,

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RTS:BJS:gk
Encl.