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Service plan regulatory compliance

Better safe than shut down

Both federal and state authorities regulate Extended Service Plans, Extended Warranties and Service Contracts (which we collectively call ESP Programs). That makes compliance challenging and complex, but absolutely critical to ensure that your ESP Program protects you and your customers. If your plan is out of compliance it may be suspended or shut down, and your company may be saddled with sizeable damage awards, injunctions, and fines, and may even face criminal prosecution.

Companies that do not understand federal and state regulations governing ESP Programs put themselves – and their profits – at significant risk.

Federal Law

Federal laws impacting ESP Programs include the Federal Trade Commission Act, the Magnuson-Moss—Federal Trade Commission Warranty Improvement Act of 1975, and the Truth-in-Lending-Act. The FTC Act generally regulates conduct in interstate commerce. The MMWA establishes disclosure and content requirements for ESP programs. TILA imposes disclosure and content requirements in consumer credit transactions. Federal financial privacy laws, such as the Gram-Leach-Bliley Act, may also apply. Companies must also comply with FTC rules and regulations supplementing and interpreting these statutes.

State Law

On the state level, companies offering ESP Programs encounter an even broader array of consumer protection and regulatory initiatives. Compliance requirements vary widely from state-to-state. Some rely on general consumer protection and unfair trade laws, while others have enacted legislation specific to ESP Programs. Several states treat ESP Programs as insurance contracts. This lack of consistency and uniformity compounds the difficulty facing companies in developing and executing an effective compliance program.

Dangers of Not Complying

It bears repeating: Companies that do not understand federal and state regulations governing ESP Programs put themselves – and their profits – at significant risk.



The FTC, which describes itself as “the nation’s consumer protection agency,” possesses broad investigative and enforcement powers. For example, in 2004, it conducted a nationwide sweep of mortgage companies to monitor compliance with the Gram-Leach-Bliley Act, a federal financial privacy law. One of the companies found in violation had no choice but to consent to an order that:

- bars the company and its president from violating the act in the future;
- requires the company to retain an independent professional to certify its security program meets the standards set by the FTC within 180 days, and then once every other year for 10 years;
- forces the company to distribute a copy of the order to all of its employees; and
- requires the company to implement FTC-dictated record keeping provisions to allow the FTC to monitor its compliance.

The FTC can also levy fines, restrict, suspend, or terminate business operations, and, in circumstances it perceives as extreme, seek criminal sanctions.

State officials have similar investigative and enforcement powers. Indeed, a company found to engage in repeated violations may lose the ability to do business in a state permanently.

Noncompliance can also spawn individual and class action law suits, resulting in exorbitant settlements, crippling damages awards, or onerous injunctions. Punitive damages in a consumer case can, and often do, dwarf the actual harm caused. The costs of defending consumer litigation can be hefty – and cut into your bottom line. So, too, do the legal fees your company pays to the consumer lawyer who brings an action against it.

In short, compliance with state and federal law is crucial to the success and profitability of your ESP program. Yet negotiating the legal labyrinth can be daunting. **Segal McCambridge Singer & Mahoney** can guide your company safely through the regulatory maze.

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Segal McCambridge Singer & Mahoney (www.smsm.com) specializes in helping companies faced with complex regulatory requirements and high-stakes litigation. We simplify, and so bring clarity and understanding, producing effective solutions to daunting problems.

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The Illinois Service Contract Act

In 1998, Illinois enacted the Service Contract Act, codified at 215 ILCS 152/1, *et seq.* (“the SCA”), to regulate agreements providing repair coverage for consumer products independent from the factory or manufacturer’s warranty. Companies desiring to sell service contracts (also referred to as extended warranties) must satisfy various registration, financial responsibility, and record keeping requirements. Additionally, the contracts they offer must meet certain content and disclosure requirements. Below is a general discussion of the SCA’s provisions.

