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# Consumer Warranty or Insurance Contract? A View Towards A Rational State Regulatory Policy

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## Consumer Warranty or Insurance Contract? A View Towards A Rational State Regulatory Policy

A pervasive and recurrent problem for state officials charged with regulating insurance is determining which business activities constitute the sale of insurance under state law. In a recent decision,<sup>1</sup> the Court of Appeals of Arizona held that the sale by the defendant of contracts extending the manufacturer's warranty on television picture tubes constituted the sale of insurance. The purpose of this note is to show that the court's decision, guided almost solely by a definition, overlooked important policy reasons not to regulate.

The Director of Insurance of Arizona had sought to enjoin defendant Guaranteed Warranty from selling its so-called "warranty agreement" contracts. Under those contracts, the defendant agreed to replace picture tubes of televisions purchased from certain stores if the picture tubes failed as a result of a manufacturing defect. Defendant conducted its business by establishing dealerships with independent stores that sold televisions to the consumer. When a consumer purchased a television from such a store, the store would offer the consumer one of the defendant's warranty agreements along with the television. By paying a fixed amount<sup>2</sup> in addition to the purchase price, the consumer could acquire one of the defendant's warranty agreements, which took effect only after the manufacturer's warranty on the picture tube expired.<sup>3</sup>

These facts raise two substantial questions. First, do the defendant's contracts constitute warranty agreements, which would be exempt from regulation, or insurance policies within the ambit of regulation?<sup>4</sup> Second, if the contracts are insurance policies, on what basis should courts distinguish these "insurance policies" from warranties given by manu-

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<sup>1</sup> *Guaranteed Warranty Corp. v. State ex rel. Humphrey*, 23 Ariz. App. 327, 533 P.2d 87 (1975).

<sup>2</sup> The warranties are priced at \$29.95 for a color tube and \$14.95 for a black and white tube. 23 Ariz. App. at 329, 533 P.2d at 89. They extend coverage to five years and three years, respectively. *Phoenix Gazette*, Oct. 14, 1969, at 60.

<sup>3</sup> 23 Ariz. App. at 329, 533 P.2d at 89.

<sup>4</sup> See ARIZ. REV. STAT. § 20-206 (A) (1975) which provides that "[n]o person shall act as an insurer and no insurer shall transact insurance in this state except as authorized by a subsisting authority granted to it by the director [of insurance] . . . ." If the defendant were selling insurance, it would have to be licensed by the State of Arizona before any more of its policies could be sold to television buyers. See ARIZ. REV. STAT. §§ 20-215, 216 (1975).

facturers in order to avoid subjecting all such warranties to the insurance laws?

In resolving these issues, the Court of Appeals generally defined "insurance" as "a contract whereby one undertakes to indemnify another or to pay a specified amount upon determinable contingencies."<sup>5</sup> It further enumerated the following five elements of an insurance contract:

1. An insurable interest
2. A risk of loss
3. An assumption of the risk by the insurer
4. A general scheme to distribute the loss among the larger group of persons bearing similar risks
5. The payment of a premium for assumption of the risk.<sup>6</sup>

The Court also relied upon the assumption that under the Uniform Commercial Code only a seller of goods can give a warranty.<sup>7</sup> Noting that the defendant was not the seller of the televisions and that the warranty agreements contained the elements characteristic of an insurance contract, the Court of Appeals held that the defendant was an insurer within the regulatory statute.<sup>8</sup> In reaching its decision, there-

<sup>5</sup> 23 Ariz. App. at 330, 533 P.2d at 90, *citing* ARIZ. REV. STAT. § 20-103 (1975).

<sup>6</sup> *Id.* at 330, 533 P.2d at 90. *See* 1973 ARIZ. OP. ATT'Y GEN. 12; 1957 ARIZ. OP. ATT'Y GEN. 147. The opinions of the Attorneys General analyze prearranged funeral plans and certain automobile warranty contracts by using the *Guaranteed Warranty* approach of noting five elements of an insurance contract in addition to a definition.

<sup>7</sup> *See* 23 Ariz. App. at 330, 533 P.2d at 90. *See also* ARIZ. REV. STAT. § 44-2330 (1967), UNIFORM COMMERCIAL CODE § 2-313 which provides:

A. Express warranties by the seller are created as follows:

1. Any affirmation of fact or promise made by the seller to the buyer which relates to the goods and becomes part of the basis of the bargain creates an express warranty that the goods shall conform to the affirmation or promise.
2. Any description of the goods which is made part of the basis of the bargain creates an express warranty that the goods shall conform to the description.
3. Any sample or model which is made part of the basis of the bargain creates an express warranty that the whole of the goods shall conform to the sample or model.

ARIZ. REV. STAT. § 44-2331 (1967), UNIFORM COMMERCIAL CODE § 2-314 which provides:

- A. Unless excluded or modified . . . , a warranty that the goods shall be merchantable is implied in a contract for their sale if the seller is a merchant with respect to goods of that kind. Under this section the service for value of food or drink to be consumed either on the premises or elsewhere is a sale.

ARIZ. REV. STAT. § 44-2332 (1967), UNIFORM COMMERCIAL CODE § 2-314 which provides:

Where the seller at the time of contracting has reason to know any particular purpose for which the goods are required and that the buyer is relying on the seller's skill or judgment to select or furnish suitable goods, there is unless excluded or modified . . . an implied warranty that the goods shall be fit for such purpose.

<sup>8</sup> *See* ARIZ. REV. STAT. §§ 20-103, -206, -256 (1975). § 20-256 defines property insurance as

insurance on real or personal property of every kind and interest therein, against loss or damage from any or all hazard or cause, and against loss consequential upon such loss or damage, other than noncontractual legal liability for any such loss or damage. Property insurance shall also include miscellaneous insurance. . . .

ARIZ. REV. STAT. § 20-252(11) (1975) states that miscellaneous insurance is

fore, the court in *Guaranteed Warranty* relied principally upon a definition of insurance to resolve the problem of whether the defendant was properly subject to insurance regulation.

This note will demonstrate that such a definitional approach is inappropriate since it fails to take into account the policies relevant to insurance regulation. Further, this note will show that the court did not properly draw the necessary distinction between the sale of insurance and the warranty given by the manufacturer of a product under the Uniform Commercial Code.<sup>9</sup>

#### PUBLIC POLICY AND THE IMPOSITION OF REGULATION

The problem underlying the *Guaranteed Warranty* case is that the court's reliance upon definitional elements of insurance as the sole guide to the imposition of regulation may overlook compelling policy reasons not to regulate a given business.<sup>10</sup> Definitions such as that used by the *Guaranteed Warranty* court have been called "so broad and general as to be virtually useless as guides to determining applicability of the regulatory system in a disputed setting."<sup>11</sup> The policies of regulation

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insurance against any other kind of loss, damage or liability properly a subject of insurance and not within any other kind of insurance as defined in this title, if such insurance is not disapproved by the director as being contrary to law or public policy.

Insurance in Arizona is regulated by the state's Department of Insurance under the authority of Title 20 of Arizona Revised Statutes. Any decision to regulate brings into play many of the sections of Title 20. See note 45 *infra* & text accompanying.

<sup>9</sup> See notes 7 *supra*, 60 *infra* & text accompanying.

<sup>10</sup> See, J. ATHEARN, *RISK AND INSURANCE* 613 (2d ed. 1969); C. ELLIOTT & E. VAUGHAN, *FUNDAMENTALS OF RISK AND INSURANCE* 11 (1972); R. KEETON, *BASIC TEXT ON INSURANCE LAW* 547, § 8.2(b) (1971); A. H. MOWBRAY, R. BLANCHARD & C. WILLIAMS, JR., *INSURANCE* 517-522 (6th ed. 1969); E.W. PATTERSON, *ESSENTIALS OF INSURANCE LAW* 1 (2d ed. 1957); R. RIEGEL, J. MILLER & C. WILLIAMS, JR., *INSURANCE PRINCIPLES AND PRACTICES: PROPERTY AND LIABILITY* 61 (6th ed. 1976); Stewart, *The Social Responsibility of Insurance Regulation*, in *INSURANCE, GOVERNMENT, AND SOCIAL POLICY* 33 (Kimball and Denenberg eds. 1969); Stewart, *Ritual and Reality in Insurance Regulation*, in *id.* at 22; Hellner, *The Scope of Insurance Regulation: What is Insurance for Purposes of Regulation?*, 12 *AM. J. COMP. L.* 494 (1963) [hereinafter cited as *The Scope of Insurance Regulation*]; Huff, *Development of Public Policy from the Viewpoint of a State Insurance Regulator*, 1975 *INS. L.J.* 393; Kimball, *The Purpose of Insurance Regulation: A Preliminary Inquiry in the Theory of Insurance Law*, 45 *MINN. L. REV.* 471, 517 (1961).

