

# Blurred Lines: Another Case of Service Contract v. Warranty v. Insurance Confusion

**By Brian T. Casey and Jon L. Gillum**

In a brand new opinion, the Oklahoma Supreme Court in *Sparks v. Old Republic Home Protection Co., Inc.*[1] held that what appeared (and was likely intended) to be a “service contract” was actually an insurance contract by way of also being a warranty, thereby preventing enforcement of an arbitration clause in the contract. Say what?

The lines separating insurance, warranties, and service contracts (more commonly known in business parlance as extended warranties, especially when issued by a product manufacturer), are not always clear. And, confusion about the categorization of such products and which laws, including important ancillary laws like data privacy and security laws, resultantly apply is not new. In recent years, numerous courts have struggled with categorizing new products that push the boundaries of traditional warranties, insurance products, and service contracts.[2] Earlier this year the Vice Chair of the Insurance Committee of the Texas House of Representatives said the following when confronted with consumer complaints about home warranties and the difficulties of identifying what they are and who regulates them:

*“It sounded like insurance so we assumed that it was the Department of Insurance but it turns out that it’s not [.]”[3]*

Similarly, in the early days of the Coronavirus outbreak members of the service contract industry struggled to determine whether they were considered “essential services” based on governmental decrees that referenced only “insurance” and whether insurance regulator pronouncements about required deferrals of insurance premiums collections and related restrictions on cancellation of insurance policies for non-payment of premium in the wake of COVID-19 also applied to extended warranties. And, even with long-standing codified legal authorities like the federal Magnuson-Moss Warranty Act, the definitions of terms like “service contract” and “warranty” may not be consistent with state laws using the same terms.[4] Indeed, as evidenced in *Sparks*, some states refer to the same product as both a home warranty and a home service contract; other states only refer to a home warranty and use such a term to mean a home service contract; and still other states use entirely different terminology.[5] Further confusion can arise as to the difference between home warranties and “home warranty insurance” and whether warranties covering home appliances (as opposed to

structural defects) are considered home warranties.<sup>[6]</sup> Generally speaking, a “warranty” is a promise usually made by the manufacturer or a distributor of a product and always made without a separate charge to the product purchaser, that the product is free of manufacturing and workmanship defects and to repair or replace the product if such a defect emerges. Warranties typically do not involve cash payments to the purchaser for their breach; rather, they promise to repair or replace a defective product or its component part, and are governed by the federal Magnuson Moss Warranty Act when a consumer product is involved.<sup>[7]</sup> Furthermore, specific warranties—such as the warranties of habitability, merchantability, and fitness for a particular purposes—are often imposed by common law and each state’s Uniform Commercial Code. <sup>[8]</sup> But some states have additional statutes generally defining warranties outright or as exceptions to contracts governing insurance and service contracts. <sup>[9]</sup>

In contrast, a “service contract,” typically provides the same type of promise as a warranty but in exchange for payment of a purchase price and in many cases is issued by a third party that is not the manufacturer or distributor of the covered, consumer product or otherwise a business in the supply and distribution chain of the product.<sup>[10]</sup> In the majority of states, service contracts are subject to their own statutory regimes, and in some states different types of service contracts (such as those that cover homes versus motor vehicles) are regulated under different statutes by different regulators.<sup>[11]</sup> Still, even among “service contracts” laws there are outliers that defy normal categorization. This additional complexity exists because state legislatures have often chosen to deregulate products that might otherwise be considered insurance and deem such products to be “service contracts” even though the types of risks they cover and benefits they provide are arguably distinct. For example, many states consider paintless dent repair, key fob replacement, certain automobile depreciation products, vehicle protection products, and even identity-theft protection to be types of service contracts.<sup>[12]</sup> Yet, such products typically do more than guarantee against defects in manufacturing and workmanship, sometimes assuming types of risks that touch the insurance classification line.

And, in further contrast, an insurance contract exists where (1) a promisor agrees to indemnify a promisee (risk shifting and indemnification promise), (2) upon the occurrence of an adverse fortuitous event beyond the reasonable control of both parties, (3) in exchange for a payment by promisee to promisor (premium), and (4) a promisor is distributing similar risks that it bears under similar contracts (risk distribution and actuarial-based pricing of the contract).<sup>[13]</sup> Yet, state laws defining insurance can also vary, and some states such as Texas actually lack a statutory definition of insurance.