“Service Contract”

A “service contract” is:

a contract or agreement whereby a service contract provider undertakes for a specified period of time, for separate and identifiable consideration, to perform the repair, replacement, or maintenance, or indemnification for such services, of any automobile, system, or consumer product in connection with the operational or structural failure due to a defect in materials or workmanship, or normal wear and tear, with or without additional provision for incidental payment or indemnity under limited circumstances, for related expenses, including, but not limited to, towing, rental, and emergency road service. Service contracts may provide for the repair, replacement, or maintenance of such property for damage resulting from power surges and accidental damage from handling.

215 ILCS 152/5 (West 2008). The term “service contract” does not “include contracts of limited duration that provide for scheduled maintenance only.” *Id.*

Registration Disclosures and Fees

Before a company may sell a service contract in Illinois, it must submit the following information to the state’s Department of Insurance:

- The name of the service contract provider;
- A list identifying the service contract provider's executive officer or officers directly responsible for the service contract provider's service contract business;
- The name and address of the service contract provider's agent for service of process in Illinois, if other than the service contract provider;

- A true and accurate copy of all service contracts to be sold in Illinois; and
- A statement indicating under which provision of §15, the financial responsibility requirements, the service contract provider qualifies to do business in Illinois as a service contract provider.

215 ILCS 152/25 (West 2008). Additionally, the service contract provider must pay an initial registration fee of \$1,000 and a yearly renewal fee of \$150.

Financial Responsibility Requirements

In order to sell service contracts in Illinois, a firm must first satisfy *one of the three* following conditions:

(1)(A) The service contract provider is insured under a service contract reimbursement insurance policy¹ issued by an insurer authorized to do business in Illinois and providing that the insurer will pay to, or on behalf of, the service contract provider all sums that the service contract provider is legally obligated to pay according to the service contract provider's contractual obligations under the service contracts issued or sold by the service contract provider; (B) a true and correct copy of the service contract reimbursement insurance policy has been filed with the Director of Insurance by the service contract provider; (C) the service contract states that the obligations of the service contract provider to the service contract holder are covered under a service contract reimbursement insurance policy; and (D) the service contract states the name and address of the issuer of the service contract reimbursement insurance policy and states that in the event covered service is not provided by the service contract provider within 60 days of proof of loss by the service contract holder, the service contract holder may file directly with the service contract reimbursement insurance company.²

or

¹ "Service contract reimbursement insurance policy" means a policy of insurance that is issued to the service contract provider to provide reimbursement to the service contract provider or to pay on behalf of the service contract provider all covered contractual obligations incurred by the service contract provider under the terms and conditions of the insured service contracts issued or sold by the service contract provider. 215 ILCS 152/5 (West 2008).

² No service contract reimbursement insurance policy shall be issued, sold, or offered for sale in this State unless the policy states that the issuer of the policy will reimburse or pay on behalf of the service contract provider all covered sums which the service contract provider is legally obligated to pay or will provide the service that the service contract provider is legally obligated to perform according to the service contract provider's contractual obligations under the provisions of the insured service contracts issued or sold by the service contract provider. If covered service is not provided by the service contract provider within 60 days of proof of loss by the service contract holder, the service contract holder may file directly with the insurance company writing the service contract reimbursement insurance policy. A service contract reimbursement insurance company that insures a service contract shall be deemed to have received payment of the premium if the service contract holder paid for the service contract coverage. If a service contract is canceled by a service contract holder, the service contract reimbursement insurance company shall be required to return the unearned service contract reimbursement insurance premium for that contract to the insured service contract provider. If the service contract provider fails to refund the amounts required under Section 35 of this Act, the service contract reimbursement insurance company shall be responsible for the refund to the service contract holder. 215 ILCS 152/20 (West 2008).

(2)(A) The service contract provider maintains a funded reserve account for its obligations under its service contracts issued and outstanding in Illinois. The reserves shall not be less than 40% of the gross consideration received, less claims paid, for all service contracts sold and then in force; (B) the service contract provider places in trust with the Director of Insurance a financial security deposit, having a value of not less than 5% of the gross consideration received, less claims paid, for all service contracts sold and then in force, but not less than \$25,000, consisting of securities of the type eligible for deposit by authorized insurers in Illinois; and (C) the service contract provider provides the Director of Insurance with an audited financial statement annually of the service contract revenues and claims.