<sup>11</sup> R. KEETON, *supra* note 10, § 8.2(a), at 543 (1971). Keeton cites the following California definition of insurance as an example of a "virtually useless" statutory guide to regulation: "Insurance is a contract whereby one undertakes to indemnify another against loss, damage, or liability arising from a contingent or unknown event." *Id.* § 8.2(a), at 543, n. 1, *citing* WEST CALIF. INS. CODE § 22 (West 1955). *Cf.* text at note 5 *supra*. Unfortunately such definitions do not adequately differentiate insurance from warranties for purposes of imposing regulation. See notes 53-56 *infra* & text accompanying. Some states have attempted to codify more sophisticated definitions of insurance. Indiana's definition states that

'Insurance' means a contract of insurance or an agreement by which one party, for a consideration, promises to pay money or its equivalent or to do an act

simply cannot be expressed in a short definition of insurance.<sup>12</sup>

The insurance industry is subject to substantially greater regulation and control than virtually all other forms of business enterprise.<sup>13</sup> One of the most important reasons for such control is that "the whole value of the promise sold to the public by insurers lies in future performance."<sup>14</sup> The obligation of the insurer to the insured is aleatory: the insurer is only potentially liable on its promise since the maturation of that promise is based on a fortuitous event.<sup>15</sup> This aleatory element of an insurance contract makes it difficult for the consumer to value his bargain. He is constrained to pay premiums for the insurer's coverage against a risk which may never mature. Regulation is thought necessary to prevent an insurer from taking unfair advantage of the consumer, who has far less knowledge and information to assess risks than does the insurer with whom he deals.<sup>16</sup>

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valuable to the insured upon the destruction, loss or injury of something in which the other party has a pecuniary interest, or in consideration of a price paid, adequate to the risk, becomes security to the other against loss by certain specified risks; to grant indemnity or security against loss for a consideration.

IND. CODE ANN. § 27-1-2-3 (a) (Burns 1975).

Another problem with definitions is that their sheer number casts considerable doubt upon the validity of any of them. See *The Scope of Insurance Regulation*, *supra* note 10, at 529. Statutes can easily contain very different elements ostensibly "characteristic" of insurance. If a definition stated that insurance was a promise by the insurer to pay money to the insured upon the happening of a fortuitous event, a promise to provide services or even replacement parts could not be regulated as insurance.

<sup>12</sup> See *The Scope of Insurance Regulation*, *supra* note 10, at 528; Huff, *supra* note 10, at 393.

<sup>13</sup> See C. ELLIOTT & E. VAUGHAN, *supra* note 10, at 116-122; A.H. MOWBRAY, R. BLANCHARD & C. WILLIAMS, JR., *supra* note 10, at 157; W.R. VANCE, *HANDBOOK ON THE LAW OF INSURANCE* 36 (3rd ed. 1951). The forms of regulation are many: controls over the structure of the insurance organization, capital and surplus requirements, rate regulation, reserve requirements, provisions for examinations, investment controls, and so on.

<sup>14</sup> A.H. MOWBRAY, R. BLANCHARD & C. WILLIAMS, JR., *supra* note 10, at 517.

<sup>15</sup> 1 R. ANDERSON, COUCH: *CYCLOPEDIA OF INSURANCE LAW*, § 1:5 (2d ed. 1959); E.W. PATTERSON, *supra* note 10, at 2.

<sup>16</sup> The inequality between the consumer of insurance and the insurer is often said to present a problem of bargaining power. Whether the inequality stems from market structure or consumer ignorance, however, is not always clear. See E.W. PATTERSON, *supra* note 10, at 3; Kimball, *supra* note 10, at 523. See also Kessler, *Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 *COLUM. L. REV.* 629 (1943); Patterson, *The Delivery of a Life-Insurance Policy*, 33 *HARV. L. REV.* 198, 222 (1919); Note, *The Adhesion Contract of Insurance*, 5 *SANTA CLARA LAW.* 60 (1964).

Professor Kimball argues that insurance has objective and subjective functions in social life. Kimball, *supra* note 10, at 478. It both reimburses the insured who has suffered a loss and gives that insured confidence that he will be reimbursed. Regulation affects both of these functions of insurance, and has particular effect upon the internal working of the insurance industry. While regulation promises the insured that his insurer is solvent, it also aims at the achievement of *aequum et bonum*, which is equity, fairness, reasonableness, and efficiency in the conduct of the industry. As Kimball points out, *aequum et bonum* means that "the cost of insurance should correspond to its value or, more generally, that the insurer should treat the whole body of policyholders in a reasonable and fair manner." Kimball, *id.*, at 490. Although Kimball acknowledges the propriety of

If the contractual obligation of the insurer matures, the value of the insurer's promise to the insured is only as great as the financial stability of the insurer.<sup>17</sup> A second reason for regulating the insurance business, therefore, is to see that an insurance company's investments yield an adequate income and that the company will be financially capable of satisfying its matured obligations.<sup>18</sup> To achieve this goal, insurance companies have often been required to invest in bonds and mortgages, both of which are reliable long-term investments.<sup>19</sup>

A third objective of regulation is the state's interest in seeing that insurers have adequate technical knowledge and skill to conduct a business which has become increasingly complex and socially important. Since the public lacks the knowledge necessary to evaluate insurance methods and contracts, the state's requirement that insurers have technical knowledge and skill encourages the public to purchase protection against the risks of everyday life.<sup>20</sup> An incidental benefit of this objective of regulation is protection for the consuming public against fraud or incompetence;<sup>21</sup> an insurer supervised in the conduct of its business

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using legal controls to assure consumers of insurer solvency, he states that "there is more disposition to question interference by the law on behalf of . . . *aequum et bonum*," which depends to some extent upon policyholders' subjective views of their treatment by an insurer and not upon an objective fact like solvency, which is more easily amenable to regulation. Kimball, *id.*, at 486.

<sup>17</sup> See, H. DENENBERG, R. EILERS, J. MELONE & R. ZELTON, *RISK AND INSURANCE* 618 (2d ed. 1974) [hereinafter cited as H. DENENBERG, *et al.*]; A.H. MOWBRAY, R. BLANCHARD & C. WILLIAMS, JR., *supra* note 10, at 432; Kimball, *supra* note 10, at 518.

<sup>18</sup> See H. DENENBERG, *et al.*, *supra* note 17, at 649; Kimball and Denenberg, *The Regulation of Investments: A Wisconsin Viewpoint*, in *INSURANCE, GOVERNMENT, AND SOCIAL POLICY*, *supra* note 10, at 126; Mayerson, *Ensuring the Solvency of Property and Liability Insurance Companies*, in *id.* at 146.

<sup>19</sup> ARIZ. REV. STAT. §§ 20-532, -536 to -538, -553 to -555 (1975); Kimball, *supra* note 10, at 518.

The insurance codes of the states thoroughly regulate the investments which insurance companies are permitted to have. See, e.g., ARIZ. REV. STAT. § 20-531 to -559 (1975); CAL. INS. CODE §§ 1170-1182 (West 1972); COLO. REV. STAT. §§ 10-3-215 to -230 (1973); FLA. STAT. §§ 625.0100-0139 (1969); ILL. REV. STAT. ch. 73, §§ 736-737.22(a); IND. CODE ANN. §§ 27-1-12-2, -13-3, -2-6-1 (Burns 1975); IOWA CODE § 515.35 (1949); MICH. COMP. LAWS ANN. §§ 500.900-960 (1967); N.J. STAT. ANN. §§ 17:2-1, 2-9.4 (West 1963); N.Y. INS. LAW § 81 (McKinney 1966); OHIO REV. CODE ANN. §§ 3925.05, -.06 (Page 1971); TEX. REV. CIV. STAT. art. 2.10 (Vernon 1963); WIS. STAT. ANN. §§ 620.01 to .32 (Spec. Pamphlet 1975).

