***Moving the Metal*: *The Auto Finance Podcast* — The Road to Regulation: Vehicle Service Contracts Explained**
Hosts: Brooke Conkle and Chris Capurso
Guest: Brian Casey
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Brooke Conkle:

Welcome to *Moving the Metal*, the premier legally-focused podcast for the auto finance industry. I'm Brooke Conkle, a partner in Troutman Pepper Locke's Consumer Financial Services Practice Group.

Chris Capurso:

And I'm Chris Capurso, an associate in Troutman Pepper Locke's Consumer Financial Services Practice Group.

Brooke Conkle:

Today, we'll be talking with our colleague, Brian Casey, regarding vehicle service contracts and ancillary products. But before we jump in, let me remind you to visit and subscribe to our blogs. We have two great ones that may be of interest to you. TroutmanFinancialServices.com and ConsumerFinancialServicesLawMonitor.com.

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For today, as I mentioned, we're joined by our colleague, Brian Casey, a partner in Troutman Pepper Locke's Insurance, Transactional, and Regulatory Practice Group, and a member of the Federation of Regulatory Council. Brian, welcome to *Moving the Metal*.

Brian Casey:

Thank you for having me. I'm excited.

Chris Capurso:

Yes. I think you're the first former Locke Lord colleague to be on the podcast. I think that's the truth. So welcome. Now, we are all one. I'm going to kick it off with probably the easiest question. Tell us a little bit about your practice, obviously, with this being called *Moving the Metal*. Kind of the work you do tangentially or in the auto finance industry and the types of clients you work with.

Brian Casey:

Yes, thank you. At a high level, I am a corporate and regulatory lawyer in the insurance and reinsurance verticals. I do a lot of M&A and regulatory, and regulatory is a broad subject for my practice. Obviously, includes insurance regulation, but I throw privacy, telemarketing, anything on the operational side that's of a regulatory flavor. In terms of how the auto finance industry relates to my practice, it's primarily centered around vehicle service contracts and similar auto protection products. Many of those are directly or indirectly offered through insurance clients.

In that space, we represent either the insurance company which issues an insurance policy that backstops the vehicle service contracts, or administrators, what we call obligors, or sometimes called providers of the actual party that issues the contract, and occasionally, an OEM, a manufacturer when they're getting into this space.

Brooke Conkle:

Thanks, Brian. Can you tell us a little bit about the history of vehicle service contracts and the insurance versus non-insurance characterizations of certain vehicle protection or ancillary products?

Brian Casey:

Yes, good question. So, when I was a baby lawyer back in the early nineties, I first got introduced to, I can't remember the name of a specific client, into the service contract industry. Let me also take a step back. So, service contracts, there's basically three submarkets. Auto, and that's a big piece of the service contract with what we call, as you mentioned, vehicle service contracts or VSCs. There's a separate market for consumer electronics, cell phones, computers, and the like. And then a third market called home warranties. It's a little bit of a misnomer in terms of what's the difference between a warranty and a service contract with the statutes and the industry calls them home warranties. Obviously, we're here today, you're talking about vehicle service contracts.

So, really back to the late eighties, the service contract industry was born, I believe, in the auto context. The cell phone and the computer folks came along later, and you might ask why were they called service contracts. Well, back then, the industry was arguing that their product, the

VSC, was not insurance because they were rendering services, repair, replace, manufacturer's defect, and that raised the issue of whether the product was insurance or not. There were also a fair number of insolvencies back then, which spurred the insurance regulators to take a close look at this product and really weigh in on whether it was insurance or not.

At the end of the day, back then, the industry said, “Uncle, we're tired of spending lots of legal fees and fighting the DOIs,” and it was an uphill fight, to be honest with you. So, the industry went with regulation light so that the industry is not regulated, the obligors or providers are not regulated as a full-stack insurance company. But there are *Regulatory Oversight* and compliance requirements in this industry. That's basically the history.