or

(3)(A) The service contract provider, or its parent company in accordance with subdivision (3)(B), maintains a net worth or stockholders' equity of \$100,000,000; and (B) the service contract provider provides the Director of Insurance with a copy of the service contract provider's or the service contract provider's parent company's most recent Form 10-K or Form 20-F filed with the Securities and Exchange Commission within the last calendar year or, if the service contract provider does not file with the Securities and Exchange Commission, a copy of the service contract provider's or the service contract provider's parent company's audited financial statements that shows a net worth of the service contract provider or its parent company of at least \$100,000,000. If the service contract provider's parent company's Form 10-K, Form 20-F, or audited financial statements are filed to meet the service provider's financial stability requirement, then the parent company shall agree to guarantee the obligations of the provider relating to service contracts issued by the service contract provider in Illinois.

215 ILCS 152/15 (West 2008).

Content and Disclosure Requirements

All service contracts issued or sold in Illinois shall contain the following disclosures written in clear and understandable language:

- The name and address of the service contract provider;
- The total consideration for the service contract paid by the service contract holder;
- The conditions and procedures for obtaining service under the service contract, including the name, address, and local or toll-free telephone number of any person from whom approval is required before covered repairs may be commenced;
- The existence and amount of a deductible, if any;
- Merchandise and services to be provided and any limitations, exceptions, or exclusions;
- The terms, conditions, and restrictions governing transferability of the service contract, if any;

- The provisions governing cancellation and refunds in accordance with §35 of the SCA; and
- Whether or not the service contract covers failure resulting from normal wear and tear.

215 ILCS 152/30 (West 2008).

Illinois service contracts must also “clearly state” that the holder may cancel it:

- within 30 days after its purchase if no service has been provided and that a full refund of the service contract consideration, less any cancellation fee stated in the service contract will be paid to the service contract holder; **or**
- at any other time and a pro rata refund of the service contract consideration for the unexpired term of the service contract, based on the number of elapsed months, miles, hours, or such other reasonably applicable measure which is clearly disclosed in the service contract, less the value of any service received, and any cancellation fee stated in the service contract will be paid to the service contract holder.

215 ILCS 152/35 (West 2008). The service contract provider may retain a cancellation fee of 10% of the contract price or \$50, whichever is less.

A service contract may provide full or partial reimbursement for other expenses incurred by the holder as a result of an operational or structural failure covered by the service contract. A reimbursement for these expenses shall not exceed the purchase price of the property serviced per incident. 215 ILCS 152/40 (West 2008).

Record Keeping Requirements

A service contract provider shall keep records concerning transactions regulated under the SCA for at least 3 years after the specified coverage period has expired. The records must include:

- Copies of each type of service contract sold;
- The name and address of each service contract holder, to the extent that the name and address has been furnished by the service contract holder;
- A list of the locations where service contracts are marketed, sold, or offered for sale; and
- Written claims files which shall contain at least the date and description of claims related to the service contracts.

215 ILCS 152/45 (West 2008). The records may be maintained on a computer disk or other record keeping technology, but must be capable of duplication to legible hard copy.

A service contract provider discontinuing business in Illinois shall maintain its records until it furnishes the Director satisfactory proof that it has discharged all obligations to service contract holders in Illinois.

Enforcement

The Director of Insurance is the SCA's chief enforcer. The Director may issue rules and orders, conduct hearings,³ file suit, and punish violations of the SCA in several ways, including cease and desist orders; orders prohibiting a service contract provider from selling or offering for sale service contracts in violation of the SCA, and any combination of the two. The Director may also issue a civil penalty of not more than \$500 per violation and not more than \$10,000 in the aggregate for all violations of a similar nature. Upon the Director's request, a service contract provider must make available all accounts, books, and records reasonably necessary to enable the Director to assess compliance with the SCA. 215 ILCS 152/50 (West 2008).