<sup>20</sup> See A.H. MOWBRAY, R. BLANCHARD & C. WILLIAMS, JR., *supra* note 10, at 520; Mayerson, *supra* note 18, states that "the major purpose of insurance is to turn uncertainty into certainty and thus provide a sense of security for the policyholder." *Id.* at 146. See also Kimball, *supra* note 10, who suggests that the regulation of insurer solvency also has the beneficial effects of building public confidence and of encouraging the public to buy insurance. *Id.* at 478.

<sup>21</sup> See H. DENENBERG, *et al.*, *supra* note 17, at 619:

[A]nother emerging goal of supervision . . . is aimed at competence. For example, at one time a person could obtain an agent's license merely by paying a fee, and all an agent needed was a rate-book and a lot of "gall." Today . . . increasing attention is being placed on agents' qualifications, education, and overall compe-

and compelled by the state to be competent is less likely to defraud the consumer.

Perhaps Professor Robert Keeton has best summarized the three principal objectives of insurance regulation.<sup>22</sup> First, because statutes and judicial doctrines control the marketing practices of insurance companies, regulation prevents overreaching by insurers. Second, regulation assures the consumer of the solvency of his insurer. Most important, this aspect of regulation protects the insured from the adverse consequences of the insurer's imprudent management of its investments and funds. Third, regulation is aimed at ensuring that premium rates and rating classifications are reasonable and fair. The effort here is to see that, among other things, a proportionate allocation among policyholders of premium charges is effected.<sup>23</sup>

### *The Inadequacy of the Judicially Created "Tests"*

Courts have attempted in numerous ways to overcome the limitations of definitions and to integrate policy considerations into their decisions on whether a business should be within a state's regulatory scheme. These attempts have assumed the form of "tests," which are relied upon to reach more nearly correct decisions on regulation than are possible by using a definition alone.<sup>24</sup>

The simplest test of all would be for a court to look only at the term used in the contract. It would then follow that whatever was termed an insurance contract would subject the "insurer" to state regulation, whereas whatever was not termed an insurance contract would not be regulated by the state.<sup>25</sup> Applied to the *Guaranteed Warranty*

tence; there is even a significant movement toward professionalization in the sale of insurance.

*But see* R. DIRKS & L. GROSS, *THE GREAT WALL STREET SCANDAL* 5 (1974) wherein, when speaking of the recent insurance scandal which they call "The All-American Fraud," the authors question the effectiveness of state regulation in controlling fraud by asking rhetorically: "And where were the various state insurance departments, whose responsibility it was to certify the activities of the Equity Funding Life Insurance Company," which perpetrated the fraud in question; J. KWITNY, *THE FOUNTAIN PEN CONSPIRACY* 151 (1973). *Cf.* note 47 *infra* & text accompanying.

<sup>22</sup> R. KEETON, *supra* note 10, at 554.

<sup>23</sup> *Id.*

<sup>24</sup> *See The Scope of Insurance Regulation, supra* note 10, at 500; Note, *Insurance-Burial Associations-Definition of Insurance*, 15 N.C.L. REV. 417 (1937).

<sup>25</sup> *But see* *State v. Spalding*, 166 Minn. 167, 170, 207 N.W. 317, 318 (1926) (It is immaterial whether or not the contract on its face purports to be one of insurance. The courts will look behind the terminology to ascertain what the parties intended to accomplish.); *Mein v. United States Car Testing Co.*, 115 Ohio App. 145, 149, 184 N.E.2d 489, 493 (1961) (Name by which contract is called does not determine whether it is warranty or insurance); *Richardson v. Railway Exp. Agency*, 258 Or. 170, 181, 482 P.2d 176, 181 (1971) (Character of contract of insurance cannot be concealed by use or absence of word "insurance". . . .).

case, this test would obviously result in nonregulation of Guaranteed Warranty since the company was selling "warranty" and not "insurance" contracts. The principal shortcoming of this test, of course, is that its application would open the door to widespread evasion of the state regulatory system.<sup>26</sup>

A second suggested guide to regulation is the purpose-of-the-contract test. Under this test, if the obligation of the promisor is merely incident to some larger purpose of the contract, then the contract would not be deemed insurance. In other words, if the principal purpose of a contract is to indemnify the promisee, a contract of insurance is present.<sup>27</sup> The court in *Guaranteed Warranty* had to confront the issue of defendant's status as an indemnifier,<sup>28</sup> although it apparently assumed that indemnification could not be the purpose of the warranty contract. This assumption is unsupported, however, because both warranties and insurance (property insurance in particular) share elements of indemnification.<sup>29</sup> If the purpose-of-the-contract test were properly applied, a great many warranty contracts would be subject to insurance regulation. But the test is too broad and would lead to regulation of such contracts in many instances where policy considerations dictate otherwise.

Another touchstone of regulation is the "control" test, which states that insurance covers the occurrence of a risk substantially beyond the control of any party to the contract.<sup>30</sup> Under this test, every

<sup>26</sup> *The Scope of Insurance Regulation*, *supra* note 10, at 500. See N.Y. INS. LAW § 41(3)(e) (McKinney Supp. 1975) where it is stated that:

The term "doing an insurance business" . . . shall be deemed to include . . .  
(e) the doing or proposing to do any business . . . in a manner designed to evade the provisions of this chapter.

<sup>27</sup> *The Scope of Insurance Regulation*, *supra* note 10, at 502; Note, *Insurance-Burial Associations-Definition of Insurance*, 15 N.C.L. REV. 417, 419 (1937). For a codified version of the purpose-of-the-contract test see N.Y. INS. LAW § 41(3)(b) (McKinney Supp. 1975).

<sup>28</sup> See notes 5 *supra*, 49-52 *infra* & text accompanying.

<sup>29</sup> See, e.g., *Metropolitan Coal Co. v. Howard*, 155 F.2d 780, 784 (2d Cir. 1946); *Epmeier v. United States*, 199 F.2d 508, 509-10 (7th Cir. 1952); *Candell v. United States*, 189 F.2d 442, 444 (10th Cir. 1951); *Hoover v. Nielson*, 20 Ariz. App. 130, 133, 510 P.2d 760, 763 (1973); *Congdon v. Oneida County Grange Co-op. Fire Ins. Co.*, 203 Misc. 98, 99, 114 N.Y.S.2d 167, 169 (Sup. Ct. 1952); *Perfecting Serv. Co. v. Product Dev. & Sales Co.*, 261 N.C. 660, 669, 136 S.E.2d 56, 63 (1964); *Barmeier v. Oregon Physicians' Serv.*, 194 Or. 659, 669, 243 P.2d 1053, 1058 (1952); *Board of Ins. Comm'rs v. Kansas City Title Ins. Co.*, 217 S.W.2d 695, 697 (Tex. Civ. App. 1949); *Whiddon v. General Mills, Inc.*, 347 S.W.2d 7, 10 (Tex. Civ. App. 1961); *Dittman v. Nagel*, 43 Wis. 155, 160, 168 N.W.2d 190, 193 (1969); 1 R. ANDERSON, COUCH: CYCLOPEDIA OF INSURANCE LAW §§ 1.2, 1.5 (2d ed. 1959).

<sup>30</sup> *The Scope of Insurance Regulation*, *supra* note 10, at 500; Note, *Insurance-Burial Associations-Definition of Insurance*, 15 N.C.L. REV. 417, 418 (1937). See N.Y. INS. LAW § 41(1) (McKinney 1966) where the control test has been codified as part of the definition of insurance:

The term "insurance contract" . . . shall be deemed to include any agreement . . . whereby one party . . . is obligated to confer benefit of pecuniary value upon another party . . . depending upon the happening of a fortuitous event. . . .



warranty embedded in a sales transaction and covering hazards other than defects in the article sold, for which a warrantor is properly responsible, would be subject to regulation as insurance.<sup>31</sup>

The control test seems . . . particularly intended for distinguishing legitimate warranties on goods sold, which relate to the quality of the goods and thus to events under the control of the seller, from insurance attached to the sale of goods, which concerns events which are substantially outside the control of the seller.<sup>32</sup>

Applied to the facts of *Guaranteed Warranty*, the control test results in regulation. Although the picture tubes warranted were in the article sold and the warranty related to the quality of the televisions, clearly neither the retail seller<sup>33</sup> nor *Guaranteed Warranty* had any control whatsoever over the risk that the picture tubes were defective. However, since few retail sellers of standardized products or manufacturers of products with standardized parts have any direct control over product quality,<sup>34</sup> the control test leads to regulation in almost every case. The

A fortuitous event is any occurrence or failure to occur which is, or is assumed by the parties to be, to a substantial extent beyond the control of either party.

