

# Automobile Extended Warranty Risk Transfer Agreements: Are They Insurance Policies?

Auto Remarketing

## WRITTEN BY

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**Brian Casey**, Co-Leader of Locke Lord's Regulatory and Transactional Insurance Practice Group and a member of the Firm's Corporate, Capital Markets and Health Care Practice Groups, authored an article published in Auto Remarketing exploring the regulatory and tax complexities surrounding auto dealers' use of so-called "risk transfer agreements" to shift the uninsured performance risks of a dealer obligor under its vehicle protection products directly to its affiliated captive reinsurance company. In the article, Casey notes: "If risk transfer agreements are insurance policies for state insurance regulatory purposes, then the dealer obligor affiliated captive reinsurance companies, and possibly the dealer obligors themselves, that enter into these agreements may not be in compliance with applicable state insurance laws."

Regarding the use of risk transfer agreements as insurance contracts, he explains that "Accordingly, auto dealers and managers of auto dealer affiliated reinsurance companies should carefully evaluate whether their risk transfer agreements constitute insurance contracts and assess the liability risk exposures that could arise therefrom, including the potential transaction of insurance as an unauthorized insurer by a dealer obligor affiliated reinsurance company and attendant liabilities for unpaid state insurance premium taxes and related interest and penalties."

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In the auto dealership world, some dealers form and own a captive reinsurance company that reinsures some or all of the risks under vehicle service contracts, or extended warranties, and related auto F&I protection products, like tire and wheel protection, vehicle appearance protection and guaranteed asset protection (GAP) waivers (vehicle protection products), that an auto dealership sells to its retail customers.

In some cases, an affiliate of the auto dealer is the provider or obligor of, and thus bears the risks under, the vehicle protection products (a dealer obligor). Many auto dealer captive reinsurance companies exist in offshore jurisdictions, such as Turks & Caicos, or more recently, under the tribal insurance laws of a U.S. recognized Indian tribe, because of lighter touch regulation and lower capitalization requirements than captive insurance companies domiciled in a state or the District of Columbia.

This article explores auto dealers' use of so-called "risk transfer agreements" to shift the uninsured performance risks of a dealer obligor under its vehicle protection products directly to its affiliated captive reinsurance company.

In order for a dealer obligor to be able to offer and sell vehicle protection products, many states require a dealer obligor to hold a vehicle service contract provider license, usually issued by a state insurance department. As a condition of licensure, vehicle service contract laws usually require that a vehicle service obligor maintain a specified form of financial security to protect consumers who purchase vehicle protection products for the performance thereunder by:

- Having at least a \$100 million net worth (which most auto dealers do not have)
- Maintaining a fund claims trust account which requires setting aside a stated percentage of the sales price of a vehicle protection product, typically 40%, as a claims reserve
- Purchasing a contractual liability insurance policy from a licensed insurance company that insures a dealer obligor's performance risks under the vehicle protection products it issues (a CLIP).

Depending on what the applicable state law allows, there are two versions of CLIPs in the marketplace:

- A first-dollar CLIP (a FD CLIP) under which an obligor transfers all its risks under its vehicle protection products to the insurer that issued the FD CLIP
- A failure-to-perform CLIP (a FTP CLIP), also known as a surety CLIP, that insures only an obligor's failure of performance risk under its vehicle protection products because of its bankruptcy, insolvency or cessation of business.

In both situations, a dealer obligor's affiliated captive reinsurance company will reinsure the insurance company that has issued the FD CLIP or FTP CLIP and receives ceded reinsurance premiums in exchange for assuming the ceded FD CLIP or FTP CLIP risks.

Because a FD CLIP fully insures an obligor, the insurance premium cost of a FD CLIP is much higher than that of an FTP CLIP, making an FTP CLIP more preferable to a dealer obligor.

Where a dealer obligor uses an FTP CLIP, the dealer obligor's performance risk that is not insured by the FTP CLIP is essentially a self-insured risk of the dealer obligor. To move the retained (uninsured by an FTP CLIP) performance risk of the dealer obligor to its affiliated captive reinsurance company and obtain the income tax benefits intended to be obtained through use of the affiliated captive reinsurance company, some dealer obligors and their affiliated captive reinsurance companies enter into so-called "risk transfer agreements" under which a dealer obligor transfers its retained performance risk to its affiliated captive reinsurance company.