³ The provisions of Section 10-25 of the Illinois Administrative Procedure Act shall apply to a hearing request under this Section. Section 10-25 states:

(a) In a contested case, all parties shall be afforded an opportunity for a hearing after reasonable notice. The notice shall be served personally or by certified or registered mail or as otherwise provided by law upon the parties or their agents appointed to receive service of process and shall include the following:

- (1) A statement of the time, place, and nature of the hearing.
- (2) A statement of the legal authority and jurisdiction under which the hearing is to be held.
- (3) A reference to the particular Sections of the substantive and procedural statutes and rules involved.
- (4) Except where a more detailed statement is otherwise provided for by law, a short and plain statement of the matters asserted, the consequences of a failure to respond, and the official file or other reference number.
- (5) The names and mailing addresses of the administrative law judge, all parties, and all other persons to whom the agency gives notice of the hearing unless otherwise confidential by law.

(b) An opportunity shall be afforded all parties to be represented by legal counsel and to respond and present evidence and argument.

(c) Unless precluded by law, disposition may be made of any contested case by stipulation, agreed settlement, consent order, or default.

Regulation of Service Contracts in New York

New York regulates third-party agreements to repair or replace defective products, commonly referred to as service contracts, extended warranties, or extended service plans, under Article 79 of its Insurance Law. The state Superintendent of Insurance has been given oversight and enforcement responsibilities. The article exempts the service contracts business from all other provisions of New York's Insurance Law. Upon request, the Office of General Counsel State of New York Insurance Department will review service contract forms for compliance with Article 79.

Article 79 defines "service contract" as:

a contract or agreement, for a separate or additional consideration, for a specific duration to perform the repair, replacement or maintenance of property, or indemnification for repair, replacement or maintenance, due to a defect in materials or workmanship or wear and tear, with or without additional provision for indemnity payments for incidental damages, provided any such indemnity payment per incident shall not exceed the purchase price of the property serviced. Service contracts may include towing, rental and emergency road service, and may also provide for the repair, replacement or maintenance of property for damage resulting from power surges and accidental damage from handling. Service contracts may also include contracts to repair, replace or maintain residential appliances and systems. Such term shall also mean a contract or agreement made by or for the manufacturer or seller of a motor vehicle tire for repair or replacement of the tire or wheel as the result of damage arising from a road hazard.

NY INS § 7902(k) (West 2008).⁴

⁴ In 2005, the New York Supreme Court defined "Third party product warranties," in which the replacement or maintenance of parts not actually performed by the manufacturer, is generally considered insurance and not a warranty, because the service provider is a third party to the seller-consumer transaction and the coverage obligation is unrelated to the quality of the product being manufactured or sold. *See Petro, Inc. v. Gregory V. Serrio, as Superintendent of Insurance of the State of New York*, 9 Misc.3d 805, 804 N.Y.S.2d 598 (2005) (Finding that a service program provided by a heating fuel oil company was **not** a service contract, but rather was a warranty contract and thus exempt from insurance regulation due to enumerated statutory exemption of heating fuel oil.). "The issuance of a warranty on a product by its manufacturer, retailer, or repairer is not "doing an insurance business" within the meaning of Insurance Law of 1939 §§ 40 [see section 1102] and 41, but the issuance of a warranty by a third party not a manufacturer, retailer, or repairer merely because he sells another product to the owner is "doing an insurance business" within the meaning of said sections." 1976, Op.Atty.Gen. 56 (quoted from McKinney's Insurance Law, Chapter 28, Article 11 Section 1101).

Registration⁵

In order to offer a service contract in New York, a company must first register with the Superintendent, providing the following information:

- the name and address of the principal office of the provider;
- the name and address of the providers' agent for service of process in this state, if other than the provider;
- the identities of the provider's executive officer or officers directly responsible for such provider's service contract business, and, if more than fifty percent of the provider's revenue is derived from the sale of service contracts, the identities of the provider's directors and stockholders having beneficial ownership of five percent or more of any class of securities registered under the federal securities law;
- the name, location and telephone number of any administrators designated by the provider to be responsible for the administration of service contracts in this state, together with an acknowledgment by each such administrator (who is not employed by the provider) of such administrator's obligations under this article; and
- A statement indicating the provider financially qualifies to do business as a service contract provider in New York pursuant to NY INS §1703(c).

Additionally, a registrant must promptly report any material changes to the information originally provided, file a biennial renewal application, and pay a yearly \$250 registration fee. Service contract providers and administrators are exempt from any other state licensing requirements.