<sup>31</sup> See *Anstine v. Lake Darling Ranch*, 233 N.W.2d 723, 729 n.8 (Minn. 1975); *Ollendorff Watch Co. v. Pink*, 279 N.Y. 32, 36, 17 N.E.2d 676, 677 (1938); *State ex rel. Duffy v. Western Auto Supply Co.*, 134 Ohio St. 163, 170, 16 N.E.2d 256, 259 (1938); *State ex rel. Herbert v. Standard Oil Co.*, 138 Ohio St. 376, 381-82, 35 N.E.2d 437, 441 (1941); *The Scope of Insurance Regulation*, *supra* note 10, at 501.

Noting that "it is essential that the distinction between warranty and insurance be clearly stated," the court in the *Duffy* case asserted that

a warranty promises indemnity against defects in the article sold, while insurance indemnifies against loss or damage resulting from perils outside of and unrelated to defects in the article itself.

134 Ohio St. at 170, N.E.2d at 259.

See also Comment, *When Contracts for Contingent Performance of Acts Other Than Payment of Money Constitute Insurance*, 36 MICH. L. REV. 311 (1937):

The use of the warranty as a device to increase sales is often confused with the contract of insurance. The warranty promises indemnity against defects in the article sold, while the insurance contract protects against loss from perils other than a defect in the article itself. Although often there are difficulties in ascertaining the true nature of the contract, the distinction should be preserved. Each serves a real purpose in modern economic life. But the function of insurance is so important that regulation is necessary to protect the general public from fraudulent insurance schemes.

*Id.* at 315 (citations omitted).

<sup>32</sup> *The Scope of Insurance Regulation*, *supra* note 10, at 500-01.

<sup>33</sup> The retail seller of the televisions did not give an express warranty like the defendant's; however, it did give the implied warranty of merchantability and, arguably, the warranty of fitness for a particular purpose under the Arizona Uniform Commercial Code. See ARIZ. REV. STAT. §§ 44-2331, -2332 (1975), UNIFORM COMMERCIAL CODE §§ 2-314, -315.

<sup>34</sup> *The Scope of Insurance Regulation*, *supra* note 10, at 501.

A retail seller arguably has no direct control over the quality of a product if he decides to adopt the manufacturer's warranty when he sells to the consumer. There is no legal obstacle to any seller's adopting the manufacturer's warranty as his own. See e.g., *Courtesy Ford Sales, Inc. v. Fariior*, 298 So. 2d 26, 31 (Ala. Civ. App. 1974); *Scovil v. Chilcoat*, 424 P.2d 87 (Okla. 1967); *Cochran v. McDonald*, 23 Wash. 2d 348, 351, 161

consequences of applying the control test are far-reaching; virtually every seller guaranteeing standardized goods or goods with standardized parts could be classified as an insurer for purposes of state regulation.

### *The Policy-Oriented Approach*

The tests discussed so far fail to integrate the policies underlying insurance regulation into judicial decisions whether to impose regulation in a particular case. An approach which might prove more successful would be to consider whether a particular business operation presents to the public those dangers which insurance regulation is designed to prevent: insolvency, lack of insurer competence, unfair premiums, fraud, and so on.<sup>35</sup> The definitional or test approach and a policy-oriented approach have been contrasted by Professor Hellner in these terms:

Instead of asking whether there is an assumption and distribution of risks, we should ask whether there is a need for a complicated technique which calls for a special skill. Instead of asking whether the promisee gives any special consideration for the promise, corresponding to a premium, we have the question of whether the value of the promise is difficult to estimate. Instead of asking whether the risk attaches to a fortuitous event, we should rather ask whether there is a need to collect and maintain special funds. Furthermore, we should ask whether there is any need for protection against fraud and for ensuring fair and equal treatment of the promises, and whether the promise has particular social importance.<sup>36</sup>

A decision to regulate a business like Guaranteed Warranty should be premised upon policy factors such as these as well as upon an appreciation of the purposes underlying insurance regulation.<sup>37</sup>

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P.2d 305, 306 (1945). However, any retail seller adopting a manufacturer's warranty could be classified as an insurer under the control test.

The basic problem with the control test may be that the meaning of "control" is either (a) impossible to define or (b) too expansive. On one view, a retailer or manufacturer *can* control the quality of its product by buying only from high quality manufacturers or sellers of standardized parts. Retailers or manufacturers can also control product quality by furnishing specifications for products which they order. These forms of control impugn the reasonableness of using the control test as a regulatory guide; for if some control, be it direct or indirect, exists in all cases, then the test cannot differentiate one case from another.

<sup>35</sup>Note, *Insurance-Burial Associations-Definition of Insurance*, 15 N.C.L. Rev. 417, 420 (1937).

<sup>36</sup>*The Scope of Insurance Regulation*, *supra* note 10, at 533.

<sup>37</sup>Such factors have influenced decisions in litigation on whether burial contracts should be regulated as insurance. *See, e.g.*, *Benevolent Burial Ass'n v. Harrison*, 181 Ga. 230, 181 S.E. 829 (1935); *Messerli v. Monarch Memory Gardens, Inc.*, 88 Idaho 88, 397 P.2d 34 (1964); *State ex rel. Londerholm v. Anderson*, 195 Kan. 649, 408 P.2d 864 (1965); *Oaklahoma Southwestern Burial Ass'n v. State ex rel. Read*, 135 Okla. 151, 274 P. 642 (1928); *State ex rel. Long v. Mynatt*, 207 Tenn. 319, 339 S.W.2d 26 (1960). *See also* *Memorial Gardens Ass'n v. Smith*, 16 Ill. 2d 116, 156 N.E.2d 587 (1959); *Robbins v. Hennessey*, 86 Ohio St. 181, 99 N.E. 319 (1912); *Cosmopolitan Life Ins. Co. v. Northing-*

THE POLICY-ORIENTED APPROACH AND THE GUARANTEED  
WARRANTY CASE

If the facts of *Guaranteed Warranty* are examined under the policy-oriented approach, the result reached by the court seems questionable. Because the policy-oriented approach imposes regulation only in those cases presenting the evils which insurance regulatory statutes are intended to eliminate, it often will produce a result different from the definitional approach of *Guaranteed Warranty*.

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ton, 201 Tenn. 541, 300 S.W.2d 911 (1957). This litigation focuses on whether an obligor who promises to furnish burial or funeral services and materials upon the death of the obligee is conducting an insurance business within the intendment of the state's insurance laws. Regulation in these cases has been upheld on the ground that regulatory statutes are reasonable in light of the protection they provide for the public health and safety. See, e.g., *Cosmopolitan Life Ins. Co. v. Northington*, 201 Tenn. 541, 554, 300 S.W.2d 911, 916 (1957).

Much of the fear about allowing burial contracts to go unregulated stems from the fact that the possibility of fraud is substantial. Annot., 68 A.L.R.2d 1251 (1959); 22 AM. JUR. 2d, *Dead Bodies* § 3 (1965). See Comment, *When Contracts for Contingent Performance of Acts Other Than Payment of Money Constitute Insurance*, 36 MICH. L. REV. 311, 313, 316 (1937). The consumer simply has no way of knowing whether his payments on a burial contract are fair in view of the benefits he is to receive. This is especially the case with so-called burial associations, which are often organized by undertakers who then contract with the association to provide sundry burial products and services. See Note, *Insurance-Burial Associations-Definition of Insurance*, 15 N.C.L. REV. 417 (1937); Note, *The Law of Burial Insurance*, 5 VAND. L. REV. 800, 803 (1952). See generally Sher, *Funeral Prearrangement: Mitigating the Undertaker's Bargaining Advantage*, 15 STAN. L. REV. 415 (1963). Courts also seem to suspect that burial contracts are entered into by persons who are most easily duped or defrauded by the promisor. It is, for example, more likely that low-income consumers will enter into burial contracts. Note, *The Law of Burial Insurance*, 5 VAND. L. REV. 800, 802 (1952). Unable to afford the considerable expense of an unexpected funeral, a low-income consumer can often pay the small premiums commonly required over a long period as part of a burial plan. A final suspicion about burial contracts is that a surviving beneficiary under a burial contract is invariably under emotional strain as a result of a death. See *Metropolitan Funeral Sys. Ass'n v. Forbes*, 331 Mich. 185, 190, 49 N.W.2d 131, 133 (1951); Sher, *Funeral Prearrangement: Mitigating the Undertaker's Bargaining Advantage*, 15 STAN. L. REV. 415, 423, 448 (1963). Thus, the beneficiary can more easily be imposed upon to pay large additional amounts for a more elaborate funeral than was provided for in the contract. Given the vulnerability of the beneficiary to exploitation in such circumstances, courts do not hesitate to impose regulation.