In the insurance regulatory world, we have a body called the NAIC, which stands for National Association of Insurance Commissioners, which is all the 51 commissioners plus Guam and Puerto Rico, and not a legislative body. But for many, many years, and as probably most of you know, perhaps not, the regulation of insurance is relegated to the states under the McCarran–Ferguson Act. The states through the regulators have always promulgated model laws and variety of topics, obviously. In the nineties, they promulgated a model service contract law, not vehicle-specific. That model has not really been widely adopted because the vehicle service contract industry tends to go to the legislative well every year to add, you mentioned ancillary products, and we'll go into that in a little more detail here in a second, I think.

But over time, the industry has expanded the definition of a service contract, which is basically an agreement for separate consideration to repair or replace a product, tangible product, primarily used for personal family household purposes, for manufacturers, defect. And then over the years, it's been stretched to include incidental indemnity, the cell phone industry dropped in there as another example of the stretching, accidental damage from handling. So, the industry as a broad group oftentimes goes to the legislature every year and the ancillary products of course are ones that have been inserted into the definition of a service contract over the years.

Also, there are kind of a mishmash of service contract laws through the evolution of the adoption of these laws through the state legislature. So, for example, a state may have adopted a vehicle service contract specific law in 1995, for example. And then a couple years later, the cell phone industry essentially said, “Well, we need the same kind of statute,” so they have a separate statute that covers broad forms of consumer products. Other states just have one broad form service contract law, which would include the vehicle service contract. So, it's kind of a mishmash out there.

Chris Capurso:

Going back to the whole insurance versus non-insurance conundrum, like in a GAP waiver law, there's always that pronouncement right at the beginning that's like, “This is not an insurance product.” Is there anything beyond regulatory pronouncement from on high that this is not insurance. Is there anything that kind of differentiates what would be an insurance product versus a non-insurance product?

Brian Casey:

Well, yes, the core issue is control over the risk. So, the definition of insurance is codified in most states, and obviously there's case law behind that. But it requires the following elements. Risk shifting from a promise or to a promise. Risk distribution, which is the pricing of the promise. So, if I issue 10 contracts that each have $10 of exposure for an aggregate exposure of $100 and I collect $1 from the 10 purchasers, I've got $10 to fund potential exposure of $100 if they all popped at the same time. That's risk distribution.

Then a promise of indemnity based upon a fortuitous event. That's the crux of it, right? Fortuity. So, if I am a business offering a vehicle service contract and I have nothing to do with the manufacturer or the distribution of the automobile, raises the question of whether my project is insurance and would be, but for the fact, and those were the battles that the industry lost back in the late eighties, would be because it meets the definition of insurance, a vehicle service contract, risk shifting, risk distribution, fortuity, no control of the risk, and a promise of indemnity. And indemnity can be in kind, meaning the performance of services, not just stroking a check like an automobile insurance company.

So, the service contract laws, including the vehicle service contract specific laws, define a service contract and they all say this thing is not insurance because that was the regulation light approach that the industry sold to the legislatures. Believe it or not, outside of this context, we're talking about here today, we get the question almost every week, is a product insurance or not? And you go through the elements of insurance, and I usually say, “Well, you might have wanted to involve me on the front end because I have to try to deconstruct the product or reconstruct it so it's a warranty or something else.”

Now, to get into one of the specific products, there's the – well, GAP, you mentioned, that's a good one. In the old days, some insurance departments took the position that GAP was an insurance product. Texas, I think, still has some law or opinion on the books there. Same issue. They've gone into the legislature and lobby to get clarification that this product is not insurance. There's also a body of case law that might be relevant here when you're analyzing whether a product or service, insurance or not, is a judicial doctrine called the primary purpose test, which has been adopted in a number of states, probably 20, 25 states by case law, which says if a contract's primary purpose is rendering of services or something else other than providing indemnity, if there's a little bit of indemnity in the contract, that doesn't tip the scale and all of a sudden make it in part an insurance contract.