Financial Requirements⁶

In order to assure the faithful performance of a provider's obligations to its contract holders, each provider must either:

- (1) insure the performance of all its obligations under all service contracts pursuant to a service contract reimbursement insurance policy⁷ issued by an insurer authorized to issue

⁵ NY INS § 7907 (West 2008).

⁶ NY INS § 7903 (West 2008).

⁷ Service contract reimbursement insurance policies insuring service contracts issued, sold or offered for sale in this state shall state that, upon failure of the provider to perform under the service contract, including failure to return the unearned provider fee thereunder, the insurer that issued the service contract reimbursement insurance policy shall pay on behalf of the provider any sums the provider is legally obligated to pay under the service contract or shall perform the service which the provider is legally obligated to perform according to the provider's contractual obligations under the service contracts issued or sold by the provider. NY INS § 7904 (West 2008).

Service contracts insured under a service contract reimbursement insurance policy shall contain a statement in substantially the following form: "Obligations of the provider under this service contract are insured under a service contract

service contract reimbursement insurance in this state or procured by an excess line licensee pursuant to NY INS § 2118. In the event the provider fails to insure its obligations pursuant to this paragraph or in the event that such insurance shall lapse or be terminated, the provider shall comply with either paragraph two or three within forty-five days of the insurance lapse or termination;

or

(2) (A) maintain a funded reserve account for its obligations under its service contracts issued and outstanding in this state, which reserve account (i) contains reserves in an amount not less than forty percent of the gross consideration received upon the sale of, less claims paid under, all its service contracts then in force, but not less than zero, and (ii) shall be subject to examination and review by the superintendent; and (B) place in trust with the superintendent a financial security deposit, having a value of not less than five percent of the gross consideration received upon the sale of, less claims paid under, all service contracts issued and then in force, but not less than fifty thousand dollars, consisting of one or more of the following:

- (i) A surety bond issued by an authorized surety;
- (ii) Securities of the type eligible for deposit by authorized insurers in this state;
- (iii) Cash; or
- (iv) A letter of credit issued by a qualified United States financial institution;

or

(3) (A) maintain a net worth or stockholders' equity of at least one hundred million dollars; and (B) provide the superintendent with a copy of the financial statements of the provider, either on a stand alone basis or consolidated with its consolidated affiliates, included in its or its direct or indirect parent company's most recent annual report on form 10-K or form 20-F filed with the securities and exchange commission within the last calendar year, or if the provider or its direct or indirect parent company is not required to file such reports with the securities and exchange commission, a copy of the audited financial statements of the provider, either on a stand alone basis or consolidated with its consolidated affiliates. If the net worth or stockholders' equity of the provider, either on a stand alone basis or consolidated with its consolidated affiliates, as shown in the foregoing financial statements is at least one hundred million dollars, the provider shall be deemed to meet the requirements of this paragraph and there shall be no requirement of a guarantee, reimbursement insurance, or other form of financial stability arrangement. In the event the net worth or stockholders' equity of the provider, either on a stand alone basis or consolidated with its consolidated affiliates, is not at least one hundred million

reimbursement insurance policy. If the provider fails to pay or provide service on a claim within sixty days after proof of loss has been filed, the contract holder is entitled to make a claim directly against the insurer under the service contract reimbursement insurance policy." The service contract shall also state the name and address and a toll-free telephone number of the insurer under the related service contract reimbursement insurance policy. NY INS § 7905(b) (West 2008).

An insurer that issues a service contract reimbursement insurance policy shall not terminate the policy except in accordance with § 3426 of New York's Insurance law and upon notice to the superintendent. The termination of a service contract reimbursement insurance policy shall not reduce the issuer's responsibility for service contracts issued in this state by providers prior to the date of the termination. NY INS § 7909 (West 2008).

dollars, or the net worth or stockholders' equity of the provider, as aforesaid, is not determinable from the foregoing audited financial statements, the provider shall comply with paragraph one or two of this subsection within forty-five days of becoming aware of such deficiency. If the provider's direct or indirect parent company's form 10-K, form 20-F, or audited financial statements are filed to meet the provider's financial stability requirement, then the parent company shall agree to guarantee the obligations of the provider relating to service contracts sold by the provider in this state.