However, generally the dealer obligor and its affiliated captive reinsurance company do not treat such a risk transfer agreement as an insurance contract for insurance regulatory purposes, presumably because they believe that the FTP CLIP's satisfaction of the dealer obligor's financial security requirement for service contract regulatory purposes somehow results in the risk transfer agreement not being an insurance product.

Unfortunately, there is little doubt that such a risk transfer agreement is indeed an insurance policy. Insurance is generally defined by state insurance codes as having four elements:

- A promisor agrees to indemnify a promisee (risk shifting and indemnification promise)
- Upon the occurrence of an adverse fortuitous event beyond the reasonable control of both the promisor and the promisee

- In exchange for a payment by promise to promisor (premium)
- A promisor is distributing similar risks that it bears under similar contracts (risk distribution and actuarial-based pricing of the contract). It is difficult to see how a risk transfer agreement does not satisfy all the elements of the definition of insurance.

To be sure, if a FD CLIP and an FTP CLIP are in fact insurance policies, why would the transfer of the risks that would, but for the use of an FTP CLIP, otherwise be insured by a FD CLIP not be the transfer of those risks under an insurance contract?

If risk transfer agreements are insurance policies for state insurance regulatory purposes, then the dealer obligor affiliated captive reinsurance companies, and possibly the dealer obligors themselves, that enter into these agreements may not be in compliance with applicable state insurance laws.

There are three basic ways in which an insurance policy may be sold and issued in the U.S.

First, a state insurance department licensed insurance company may sell and issue an insurance policy, and generally its insurance policy forms and insurance premium rates (in the case of non-life insurance policies) must be approved by a state insurance department.

Second, an unlicensed, or unauthorized, insurance company may issue insurance policies by being an eligible surplus lines insurance company where its surplus lines, or non-admitted, insurance policies are placed through a licensed surplus lines insurance broker in compliance with applicable state surplus lines insurance laws.

Third, a person (an insured) can self-procure insurance under state self-procurement of insurance, or direct procurement, laws from an unlicensed insurer, which literally requires the prospective insured to travel outside of its residency state to a jurisdiction in which the unlicensed insurer is authorized to transact its insurance business to apply for, negotiate the terms of, pay the initial insurance premium for and receive delivery of the insurance policy.

In the case of the risk transfer agreements, if they are insurance contracts, they do not meet any of these three means of lawfully selling and issuing insurance policies as

- The dealer obligor affiliated captive reinsurance company is usually not licensed in the jurisdiction in which dealer obligor has its principal of business
- The risk transfer agreement are not entered into in compliance with state surplus lines insurance laws (for sure there is no state licensed surplus lines insurance broker involved in the risk transfer agreement and no state surplus lines insurance broker tax is paid)
- The dealer obligor normally does not travel to the domicile of its affiliated captive reinsurance company to enter into and pay for the risk transfer agreement in compliance with self-procurement of insurance laws of the jurisdiction in which dealer obligor has its principal of business.

To the extent the dealer obligor and its affiliated captive reinsurance company treat a risk transfer agreement as an insurance contract for federal income tax purposes but not for state insurance law purposes, there is an obvious incongruity.

While vehicle protection products are deregulated from being insurance contracts under state insurance codes' service contracts or vehicle protection laws, these products can still qualify as non-life insurance contracts under the Internal Revenue Code. Some dealer obligors may harbor under the belief that a risk transfer agreement is not an insurance contract because the dealer obligor's underlying vehicle protection products are not insurance products under state regulatory laws.

But, if that logic prevailed, then similarly FD CLIPs and FTP CLIPs would not be classified as regulated insurance policies.

Accordingly, auto dealers and managers of auto dealer affiliated reinsurance companies should carefully evaluate whether their risk transfer agreements constitute insurance contracts and assess the liability risk exposures that could arise therefrom, including the potential transaction of insurance as an unauthorized insurer by a dealer obligor affiliated reinsurance company and attendant liabilities for unpaid state insurance premium taxes and related interest and penalties.

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