Based on those distinctions, service contracts do resemble insurance, especially where the promisor is not the manufacturer or a distributor of the covered product. And, but for the service contract laws in most states, a service contract would be insurance, and service contracts may still be categorized as insurance in states that lack service contract laws. However, service contracts are not treated as insurance because the service contract laws say so—a deliberate choice by state lawmakers to remove service contracts from the more onerous world of insurance regulation.[14] In other words, the service contract laws deregulate—partially and significantly—a product that would otherwise be insurance if issued by a “third party obligor”. In many states, insurance contracts and service contracts remain regulated by the same regulatory body that regulates insurance (typically the Department of Insurance), and the laws governing both insurance and service contracts often reside in a state’s insurance code. But, despite those commonalities, ultimately service contracts are distinct from insurance because most laws governing service contracts state that they are not insurance or otherwise not subject to provisions of a state’s insurance code governing insurance contracts.[15]

With that backdrop, it is no wonder that the Oklahoma Supreme Court struggled in *Sparks* with the distinction between warranties, service contracts, and insurance. In that case, Old Republic issued to the plaintiff homeowners a contract labeled as an “Oklahoma Home Warranty” that provided coverage to them for the repair or replacement of their home air conditioning system for certain loss events. Based on a coverage claim dispute, plaintiffs sued Old Republic for breach of contract and bad faith breach of contract, and Old Republic sought to compel arbitration under the contract’s arbitration clause which provided that the Federal Arbitration Act would govern disputes involving the contract. The trial court denied Old Republic’s motion to compel arbitration, finding that the contract at issue was insurance in nature and thus the federal McCarran-Ferguson Act reverse preempted the application of the federal Arbitration Act and the Oklahoma arbitration act’s exclusion for insurance applied. The state’s appellate court affirmed that decision following Old Republic’s interlocutory appeal, which the Oklahoma Supreme Court affirmed [16]

In *Sparks*, Old Republic argued that its “home warranty” contract was really a “home service” contract and thus not insurance and not subject to the Oklahoma Arbitration Act’s exception for a contract that “references insurance”. [17] However, the court noted that Old Republic had initially pleaded in the case that it was an insurance company and its home warranty contract was an insurance contract. And, the contract referred to Old Republic as being part of an insurance group. In addition, the court was skeptical about Old Republic’s argument in light of a prior California case in which the company successfully argued that an identical home

warranty contract was analogous to insurance to avoid claims made under a California consumer protection law that excluded claims based on an insurance contract.[18]

In finding that Old Republic's home warranty contract was insurance for purposes of Oklahoma's arbitration law, the court followed its prior, 2011 Oklahoma case, *McMullan v. Enterprise Financial Group, Inc.*, in which it held that a vehicle service contract was an insurance product.[19] In addition, the court burrowed into the combined definitions of "home warranty" and "home service contract" and the insurance declassification language of the Oklahoma Home Service Contract Act to support its conclusion. The definitions of "home warranty" and "home service contract" are combined in the Oklahoma Home Service Contract Act and the court stated the following:

'Home service contract' or 'home warranty' means a contract or agreement for a separately stated consideration for a specific duration to perform the service, repair, replacement or maintenance of property or indemnification for service, repair, replacement or maintenance, for the operational or structural failure of any residential property due to a defect in materials, workmanship, inherent defect or normal wear and tear, with or without additional provisions for incidental payment or indemnity under limited circumstances. Home service contracts may provide for the service, repair, replacement, or maintenance of property for damage resulting from power surges or interruption and accidental damage from handling and may provide for leak or repair coverage to house roofing systems. *Home service contracts are not insurance in this state or otherwise regulated under the Insurance Code.*[20]

Because Old Republic termed its contract as a "home warranty" and not a "home service contract", the *Sparks* court concluded that Old Republic's contract did not obtain the benefit of the inclusion within the combined definitions that "[h]ome service contracts are not insurance in this state or otherwise regulated under the Insurance Code." In other words, the unique language in the Oklahoma statute did not reference "home warranties" at the end of the definition when stating that "home service contracts" (but not home warranties) are not insurance. Thus, the court determined that a home warranty could be insurance notwithstanding the combined definitions.

