Declaratory Ruling 95-254-M

Original equipment manufacturer warranty programs not insurance

March 30, 1995

I. BACKGROUND

RAMP Program Systems, Inc. ("RAMP") has developed a broadened warranty program ("Program") that an original equipment manufacturer ("OEM") will issue upon the lease of a new vehicle. The Program will include damage repair coverage for three years. By its letter of February 15, 1995, RAMP seeks a declaratory ruling by the Acting Commissioner of Insurance ("Commissioner") as to whether the Program constitutes insurance.

II. ISSUES

The principal issues are:

> 1. Does a warranty issued by an OEM that includes damage repair coverage constitute insurance where the coverage is not the principal object and purpose of the transaction?
>
> 2. Does a warranty issued by an OEM that includes damage repair coverage constitute insurance where the coverage is part of a lease agreement?

III. ANALYSIS

Introduction

The Commissioner is authorized to issue this declaratory ruling by Section 63 of the Administrative Procedures Act of 1969, as amended, MCL 24.263; MSA 3.560(163), which provides:

> On request of an interested person, an agency may issue a declaratory ruling as to the applicability to an actual state of facts of a statute administered by the agency or of a rule or order of the agency. An agency shall prescribe by rule the form for such a request and procedure for its submission, consideration and disposition. A declaratory ruling is binding on the agency and the person requesting it unless it is altered or set aside by any court. An agency may not retroactively change a declaratory ruling, but nothing in this subsection prevents an agency from prospectively changing a declaratory ruling. A declaratory ruling is subject to judicial review in the same manner as an agency final decision or order in a contested case.

It is critical to RAMP to have a determination as to whether the Program is insurance. An OEM is not an insurer. If the Program constitutes insurance, only a licensed insurer may sell it. Section 402 of the Insurance Code of 1956, as amended ("Code"), MCL 500.402; MSA 24.1402, provides:

> No person shall act as an insurer and no insurer shall issue any policy or otherwise transact insurance in this state except as authorized by a subsisting certificate of authority granted to it by the commissioner pursuant to this code.

The Program consists of two elements. First, it will extend defect repair coverage an additional two or more years. Second, with a few stated exceptions, for three years it will repair damage to eligible new leased vehicles, less a $500.00 charge to the lessee. RAMP defines damage as follows [p 5, ftn 4]:

> Under the Program, damage means the upset of the covered vehicle, its impact with another vehicle or object, or other delineated occurrences damaging the vehicle, but excludes damage, for instance, caused by certain intentional acts of the lessee or operator of the vehicle.

This agency has long recognized that basic or extended warranties made by an OEM are not insurance. However, in this matter, the warranty includes damage repair coverage along with mechanical repair coverage. This agency first examined this issue in a Declaratory Ruling issued January 24, 1995.

The January ruling originated from a request by RAMP, with two main differences from the Program under review. First, the repair damage coverage only applied to the first year of the warranty. Second, the warranty applied to both purchased and leased vehicles.

While the damage repair coverage is considerably expanded in the Program under review, RAMP maintains that this coverage is only incidental to the OEM's central business, to the lease, and to the warranty. Accepting this as correct, the analysis contained in the January ruling on this issue is restated below. A discussion of the significance of limiting the coverage to leased vehicles will follow.

Before proceeding with the analysis of the Program, it is useful to set forth the key elements of the Program as listed by RAMP [pp 6-7]:

The defect repair coverage and damage repair coverage are incidental to the OEM's central business, which is the sale or lease of new vehicles;

The mechanical and defect repair and damage repair warranties are provided by the OEM (*not* a third party);

There is no separate consideration or premium paid by the lessee of the new vehicle for either the mechanical and defect repair coverage or the damage repair coverage;

There is no transfer of risk to a third party; rather, the OEM simply retains a portion of the risk of breakdown or damage for a limited period of time;

There is no payment of money by the OEM to the new vehicle lessee for "loss" caused by the breakdown or damage; rather the OEM merely agrees to repair or replace; and

Both portions of the Program involve the provision of service to the new vehicle lessee in an attempt by the OEM to provide total comprehensive vehicle quality, to provide additional services and warranty coverage to lessees of new vehicles, and to increase the residual value of an OEM leased vehicle upon the termination of the lease term.