Generally, a court responsive to the position of a consumer who has entered into a burial contract has little problem in finding elements of insurance in the burial contract. See 1973 ARIZ. OP. ATT'Y. GEN. at 12. Since the contract is determinable upon death, involves an assumption of risk, and has an aleatory element, the contracts can coincide with a definition of insurance. See, e.g., *State ex rel. Reece v. Stout*, 17 Tenn. App. 10, 12, 65 S.W.2d 827, 829 (1933); *Garrett v. Forest Lawn Memorial Gardens, Inc.*, 505 S.W.2d 705, 707 (Tenn. 1974). Further, since the burial contractor needs funds on hand to provide its promised products or services upon death, at least one important purpose for regulation is frequently present. See *Messerli v. Monarch Memory Gardens, Inc.*, 88 Idaho 88, 97, 98, 397 P.2d 34, 39, 40 (1964); *State ex rel. Long v. Mynatt*, 207 Tenn. 319, 324, 339 S.W.2d 26, 28, 29 (1960). Nevertheless, statutes regulating insurance companies can be inappropriately applied to some burial arrangements, for the same risks and considerations need not apply to both businesses. A burial contract which requires the promisor to provide only services presents less need to regulate for the purpose of seeing that the promisor has large reserves and investments.

There is no evidence, in the *Guaranteed Warranty* example, of any overreaching or unequal bargaining power calling for insurance regulation. There is no reason to suppose that any particular class of

Group health plans have also been a source of considerable litigation on whether certain associations offering medical plans are insurers within the reach of state insurance law. Since the insurers' requirements respecting paid-in capital, deposits of securities, and preservation of funds are very strict, their imposition upon a medical association can be fatal to a small plan or very burdensome to a large plan. Note, *The Legal Problems of Group Health*, 52 HARV. L. REV. 809, 814 (1939). On the whole, the cases dealing with the subject of medical health plans are split, but many of the cases have held that associations offering such plans are not insurers. Compare *Jordan v. Group Health Ass'n*, 107 F.2d 239 (D.C. Cir. 1939); *California Physicians' Serv. v. Garrison*, 28 Cal. 2d 790, 172 P.2d 4 (1946); *State ex rel. Fishback v. Universal Serv. Agency*, 87 Wash. 413, 151 P. 768 (1915) with *People ex rel. Roddis v. California Mut. Ass'n*, 68 Cal. Rptr. 585, 68 Cal. 2d 677, 441 P.2d 97 (1968); *Associated Hosp. Serv. v. Mahoney*, 161 Me. 391, 213 A.2d 712 (1965); *McCarty v. King County Medical Serv. Corp.*, 26 Wash. 2d 660, 175 P.2d 653 (1946). See *New Jersey Ass'n of Independent Ins. Agents v. Hospital Serv. Plan*, 128 N.J. Super. 472, 320 A.2d 504 (1974).

An often cited case that declined to regulate is *Jordan v. Group Health Ass'n*, 107 F.2d 237 (D.C. Cir. 1939). The Superintendent of Insurance of Washington, D.C., brought a suit against defendant Group Health for conducting an unauthorized insurance business. Defendant offered a plan whereby medical services would be rendered by independent practitioners to its members. Members of the plan made regular, limited payments to receive services and supplies within specified limitations according to their needs. The physicians and hospitals providing services to members received their compensation solely from Group Health. On these facts, the District of Columbia Circuit held that defendant's agreement was not to pay its members the amount of their losses; instead, the court stated that Group Health agreed only to pay the physicians for services they provided to members of Group Health. "[I]n an accurate, nontechnical sense, [the physician], rather than Group Health, is . . . more nearly analogous to an insurer." *Id.* at 246. Further, since Group Health's by-laws provided that

[it should] not be liable to its members . . . for any act of omission or commission on the part of physicians . . . with whom it [contracted] for the rendition of services. . . ,

it was not deemed an insurer. *Id.* at 243 n.9.

Speaking of *Jordan*, one commentator has observed:

Although the arrangement . . . was well-conceived to minimize and subordinate the elements of risk transference and distribution through the Association, it is difficult to escape the conclusion that the decision was influenced by an appraisal of the arrangement as socially useful and as giving rise to a less urgent need for public regulation than ordinary insurance arrangements.

KEETON, BASIC TEXT ON INSURANCE LAW, § 8.2(b), at 547 (1971).

That is, *Jordan* evinces that policy does play an important role in regulatory decision-making. Inasmuch as a policy-oriented approach allows a court to take account of the want-satisfying ability of a plan as well as its value to the public before imposing regulation, it has great practical advantages over a definitional approach. See *People ex rel. Roddis v. California Mut. Ass'n*, 68 Cal. 2d 677, 682-83, 68 Cal. Rptr. 585, 588-89, 441 P.2d 97, 100-01 (1968) (Any "workable test must be a compromise of two policies:" insuring adequate financial reserves and encouraging the services which health plans provided the public). See also *West & Co. v. Sykes*, 257 Ark. 515 S.W.2d 635 (1974); *State ex rel. Farmer v. Monsanto*, 517 S.W.2d 129 (Mo. 1974); 28 ARK. L. REV. 515 (1975).

Of course, certain medical plans can be brought within the scope of a regulatory statute if a court relies only upon definitions or looks only for elements characteristic of insurance. For instance, some cases have turned almost entirely upon the presence or absence of indemnity in a plan. *Maloney v. American Independent Medical & Health Ass'n*, 119 Cal. App. 2d 319, 325-26, 259 P.2d 503, 506-07 (D. Ct. App. 1953); *New Jersey Ass'n of Independent Ins. Agents v. Hospital Serv. Plan*, 128 N.J. Super. 472, 484-86, 320 A.2d 504, 511-12 (1974). The indemnity element has been deemed so substantial as to make

consumer—low, middle, or high income—purchased Guaranteed Warranty's agreements, so no apparent need to protect any peculiarly susceptible class of consumer is present. Nor would it seem that there was any substantial possibility of fraud since Guaranteed Warranty had set up a trust fund, with a bank as trustee, to meet its contractual obligations as they matured.<sup>38</sup> However, even assuming that some risk of fraud did in fact exist, regulation of Guaranteed Warranty as an insurer does not offer any sure solution. Consumers have little incentive to complain to regulatory agencies unless such agencies have the power to award them damages for exposing such abuses as consumer fraud.<sup>39</sup>

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the plan insurance where, upon the occurrence of a contingency, the plan entails the payment of money rather than the rendition of a service. *Associated Hosp. Serv. v. Mahoney*, 161 Me. 391, 407-08, 213 A.2d 712, 721 (1965).

<sup>38</sup> *Phoenix Gazette*, Oct. 8, 1969, at 60; *Phoenix Gazette*, Oct. 11, 1969, Answer Line Column.