Apart from its reminder of the blurred lines that distinguish warranties, service contracts, and insurance, *Sparks* provides some key takeaways for service contract providers:

- Do not misuse warranty nomenclature in drafting what is intended to be a service contract.
- Avoid using insurance nomenclature, such as a "declarations page", for a service contract.

- Pay attention to the insurance declassification language within each state’s service contract laws.
  - Use extra caution if the service contract obligor is or is affiliated with an insurance company.
  - Watch out for the few states that have not adopted service contract laws, and which may result in service contract laws being considered insurance.
  - Be aware of how commercial service contracts, as opposed to consumer goods service contracts, are regulated.
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[1] *Sparks v. Old Republic Home Protection Co., Inc.*, No. 115,789, 2020 WL 2745507 (Ok. May 27, 2020) (not yet released for publication).

[2] See Brian T. Casey & Jon L. Gillum, “Extending the Murky Divide Between Warranty and Insurance,” *Law360* (Aug. 21, 2017).

[3] See Mario Diaz, “Home warranty wars: homeowners, attorney general fight for stricter practices within industry”, *click2houston.com* (Jan. 30, 2020) (emphasis added).

[4] See Brian T. Casey & Jon L. Gillum, “Navigating Federal and State Rules For Extended Warranties” *Law360* (Feb. 8, 2019), republished in *Warranty Week* (2019) and the *Journal of Consumer & Commercial Law* (Vol. 23, No. 1, Fall 2019).

[5] See, e.g., Az. R. S. § 20-1095(3) (defining a “home warranty or home protection contract” as a “service contract”); Col. R. S. A. § 12-10-901 (2) (using the term “home warranty service contract”); Tex. Occ. Code §§ 1303.002 (using the term “residential service contract”).

[6] See, e.g., Tex. Occ. Code §§ 1303.003(b) & 1303.1305(5) (excluding “home warranty insurance” from definition of a “residential service contract and stating that Texas’s home warranty law does not apply to “an insurance company licensed and regulated under the insurance laws of this state”).

[7] See, e.g., 15 U.S.C. §§ 2301-2312; 16 Code of Federal Regulations § 700.1-1-703.8

[8] See, e.g., Tex. Bus. & Comm. Code §§ 2.314-15.

[9] See, e.g., W. Va. Code, § 33-4-2(b)(5).

[10] See National Association of Insurance Commissioners Service Contracts Model Act (available at <https://www.naic.org/store/free/MDL-685.pdf>).

[11] See Jon L. Gillum & Lauren M. Fincher, “Cross-Agency Regulation of Service Contracts in Texas,” *Texas Tech Administrative Law Journal*, Volume 19, Book 1, 107-150 (Fall 2017)

[12] See, e.g., Tex. Occ. Code § 1304.003; Jon L. Gillum & Brian T. Casey, “Key-Fob Amendment to Texas Service Contract Law Considered by Legislature,” *InsureReinsure* (Mar. 29, 2017).

[13] See, e.g., *Guaranteed Warranty Corp. Inc. v. Humphrey*, 533 P.2d 87, 90 (Az. Ct. App. 1975); Couch on Ins. § 1:6 (2016).

[14] See, e.g., Tex. Occ. Code § 1303.003 (“Except as otherwise provided by this chapter, the insurance laws of this state do not apply to a residential service company.”).

[15] See, e.g., Fla. S. A. § 634.3025(1) (“Except as provided in this part, home warranty associations shall be governed by the provisions of this part and shall be exempt from all other provisions of the Florida Insurance Code.”); *but see* Ct. G. S. A. § 38a-320 (“A home warranty contract or home warranty service agreement as defined in subsection (a) of this section shall constitute a contract of insurance within the meaning of section 38a-319.”)

[16] See *Sparks*, 2020 WL 2745507.

[17] 12 Ok. Stat. 1855(D).

[18] See *Sparks*, 2020 WL 2745507.

[19] See *McMullan v. Enterprise Financial Group, Inc.*, 247 P.3d 1173 (Ok. 2011).

[20] 36 Ok. Stat. § 36-6752(9) (emphasis added).