That was an issue that came up. It was adjudicated in a number of states for the so-called etch products, if you're familiar with that. That's an auto product, theft deterrent product, right? Some regulators were saying, “Well, the underlying risk is auto-theft, right?" Instinctively, they say, “Well, that's insurance, right?” Well, counterargument was, “No, this is a warranty. We are printing, the performance of our product. Yes, there's an underlying risk, but we're not agreeing to pay any damages or indemnity because of the theft of the vehicle per se. It's just the failure of our product.”

Now, that said, the cases kind of go both ways on the etch product. Some states have said, “You're right. It's a warranty.” Others said, “No, we're not buying that. We think it's an insurance product.” Then they went to the legislative well again.

Brooke Conkle:

Can you tell us a little bit about how states regulate vehicle service contracts, whether it's through licensing or disclosures, sales tax considerations. Tell us a little bit about that on the state level.

Brian Casey:

There are basically two buckets of states. Those that define a service contract, whether it's automobile-specific or not, and have statutory requirements in terms of what the contract itself must say. For example, cancellation refunds, cooling off period, can't be misleading and deceptive, of course. No licensing or registration. There's another bucket of states that do the same thing the bucket one does, but also impose a licensing or registration requirements.

So, the providers or what the industry usually calls obligors, it is their paper, their contract. In many states, they have to get a registration. Some states, about nine states have a separate licensure category for an administrator, so sometimes the VSC will say it’s A, B, C's company is the obligor, but it's administered by X, Y, Z company, and a few states have a separate license and category for an administrator.

Then on the sales side, thankfully from my perspective, there's not too many states that require licensure for a sales agent, akin to an insurance agent in my world. Florida is one of them. Missouri has an agent licensing sales rep license concept for motor vehicle service contracts not for other types of service contracts. Texas has a requirement that the obligor deliver annually a list of who the parties are that are selling their contracts so the government can kind of monitor that from a consumer protection standpoint.

Those are the basic categories of licensure that you see in the service contract world. Sales tax, you mentioned, yes, sales tax, that's a tricky area. Can’t apply to service contracts broadly, including vehicle service contracts. That's an issue that comes up frequently high on our diligence list when we're representing a buyer that might be buying an obligor that's in the auto business or an administrator. So, that's the basics. In terms of disclosures, most of it's in the contract. There are a lot of state-by-state specific disclosures, so if you look at a VSC at the end of the contract, you're going to see a state-by-state list that has certain specific disclosures that that particular, if you're a resident of Utah, whatever, it would say X, Y, and Z.

Oftentimes, those disclosures are required because the cancellation refund period might be 30 days in one state, 20 days in another state. Also, there are disclosures oftentimes required about the insurance company that essentially backs up the vehicle service contract that ensures the risks of the obligor. Most states that require licensure or registration require an obligor to satisfy a financial security requirement in order to get a license and maintain a license, which you can generally do in one of three ways. If you're lucky enough to have $100 million of net assets, meaning net of certain intangible assets on your balance sheet, you don't have to be a big company, you're good to go.

The second way is to form a trust. It's a claims trust or claims fund where you have to throw in at the trust a certain percentage of the sales price, the retail sales price of the VSC, usually 40%, that might result in over-reserving from an actuarial standpoint. Most companies don't do that. It's clumsy.

The third way, which is the most predominant way, is that the obligor purchases what we call a Contractual Liability Insurance Policy or a CLIP. That's issued by many of our clients, licensed insurance company to ensure the risks of the obligor under the VSC, and there are two types of CLIPs. One, we call a first dollar CLIP, so that means that every claim that's under the VSC is fully insured by the insurance company that has issued the clip. The second form of clip is what we call a FTP, failure to perform CLIP that ensures only the risk of the obligor going out of business, including bankruptcy, therefore not performing on their contract. It states differ on whether they accept an FTP CLIP versus a first-dollar CLIP for licensing and registration purposes.

Chris Capurso:

I'm learning a ton of new stuff right now. We consistently talk about privacy on this podcast. It touches everything. Specifically, in this realm, in terms of VSCs or just insurance industry in general, what are some privacy considerations that folks need to be aware of?