Defendant Guaranteed Warranty established its trust fund, irrevocable during the time that any warranty contract remained outstanding and unexpired, on July 3, 1969 with the United Bank of Arizona as trustee. The trust was expressly intended to protect consumers of defendant's warranties by ensuring a fund out of which payments owed under matured warranty contracts could be made, in the event that defendant was unable to meet its outstanding obligations from other funds. The terms of the trust property section of the trust read as follows:

The COMPANY agrees to transfer, assign and deliver to TRUSTEE, at least quarter annually, an amount in cash, equal to twenty-five percent (25%) of the warranty payments collected from the sale of COMPANY'S warranty contracts, until the aggregate value of the trust fund equals Two Hundred Fifty Thousand Dollars (\$250,000); thereafter, fifteen per cent (15%), until the aggregate value of the trust fund equals Five Hundred Thousand Dollars (\$500,000); and thereafter, ten per cent (10%), until the aggregate value of the trust fund equals One Million Dollars (\$1,000,000.00), at which time no further contributions shall be made by the COMPANY.

The trustee was not required to verify the amount of contributions to the fund; its administrative duties and powers were specified in other sections of the trust. [A copy of defendant's trust agreement is on file with the *INDIANA LAW JOURNAL*.]

Defendant became a member of the Better Business Bureau in July of 1969.

<sup>39</sup> See R. POSNER, *ECONOMIC ANALYSIS OF LAW*, § 10.1-10.2 (1973).

In connection with his analysis of the merits of regulation and common-law remedies, Professor Posner has developed the idea of consumer incentives to resort to the FTC for redress of fraud. He notes that

The inadequacy of the common law remedy is the usual justification offered for the Federal Trade Commission's (FTC) program of policing the accuracy of representations made in advertising, labeling, and other sales materials. But before the justification is accepted, the possibilities for improving the common law remedy should be explored. The possibilities are many. Defrauded consumers could be permitted to obtain their legal fees, plus a penalty as an additional incentive to sue, in any successful action against the seller. Consumer class actions, which permit a number of insignificant individual claims to be aggregated into a single large claim, could be encouraged. . . .

These possibilities seem attractive in part because the commission's record of performance has not been impressive. We shall not elaborate this well-documented conclusion here, but we shall suggest some economic reasons for the commission's problems. One is that consumers have little incentive to invoke the commission's enforcement machinery. The commission cannot award any damages or penalty to a defrauded consumer. The threat of a complaint to the commission may sometimes induce a seller to buy off an angry consumer but once the commission begins pro-

At all events, the case for regulating Guaranteed Warranty as an insurer to prevent consumer exploitation or fraud is no stronger than the case for regulating any warrantor.<sup>40</sup>

Moreover, the *Guaranteed Warranty* case does not present a situation in which consumers are peculiarly unable to value their bargain. On the contrary, one fixed sum was payable for protection against a contingency that could easily be understood: the failure of a television picture tube after the manufacturer's warranty thereon had expired. Unlike warranties generally available on most consumer goods in which the warranty is priced as part of the goods, the Guaranteed Warranty contract is offered to the consumer at a distinct price; the warranty contract is, therefore, relatively easy to value. Equally important, and unlike the case of fire or life insurance, no one would feel compelled to buy one of the defendant's contracts because of the magnitude of potential loss. In sum, since nothing shows that the market is not functioning properly, market controls obviate the necessity for regulation. Market processes prevent a warrantor not meeting its promises from surviving for long in the marketplace.<sup>41</sup>

One is also hard pressed to establish that the marketing practices of the defendant were unreasonable or unfair or that they left the consumer in an unfavorable bargaining position. Defendant's marketing practices simply did not allow it to use high-pressure tactics to effect sales of its warranty contracts. Further, inasmuch as the consumer could ask the store about the terms of defendant's contracts before buying and could thereby easily protect himself, state regulation of defendant to protect the consumer from unreasonable marketing practices is unnecessary. To justify regulation based upon defendant's marketing practices could conceivably lead to regulation of the store

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ceedings the seller will have no further incentive to come to terms with the consumer; this must limit consumers' interest in filing complaints with the FTC. . . .

*Id.* at § 10.2.

<sup>40</sup> Important federal warranty regulation recently came into existence with the enactment of the Magnuson-Moss Warranty Act. Discussion of the merits and demerits of the Act has been frequent. See Clark & Davis, *Beefing Up Product Warranties: A New Dimension in Consumer Protection*, 23 KAN. L. REV. 567 (1975); Leete, *A Look at the Consumer Warranty Problem—The Federal Solution*, 6 U. TOL. L. REV. 351 (1975); Note, *The Magnuson-Moss Warranty Act: Consumer Information and Warranty Regulation*, 51 IND. L.J. 397 (1976); Comment, *Magnuson-Moss Act Seeks to Promote Enforceability and Comprehensibility of Written Warranties*, 7 RUTGERS CAMDEN L.J. 379 (1976); Note, *The Magnuson-Moss Warranty-Federal Trade Commission Improvement Act: Protecting Consumers Through Product Warranties*, 33 WASH. & LEE L. REV. 163 (1976).

A pre-enactment discussion of the pros and cons of warranty regulation is contained in AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH, PROPOSALS TO REGULATE CONSUMER WARRANTIES AND EXPAND THE POWERS OF THE FTC 25-32 (1973).

<sup>41</sup> Lynn, *Achieving Effective Warranty Protection—Competition or Regulation*, 42 PENN. B.Q. 44, 46 (1970).

which sold the contracts, a result which would be flagrant overregulation.

Nor does it appear that regulation was necessary to guarantee that the "insurer" would be competent and technically knowledgeable. The defendant offered a specialized service and sold narrowly drawn protection against a readily ascertainable contingency. On these facts, the necessity for defendant to have the same broad and technical knowledge of insurance methods as, for example, a major life or property insurer is not apparent. The services offered by the latter are subject to the supervision of the state's insurance department in part because they are of enormous social importance. But the television picture tube warranty does not raise such concerns.

Maintaining insurer solvency is another important factor in a decision to regulate. State insurance codes specify financial requirements which must be satisfied by insurers before starting business. For instance, certain amounts of capital or surplus are required and must be maintained before a license to do business as an insurer will be issued by the state.<sup>42</sup> Deposits of cash and securities often make up a fund used to pay off consumers in the event that an insurer becomes insolvent.<sup>43</sup> These requirements advance the state's interest in building

<sup>42</sup> See, e.g., ARIZ. REV. STAT. § 20-210(A) (1975):

To qualify for authority to transact any one kind of insurance an insurer shall possess and thereafter maintain paid-in capital stock, if a stock insurer, or surplus, if a foreign or alien mutual or reciprocal or Lloyd's association insurer, in an amount not less than as shown by the applicable portion of the following schedule:

Kind of Insurance	Minimum Capital or Surplus Required
Life and/or disability	\$100,000
Domestic limited stock life and disability	25,000
Property	200,000
Marine and transportation	200,000
Casualty (including vehicle and other casualty lines)	250,000
Vehicle (exclusive of other casualty lines)	200,000
Surety	250,000
Title	250,000
All insurances except life and title	350,000

See also ARIZ. REV. STAT. § 20-536(A) (1975):

Every insurer shall invest and maintain invested funds to the amount of the minimum paid-in capital required under this title of a like domestic stock insurer transacting like kinds of insurance, only in cash and the securities described in the following sections of this article: [enumerating the following permissible investments: securities of or guaranteed by the United States, securities of states, territories, counties, municipalities, school districts, political subdivisions, public districts or civil divisions thereof, mortgage loans on real estate].

<sup>43</sup> See ARIZ. REV. STAT. § 20-213 (1975):

The director shall not issue a certificate of authority to any insurer unless it has deposited in trust with the state treasurer . . . cash or securities . . . in an amount not less than the minimum paid-in capital stock, if a stock insurer, or minimum surplus, if a mutual or reciprocal insurer, required pursuant to this article. . . . ARIZ. REV. STAT. § 20-581 (1975):

public confidence in the insurance industry. The *Guaranteed Warranty* court, however, did not consider whether these concerns were relevant to the case; nor did it consider whether investment controls upon defendant would serve any particular purpose.

In any event, the financial requirements and security provisions of the insurance code are grossly disproportionate to the purpose of protecting warranty consumers. Such provisions are calculated to assure the ability of a property, vehicle, casualty or other major insurer to meet its outstanding obligations. The outstanding liability on even a great number of warranty contracts is by no means comparable to a normal property insurer's potential liability on merely a few of its insurance policies,<sup>44</sup> which may cover property valued at many thousands of dollars. Nonetheless, although there was no suggestion that *Guaranteed Warranty* was unable to meet its outstanding warranty obligations, it was still found to be an insurer, mandating compliance with the security provisions of the insurance code and threatening the existence of its business if those requirements could not be satisfied.<sup>45</sup>

The state treasurer shall accept and hold in trust . . . deposits of securities or funds by insurers as follows:

1. Deposits required for authority to transact insurance in this state.

ARIZ. REV. STAT. § 20-582 (1975):

Deposits made under the provisions of § 20-581, shall be held for purposes as follows:

1. When the deposit is required for authority to transact insurance in this state the deposit shall be held for the protection of all the insurer's policyholders within the United States.