Disclosure Requirements⁸

A service contract must be dated and written in clear, understandable language and be printed or typed in easy to read type. Additionally, a service contract must:

- Identify any administrator if different from the provider or seller, the provider, and the service contract seller;
- State the procedure that the holder must take to obtain service under the service contract;
- State the total purchase price and the terms and conditions under which the service contract is sold;
- State the procedure for obtaining prior approval and for making a claim, including a toll free telephone number for claim service and if the service contracts provide services essential to public health, safety or welfare, the service contracts shall either provide for twenty-four hour telephone assistance or state the procedure for obtaining emergency repairs performed outside of normal business hours;
- State the existence of any deductible amount;
- Specify the merchandise and services to be provided and any limitations, exceptions or exclusions from coverage;
- State any terms, restrictions or conditions governing transferability;
- State the terms, restrictions or conditions governing termination;
- Set forth all of the obligations and duties of the holder;
- State whether the service contract provides for or excludes preexisting conditions;
- Contain a statement of the holder's right to return the contract; the applicable time periods; that if no claim has been made the provider shall refund the full purchase price; and that a monthly 10% penalty shall be added to a refund not made within 30-days of return;
- Service contracts insured under a service contract reimbursement insurance policy pursuant to §7903(1)(c) shall contain a statement in substantially the following form: "Obligations of the provider under this service contract are insured under a service contract reimbursement insurance policy. If the provider fails to pay or provide service on a claim within sixty days after proof of loss has been filed, the contract holder is entitled to make a claim directly against the insurer under the service contract reimbursement

⁸ NY INS § 7905 (West 2008).

insurance policy.” The service contract shall also state the name and address and a toll-free telephone number of the insurer under the related service contract reimbursement insurance policy; and

- Service contracts not covered by a service contract reimbursement insurance policy must contain a statement to the effect that: “Obligations of the provider under this service contract are backed by the full faith and credit of the provider,” and identify the provider.

Prohibitions⁹

Service contract providers may **not**:

- Use in its name the words insurance, casualty, guaranty, surety, mutual or any other words descriptive of the insurance, casualty, guaranty or surety business, or a name deceptively similar to the name or description of any insurance or surety corporation or any other provider.
- Make, permit or cause to be made any false or misleading statement, or deliberately omit any material statement that would make the service contracts or literature misleading if omitted, in connection with the sale, offer to sell, or advertisement of a service contract in its service contract literature.
- Require the purchase of a service contract as a condition of a loan or other extension of credit or a condition for the sale or other disposition of any property.

Record Keeping Requirements¹⁰

A provider or its administrator must maintain records for at least three years after the coverage period expires. The records must include:

- copies of each type of service contract issued;
- the name and address of each service contract holder to the extent that the name and address have been furnished by the service contract holder to the provider;
- a list of the provider locations where service contracts are marketed, sold, offered for sale, issued, made or proposed to be made or administered; and
- Written claims filed which shall contain at least the dates and description of all claims related to the service contracts.

A provider may keep the required records on a computer disk or other similar technology provided they can be printed in hard copy form upon request of the Superintendent. A provider discontinuing business must maintain its records until it furnishes to the Superintendent satisfactory proof that it has discharged all obligations to service contract holders in the state.

⁹ NY INS § 7906 (West 2008).

¹⁰ NY INS § 7908 (West 2008).

Enforcement Provision¹¹

The Superintendent has broad investigatory and enforcement powers. Indeed, the Superintendent may take any action necessary or appropriate to enforce Article 79's provisions and the regulations and orders promulgated to carry them out.

Where a violation is found, the Superintendent may order a service contract provider to cease and desist from prohibited conduct, suspend or revoke a provider's registration, or impose a civil penalty of up to \$500 per violation, or any combination of these.

Additionally, the Superintendent may bring an action for injunctive or other appropriate relief as well as seek restitution on behalf of persons aggrieved by a violation.

¹¹ NY INS § 7910 (West 2008).