Brian Casey:

Key issues, certainly high on our diligence list in an M&A transaction representing a buyer. Gramm-Leach-Bliley Act, as you probably know from your *Moving the Metal* world, is the primary privacy law/regulation for financial institutions. I was a baby lawyer when Gramm-Leach-Bliley came out. For insurance products, GLB basically said, given the history and the current status of state regulation of insurance, we're just going to set the basic bar in states, insurance departments and legislatures, you implement GLBA for insurance purposes, otherwise we the feds will do it for you.

What the NAIC, National Association of Insurance Commissioners did in 1999 was take the original GLBA regulations which were jointly promulgated by the OCC, the FTC, the credit union administrator, and a few other federal regulators. Dodd-Frank hadn't come along, so there was now CFPB at the time, of course. But that was a banking-oriented version of GLBA, and the insurance regulators took that and insurance-ized it, if you will.

Now, in the wake of that, the service contract industry took an interesting position, not advocated by yours truly here, which was that, well, the statutes, as you mentioned, Chris, for the service contracts, say, and we wanted them to say, “This thing, this product is not insurance,” right? So, the industry at the time say, “Well, great. We're not insurance. Therefore, we're not subject to the state insurance GLBA regulations,” which was a correct conclusion in my view. The industry said, “That's it. We're not subject to privacy laws.” I never agreed with that position because the pre-Dodd-Frank, the Federal Trade Commission, used to be what I call the default GLBA privacy regulator. In other words, if it's a financial product or service and doesn't have a functional regulator, you're under the jurisdiction of the FTC.

I think the industry's argument broke down because you would have to take the position that the VSC is not a financial product or service, which I never bought, because the VSC would be an insurance product, but for the fact that it's deregulated through the statutes. If it were insurance, obviously, that would be a financial product or service in the cloak of insurance. So, I never believed in that. The industry changed its tune, I think primarily because of the aggressive positions of the CFPB and the FTC in the last 10, 15 years in the auto industry generally.

So, long and short of it is that the VSCs are a financial project or service, in my view, in subject to Gramm-Leach-Bliley. Then you have to take a step back and go over to the so-called omnibus or comprehensive privacy laws, which I'm sure you guys have discussed on your prior podcast, like the CCPA, California Consumer Privacy Act, and there's 20 some states now, I think, that have that, and question whether does that apply to VSC obligors.

From an insurance perspective, most of those laws, meaning the California Consumer Privacy Act-type laws, have an exemption for GLBA in one of two respects. Some states, California, for example, excludes GLBA data, not entities. Other California-like comprehensive laws exclude both GLBA data and an entity that's subject to GLBA, entity being preferable, of course. So, as long as the VSC obligor is only collecting GLBA-covered data, protected data, then they should be exempt from the CCPA-like laws.

In the real world, certainly in other service-contract areas like cell phones, collecting website traffic movements, which has its own issues, but is not GLBA data. But in the auto industry, if the product is just being sold through a dealer, there may be some situations where only GLBA data is being collected and therefore the obligors are outside the scope of these comprehensive state-based privacy laws.

Brooke Conkle:

Wow. That's so interesting. Brian, we've talked a little bit about the regulatory environment under the new Trump administration. Can you tell us a little bit about what that environment is like for vehicle service contracts and ancillary products?

Brian Casey:

Yes, it's certainly changed, of course. I think generally speaking, you guys have probably addressed this in your prior podcast. You're seeing more state AGs get active in picking up the reins that have fallen down at the CFPB at least, currently. From a UDAAP perspective, there has not been a lot of enforcement by state insurance departments. Let me also take a step back on this, too. Most of the VSC laws are enforced by state insurance departments. There are a few other states where it's not the insurance department, Texas, for example.