The deposit in § 20-582 is used for the payment of outstanding claims in the event that the insurer becomes insolvent. See R. RIEGEL, J. MILLER & C. WILLIAMS, JR., *INSURANCE PRINCIPLES AND PRACTICES: PROPERTY AND LIABILITY* 62 (6th ed. 1976): "All but a few states have established insolvency funds that can be used to meet losses of claimants and creditors of an insolvent property and liability insurer." See also Mayerson, *Ensuring the Solvency of Property and Liability Insurance Companies*, in *INSURANCE, GOVERNMENT, AND SOCIAL POLICY*, 149, 156 (Kimball and Denenberg eds. 1969).

<sup>44</sup> Assuming that defendant had no trust fund; that it was unable to meet claims on its outstanding warranties from other funds; and that its deposit with the state treasurer were \$200,000, it would seem that defendant would have to sell at least several thousand of either its \$14.95 black and white warranties or its \$29.95 color warranties before the deposit held by the state would be exhausted by outstanding consumer claims. Even among the more unusual kinds of property insurance—machinery, glass, crop-hail, rain, earthquake, or livestock—it is rather difficult to imagine several thousand policies which, upon maturation, would fail to exceed the sum of \$200,000.

<sup>45</sup> A company or corporation found to be transacting insurance business generally must comply immediately with the state insurance code, which will specify different financial and solvency standards for different classes of insurers. Contrary to general practice, defendant has not been compelled to comply with the statutory requirements of the Insurance Code. Instead, it has been permitted to continue its business pending the passage or rejection in the Arizona Legislature of a proposed amendment to a house bill. This amendment deals with "extended warranty insurers," and proposes to exempt such insurers from the burdensome financial requirements of the Insurance Code. In pertinent part, the proposed amendment provides as follows:

A. Every extended warranty insurer shall deposit with the state treasurer



Not only are the normal policies in favor of state regulation inapplicable to the Guaranteed Warranty situation, but other relevant policies militate against regulation. State insurance departments are commonly understaffed and overworked,<sup>46</sup> and regulation in a mar-

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and thereafter maintain on deposit for the benefit and protection of any person purchasing such extended warranty or guaranty in the event of insolvency of the extended warranty insurer under its contract with such person:

1. A bond in the amount of twenty-five thousand dollars issued by an insurance company holding a current certificate of authority issued by the Arizona director of insurance, or

2. Eligible securities as defined in section 20-583 having the lesser of par or market value of not less than twenty-five thousand dollars.

B. The Attorney General shall adopt and promulgate rules and regulations to enforce the provisions of this section.

C. For purposes of this section 'extended warranty insurer' means any business as otherwise defined by Title 20, Arizona Revised Statutes, which:

1. For a premium charged, not greater than twenty dollars per annum, nor greater than three-year term, provides a nonrenewable warranty, guaranty or service contract on radio, television and sound reproduction equipment in addition to, or as an extension of, any warranty, guaranty or service provided by the manufacturer of such equipment.

2. Is not otherwise authorized to transact property or casualty insurance business in Arizona or any other governmental jurisdiction.

3. Is not owned or controlled in any degree nor to any extent by a person, persons or business otherwise authorized to transact property and casualty insurance business in Arizona or any other state or jurisdiction.

4. Has gross Arizona sales not exceeding one hundred thousand dollars annually.

5. Has maximum contractual contingent liability not exceeding three hundred thousand dollars in Arizona.

Proposed House Amendments to H.B. 2237 § 41-196.

In the event that this amendment fails to pass, Guaranteed Warranty will be required to comply with the provisions of the Insurance Code. It conceivably could then have to maintain and possess the amount of capital funds required of a property insurer and deposit an equal amount of cash and securities with the state treasurer. Commendably, the amendment at least realistically tailors solvency guarantees to the risk of insolvency presented to the consumer by a business like defendant's that is just entering the market. In the long run, however, defendant's trust agreement, which provides that a percentage of each warranty contract sale goes to the trust, seems the best means to the end of protecting consumers. See note 38 *supra* & text accompanying.

<sup>46</sup>The Arizona Department of Insurance conforms to the general rule. As of August 12, 1975, the Department had a staff of fifty-three personnel in six basic divisions: administrative, property and casualty, examination and financial analysis, inspection and compliance, hearing, and licensing. As of January 31, 1976, 1,497 insurance companies held the Department's certificate of authority and were regulated. Operating on a minimum budget, the Department had the following appropriations and expenditures during the fiscal year 1974-1975:

	Appropriations	Expenses Incurred
Salaries	\$563,700.00	\$551,427.27
Employee Related Expenditures	76,700.00	73,075.78
Other Operating Expenditures	130,400.00	129,728.14
Travel-State	5,300.00	2,013.00
Travel-Out of State	3,300.00	1,915.78
Capital Outlay	4,800.00	906.46
Professional & Outside Services	30,000.00	29,828.57
<b>TOTALS</b>	<b>\$814,200.00</b>	<b>\$788,895.00</b>
Amount Reverted to General Fund		\$ 25,305.00

ginally justifiable case merely diminishes the state's capacity to regulate in those instances in which regulation is clearly needed. Moreover, state regulation of insurers occasionally is ineffective, a fact readily seen from the number of insurers who have nonetheless become insolvent.<sup>47</sup> Given the marginal nature of defendant's "insurance"

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See STATE OF ARIZONA, DEPARTMENT OF INSURANCE, 62D ANNUAL REPORT, at 3 (1974-1975).

<sup>47</sup> See M. Kaplan, *Regulation for Insolvency*, 3 FORUM 166 (1968).

The Indiana case of the Underwriters National Assurance Company (UNAC) exemplifies some of the difficulties encountered by the state and the consumer following a determination that an insurer has become insolvent. UNAC, with its principal office in Indianapolis, was organized and incorporated on Feb. 16, 1960 and was granted a certificate of authority on May 9, 1961. An examination of UNAC made in 1974 by the National Association of Insurance Commissioners revealed that the company's capital and surplus were depleted and that further transaction of its business would jeopardize the interests of policyholders and the public. IND. CODE ANN. § 27-1-3-8 (Burns 1971). As a result, the Indiana Department of Insurance, as rehabilitator, took control of UNAC for purposes of conducting its business. INV. CODE ANN. §§ 27-1-4-1, -2 (Burns 1971). Subsequent rehabilitation proceedings mandated staying litigation by various policyholders against UNAC and determined that the company should either liquidate its available assets or be reorganized. The Department of Insurance chose to reorganize UNAC with the goal of eventually offering insurance to new policyholders. Making this choice necessitated immediately eliminating the writing of certain policies, compromising the company's liability on certain existing benefits, and reducing benefits afforded under disability income policies. Currently, proposed plans for reorganizing UNAC are under consideration by the Department of Insurance and other concerned parties. See UNAC Court File, Superior Court of Marion County, Room No. 5, Indianapolis, Indiana.

A complex example of ineffective regulation resulting in insolvency recently centered on a subsidiary of the Equity Funding Corporation of America. This example came to the attention of the public in April of 1973, and has been called "one of the biggest scandals in the history of the insurance industry." The Wall Street Journal, April 2, 1973, at 1, col. 6. The scandal stemmed from the discovery that some 64,000 insurance policies, with a face value in excess of two billion dollars, did not really exist. R. DIRKS & L. GROSS, *THE GREAT WALL STREET SCANDAL* 3 (1974). The policies were "bogus business, pulled out of thin air, put on the books, and then sold for cash, to reinsurers." The Wall Street Journal, April 2, 1973, at 1, col. 6. After fraudulently selling the bogus insurance policies, taken out on non-existent policyholders, Equity Funding Life Insurance Company (EFLIC), the subsidiary, would frequently forge a death certificate and send it to the reinsurer holding the policy. The unknowing reinsurer, who bore all the risk, would then forward the proceeds on the "matured" policy to EFLIC, which would have no beneficiary to whom it needed to pay the policy proceeds. As a result, EFLIC merely kept as profit all the money it received from the reinsurers.