The Principal Object and Purpose Test

As seen above, according to RAMP, the damage repair coverage is incidental to the OEM's central business [p 6]:

> The damage repair coverage and defect repair coverage are incidental to the OEM's central business, which is the sale and lease of new vehicles;…

RAMP explains further [p 24]:

> Here, the lease of expensive, complex goods — new vehicles — and the provision of service to customers are the principal objects and purpose of the Program. In addition, the OEM's damage repair warranty is not the predominant element of the lease transaction, or even of the overall warranty. Indeed, the predominant element of the transaction, and the one that gives the transaction its distinctive character, is the lease of a new vehicle by the OEM to a lessee…

The Commissioner's examination of this matter is greatly facilitated by advice given to this agency by two Assistant Attorneys General in a memorandum dated April 25, 1980. They had under consideration whether a limited warranty offered by an automobile glass manufacturer and installer was insurance. In addition to coverage that was clearly warranty coverage, such as guarantees against leakage, the manufacturer agreed to replace without charge a broken windshield. While this excluded collision damage, it included other road hazards, such as flying stones.

The Assistant Attorneys General found that the replacement provision of the warranty provided for a small degree of risk assumption, but that risk assumption was not the principal object and purpose of the glass sale contract. They concluded that the manufacturer would not be deemed to be an insurer in the courts.

In reaching this conclusion, the Assistant Attorneys General focused upon *Transportation Guarantee Co* v *Jellins*, 29 Cal 2d 242, 249 (1946), where the Court quoted from a federal decision as follows:

> That an incidental element of risk distribution or assumption may be present should not outweigh all other factors. If the 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 was 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.

In its letter, RAMP also draws upon *Jellins* and other cases in support of this position, most notably *Truta* v *Avis Rent A Car System, Inc*, 193 Cal App 802 (1987).

In *Truta*, a lessee of a car challenged the legality of a collision damage waiver provision. Pursuant to this provision, for $6.00 per day, Avis would waive the liability of the lessee for collision or upset damage or loss to the vehicle in an amount up to $ 1,000.00. In concluding that the collision damage waiver did not make the lease a contract of insurance, the *Truta* court stated [at 813]:

> The principal object and purpose of the transaction before us, the element which gives the transaction its distinctive character, is the rental of an automobile. Peripheral to that primary object is an option, available to the lessee for additional consideration, to reallocate the risk of loss (up to the sum of $1,000) to the lessor in the event the vehicle sustains damage during the rental term. Thus, as in *Jellins*, after reviewing the entire contract, we are satisfied that this tangential risk allocation provision should not have the effect of converting the defendants as contracting lessors into insurers subject to statutory regulation.

Both the Program and *Truta* involve the leasing of automobiles. In both situations, the principal object of the contracting parties is the lease. The risk allocation is tangential to the lease. *Truta* is, therefore, persuasive authority for concluding that the Program does not constitute insurance.

In addition to case law, further authority respecting the principal object and purpose test may be found in *12 Appleman Insurance Law and Practice* (1981), Section 7002, p 14, where the author states:

> A statute designed to regulate the business of insurance . . . is not intended to apply to all organizations having some element of risk assumption or

> distribution in their operations. The question of whether an arrangement is one of insurance may turn, not on whether a 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. [footnotes omitted]

A former Michigan Commissioner embraced this position in Bulletin 81-20, which she issued October 20, 1981. The Commissioner had under review questions regarding the unauthorized transaction of insurance by motor clubs. In determining whether indemnification for towing and emergency road services would be deemed insurance, the Commissioner stated:

> An agreement for provision of services will not be considered insurance because it provides for occasional reimbursement of expenses, if such reimbursement is only incidental to the operation of a plan which taken as a whole has as its principal object and purpose the provision of services rather than indemnity.

RAMP has stated as a matter of fact that damage repair coverage is incidental to the OEM's lease of vehicles and its overall warranty. In light of Bulletin 81-20, court precedent, *Appleman*, the advice of the Assistant Attorneys General, and the soundness of the underlying reasoning, the Commissioner should rule that the Program does not constitute insurance because the coverage is not the principal object and purpose of the lease agreement.

Risk Allocation in Leases

The Program will only be offered in connection with the lease of new vehicles. Thus, the first titled owner of the vehicles will be the lessor. As owner of the leased vehicles, the lessor bears the ultimate risk of their loss. Pursuant to the Program, there is a retention, rather than a transference, of the risk of loss due to damage of the vehicles.

The underwriting or transference of risk is an essential element of an insurance contract. As the United States Supreme Court stated in *Group life* v *Royal Drug*, 440 US 205, 211; 99 SCt 1067 (1979):

> The primary elements of an insurance contract are the spreading and underwriting of a policyholder's risk . . . R. Keeton, Insurance Law Section 1.2(a)(1971)("Insurance is an arrangement for transferring and distributing risk")

The Michigan Supreme Court has also recognized that a shifting of risk is a defining component of an insurance transaction. In *St. Paul Fire & Marine Insurance Co* v *American Home Assurance Co*, 444 Mich 560, 564; 514 NW2d 521 (1994), the court stated, in the context of a dispute involving "other insurance" clauses:

> …Broadly defined, insurance is a contract by which one party, for a consideration, assumes particular risks of the other party…

The *Truta* court explored the implications of this in a vehicle lease. While the court relied in part upon the principal object and purpose test discussed above, it also deferred to the opinion of the California Department of Insurance, which viewed the collision damage waiver as only a contractual allocation of risk, not a spreading of risk as found in insurance transactions. The court quoted with approval from the Department's legal opinion as follows [at 811]:

> My conclusion is that the Ford Rent-A-Car System operator is not involved in providing insurance. The subject charge is not accumulated to pay any liabilities or costs incurred by the renter. Rather, the system operator has simply, by contract, released the lessee from responsibility for any damage to the property of the lessor. This is not a spreading of risk within insurance concepts, but is rather an allocation of risk by contractual agreement. As the parties can contract to place full responsibility for damage on the lessee, it seems no less reasonable that they can contract to place this responsibility on the lessor.

In accord is *Chabraja* v *Avis Rent A Car Sys.*, 192 Ill App 3rd 1074, 1077 (1989), where the court placed the collision damage waiver in the context of bailments:

> Renting a car creates a bailment between the leasing company (bailor) and the customer (bailee). Generally, a bailee is responsible for any injury to the bailed property. Thus, the customer would be responsible for damage to the rented vehicle.

However, when the customer (bailee) selects the CDW, responsibility for damage to the car returns to the leasing company (bailor). This is a change in the contract of bailment. The parties to a contract may agree to any terms they choose as long as the agreement is not contrary to public policy. [citations omitted]

While no Michigan appellate court has addressed the issue of collision damage waivers, several cases have dealt with bailment and the allocation of loss of bailed property. Bailment itself is defined in *Universal Underwriters Ins. Co.* v. *Vallejo*, 179 Mich App 637, 646 (1989):

The term "bailment" has been defined by this Court as follows:

> ‘Bailment,’ in its ordinary legal signification, imports the delivery of personal property by one person to another in trust for a specific purpose, with a contract, express or implied, that the trust shall be faithfully executed and the property returned or duly accounted for when the special purpose is accomplished. Phrased another way, it is a relationship wherein a person gives to another the temporary use and possession of property

> other than money, the latter agreeing to return the property to the former at a later time. [citations omitted]

The lease of an automobile gives rise to bailment. In *Universal Underwriters*, at 446, the court quoted from a California case as follows:

> When the owner of an automobile gives possession of it, with permission to operate it, to another person, a contract of bailment is created. [citation omitted]

The Michigan Supreme Court, in *Johnston* v *Miller*, 326 Mich 682, 694, (1950), has recognized that parties to a bailment contract, such as a lease, are generally free to allocate the risk of damage to the bailed property. The court quoted with approval from a North Dakota case as follows:

> The appellant's contention is that the relative rights of the plaintiff and defendant, as bailor and bailee, must be determined from the contract of bailment, and not by the general rules of liability under the law of bailments. We have no doubt of the correctness of this contention. Parties are permitted to make their own contracts in reference to their mutual rights and liabilities under bailments of property as well as in reference to other subjects, but, of course, are not permitted to contract in contravention of positive law or public policy, and perhaps may not in all cases relieve themselves from the results of their own negligence… [citation omitted]

There is no positive law in Michigan that specifies the allocation of risk of damage to leased vehicles. In *Universal Underwriters, supra*, at 512, the court specifically found that the law of bailment did not conflict with Michigan's automobile no-fault law:

> The no-fault act in large measure abolished tort liability for injuries or damages arising from the ownership, maintenance, or use in Michigan of a motor vehicle. However, the act did not abolish contractual liability for losses arising from the use of a motor vehicle.

Moreover, there is no reason to conclude that the Program would contravene public policy. In particular, there is no danger of this risk allocation stemming from a contract of adhesion, since the lessor is retaining the risk of loss at no separate charge to its lessees. Thus, the lessor and its lessees are permitted to make their own agreements in this regard.

In summary, the Program will only be used in connection with the lease of new vehicles. The ownership and ultimate risk of loss will remain with the lessor. This is not an insurance transaction since there is no transference of risk to the lessor. Rather, there is an allocation of risk pursuant to the lease agreement. This allocation is lawful under Michigan contract law.

IV. RULING

Therefore, it is the Commissioner's ruling that:

1. A warranty issued by an OEM that includes damage repair coverage does not constitute insurance where the coverage is not the principal object and purpose of the transaction.

2. A warranty issued by an OEM that includes damage repair coverage does not constitute insurance where the coverage is part of a lease agreement.

This ruling is limited to the facts which were presented by the applicant and the statutory sections identified by the applicant in its declaratory ruling request.

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