We have our own UDAAP statutes. We being insurance people in our insurance codes, we have an Unfair Trade Practices Act, which prohibits 100 different things, including unfair deceptive practices. But those laws generally don't apply to a service contract because it's not an insurance product, because our Unfair Trade Practices Act applies to persons engaged in the business of insurance. That said, there's one important footnote. There are about four states that retain the applicability of the state insurance code’s Unfair Deceptive Trade Practices Act to service contracts. But nonetheless, I have not seen any pure UDAAP enforcement by an insurance department in the VSC area, which is what it is. So, you're left with the state AGs or a governor's consumer protection office that could bring some kind of claim on the basis of UDAAP in the VSC industry.

Chris Capurso:

It's so nice hearing from somebody in another discipline who can also confirm that state laws are just unbelievably tricky and kind of all over the place because I mean, we see that in financial services, every state is different. We tell our clients every state is different and insurance the same way.

I guess we'll finish off with kind of the catchall question, which is, what are some other common issues you've seen other than those we've talked about, obviously, with VSCs in the auto finance space?

Brian Casey:

Well, again, you referenced GAP. You may have covered this on your prior broadcast, but when an auto loan is canceled and there are refund rights that are in play, there are some actions, civil lawsuits, and attorney general actions about customers not remembering that they have a right of cancellation and requiring that the lender or the administrator of the GAP product be obligated to essentially make the cancellation refund occur, so that's been a hot button issue in the gap area.

Another somewhat tricky issue that comes up is for commercial service contracts or commercial vehicle service contracts in this context today. The service contract laws, again, mostly in the insurance code, usually have, next to the definition of a service contract, exclusions. A service contract does not include a warranty, a true warranty, a maintenance agreement, or a commercial service contract. The issue that was presented by the exclusion of commercial service contracts to the industry, including me, is, okay, where does this dust settle on a commercial service contract? Does that either mean, A, that a commercial service contract is not regulated at all, neither fish nor fowl, not a service contract, not insurance. Or, perhaps perversely, does that kick you back into being an insurance product because, as I said at the outset here, and we talked about the definition of insurance, a commercial service contract if offered by a third party not related to the manufacturing distribution of the product would be presumptively an insurance contract.

Most states take the position, state insurance departments, that a commercial service contract is not an insurance product. On the theory that two sophisticated parties, they kind of look the other way, if you will, in terms of the true definition of insurance, a few states by position, by enforcement position say, “We'll take the position that's not an insurance product. If you have a clipped contractual liability insurance policy that's backing it up from a solvency perspective.”

From an insurance perspective, the insurance departments are charged with, A, consumer protection and B, solvency. So, under that line of thinking, some states have said, we don't care about commercial service contracts. I had an interesting situation come up a couple of years ago. It was a commercial service contract, it was in the auto area. An insurance agent called me and said, “Hey, I think my competitors are doing commercial service contracts, I think it's insurance.” I'm like, “Yes, presumptively meets the definition of insurance. Will you go down to the insurance department here in Georgia and help me make the case?” I'm like, “No, I can't do that because I have all these clients in the industry that issue the CLIPs and like.” He irritated the insurance department so badly that the insurance department went to the legislature, the very next legislative season, and got a statutory provision in the Georgia Insurance Code that says a commercial service contract is not insurance. Generally speaking, we're okay with that product, not being insurance.

Chris Capurso:

Awesome. That'll wrap it up for today's podcast. Thank you to Brian for joining us and thank you to our audience for tuning in. Don't forget to check out our blogs where you can subscribe to the entire blog or just the specific content you find most helpful. That's the ConsumerFinancialServicesLawMonitor.com and the TroutmanFinancialServices.com blogs. While you're at it, why don't you head on over to troutman.coma and sign up for our Consumer Financial services mailing list, so that you can stay abreast of current issues with our insightful alerts and advisories, and receive invitations to our industry insider webinars. And of course, please mark your calendars for this podcast, *Moving the Metal*, which we will be releasing every two weeks in 2025 that will generally be on the second and fourth Tuesdays of each month. As always, if you have any questions or if we can help in any way, please reach out. Until next time.