Although the Illinois Department of Insurance discovered the scandal and responded by doing a surprise audit on the defrauding insurer, which was incorporated in Illinois and was audited every three years,

Team after team of auditors [had] come and gone at EFLIC over the past few years without uncovering [the fraud] . . . Given the general audit procedures used on an insurance company, [said] one state regulator, it isn't that surprising that an ingenious, complex plan like EFLIC's could confound [the auditors]. "We are just going to have to overhaul our methods," he remark[ed]. The Wall Street Journal, April 2, 1973, at 14, col. 3.

This conclusion was reached by other authorities. Business Week stated that the Equity Funding scandal "casts grave doubts on the way insurance companies are regulated—and almost equally grave doubts on auditing systems." BUSINESS WEEK, April 14, 1973, at 80, col. 2. A partner in a top New York accounting firm opined that

the surprising thing about the Equity Funding swindle is not that it happened,

activity and the need to maximize the effectiveness of state insurance departments, defendant's business seems to have been of insufficient social importance to justify regulation.

Apart from the fact that regulation of the defendant was inappropriate within the meaning of the insurance code, the court could as easily have concluded that regulation was unwarranted because it would prevent the development of a socially desirable industry. Ensuring relative ease of market entry for legitimate enterprises which satisfy consumer needs is a desirable objective. Regulating an enterprise such as that of defendant erects formidable economic barriers to market entry; the decision in *Guaranteed Warranty* imposes upon all such businesses the extraordinary and unwarranted costs of insurance regulation.<sup>48</sup>

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but that it does not happen more often. "In a case where a whole bunch of people, from the chief executive down to the clerks, are in collusion, I'd defy any auditor to detect fraud."

BUSINESS WEEK, April 14, 1973, at 84, col. 3.

Commenting on the effectiveness of state insurance departments in detecting fraud, the New York accountant stated that "you might expect them to detect it . . . but I wouldn't. State commissioners tend to rely on those records a company chooses to offer them. . . ." *Id.* Another commentator pessimistically summed up: "In the wake of the Equity Funding scandal . . . many investors decided that independent auditors, state examiners and the SEC are not reliable protection against fraud. . . ." Shepherd, *Weighing the Scandal Factor*, BUSINESS WEEK, April 14, 1973, at 71, col. 1. Cf. note 21 *supra* & text accompanying. See R. DIRKS & L. GROSS, *THE GREAT WALL STREET SCANDAL* (1974); R. SOBLE & R. DALLOS, *THE IMPOSSIBLE DREAM: THE EQUITY FUNDING STORY* (1975).

Interesting problems resulting from ineffective regulation are often created by the insolvent insurer who wishes to merge his business with a solvent insurance company to avoid having his outstanding policies become worthless. See SUBCOMMITTEE OF THE PUBLIC REGULATION OF THE BUSINESS OF INSURANCE COMMITTEE OF THE SECTION OF INSURANCE, NEGLIGENCE AND COMPENSATION LAW OF THE AMERICAN BAR ASSOCIATION, *MERGER OF INSURANCE COMPANIES* 4-5 (1966):

To a greater extent than is generally known or appreciated merger is used by the insurance business to protect the insuring public from losses arising from inept or profligate management. In order to protect the good reputation of the business, strong companies sometimes absorb financially impaired competitors through merger, without expectation of gain.

For a list of insurance companies that have merged or been placed in receivership since 1972, see BEST'S INSURANCE REPORTS: LIFE-HEALTH M-12 (70th ed. 1975).

<sup>48</sup> In addition to the cost of depositing with the state treasurer an amount of cash and securities equal to the sum of capital funds required for authority to transact business, the insurer has other costs to bear. The director of insurance is required to collect in advance a number of fees. These include \$25.00 for filing charter documents, \$65.00 for a certificate of authority, \$45.00 for renewal of the certificate of authority, \$100.00 for filing an annual statement, \$20.00 for a license, and several other fees. ARIZ. REV. STAT. § 20-167 (1975). Cf. IND. CODE ANN. § 27-1-3-16 (Burns 1975).

The director of insurance is also empowered to examine the affairs, transactions, accounts, records, and assets of each authorized insurer as often as he deems such examination advisable. ARIZ. REV. STAT. § 20-156(a) (1975). Cf. IND. CODE ANN. § 27-1-3-8 (Burns 1975). An examination is required of each insurer applying for an initial certificate of authority to do business. ARIZ. REV. STAT. § 20-156(b) (1975). The insurer bears the cost of the examiners' travel expenses, reasonable living expenses, and per diem compensation for making the examination. ARIZ. REV. STAT. § 20-159 (1975). Cf. IND. CODE ANN. § 27-1-3-9

## THE WARRANTY-INSURANCE "DISTINCTION"

Even if the policies underlying insurance regulation could justify the regulation of Guaranteed Warranty, the court's definitional approach failed to draw a workable distinction between warrantors and insurers. As such, the court's approach can only be viewed as precedent for the imposition of insurance regulation on other warrantors, however socially undesirable this result might be.

The court attempted to justify regulation of Guaranteed Warranty on the ground that the main characteristic of insurance is indemnification. Because one purpose of this distinction was to *differentiate* warranties and insurance, the implication was that a warranty does not indemnify. However, the court appears to have been mistaken, since a major purpose of both warranties and insurance is indemnification.<sup>49</sup> To allow defendant's status as an indemnifier to determine whether the defendant was an insurer or warrantor only obscures the close relationship between warranties and insurance.<sup>50</sup>

The difficulties inherent in the court's treatment of the indemnity problem can be seen in the resolution of a related issue in the case. This issue centered on the defendant's intention to enlarge its contractual coverage to provide services and labor in the event that a picture tube warranted by the defendant proved faulty as a result of a manufacturing defect.<sup>51</sup> The defendant argued that once it began to provide services and labor it would be offering a contingent service and not merely indemnity and that it would therefore no longer be an insurer. The court responded by stating that defendant's

enlarged future plan is still to indemnify the purchasers of the contract. Indemnity is the principal object of the contract and the mere addition of labor does not substantially alter this purpose.<sup>52</sup>

Following this logic, however, any agreement to supply all necessary parts and repairs for a given period of time could be characterized as insurance subject to state regulation.

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(Burns 1975). Further, no one can act as an agent, broker, or solicitor without a license. ARIZ. REV. STAT. § 20-287 (1975). Cf. IND. CODE ANN. § 27-1-15-3 (Burns 1975). The required examination of applicants for a license increases costs. ARIZ. REV. STAT. § 20-292 (1975). Cf. IND. CODE ANN. § 27-1-15-4 (Burns 1975). In *Guaranteed Warranty*, the retail store marketing defendant's contracts would be the party bearing the costs of agent's fees and examinations.

<sup>49</sup> See note 29 *supra* & text accompanying.

<sup>50</sup> See notes 52-56 *infra* & text accompanying.

<sup>51</sup> *Guaranteed Warranty Corp. v. State ex rel. Humphrey*, 23 Ariz. App. 327, 330, 533 P.2d 87, 90 (1975).

<sup>52</sup> *Id.* at 331, 533 P.2d at 91.

The court's attempt to distinguish insurance and warranties by considering five "elements" of insurance<sup>53</sup> fails also, for similar reasons. With both property insurance and warranties, the owner of the property has an insurable interest therein. The risk of loss is normally on the buyer as the owner of the property. Further, the risk of loss is shifted to the warrantor or insurer under a warranty contract as well as under an insurance contract. The same risk in either case is ultimately spread to a large group of persons who bear similar risks: to either all buyers of property insurance or all buyers of warranties. In each case a premium is paid for the service; for insurance the premium is a separate payment, whereas with warranties the premium is normally contained in the price of the property purchased.

There are other similarities between insurance and warranties. Warranties and insurance both entail indemnification,<sup>54</sup> and both involve a promise.<sup>55</sup> Both also offer protection against some kind of contingency.<sup>56</sup> The definitional approach, in fact, yields only the essential similarities between insurance and the common warranty; it offers no principled basis for preventing the expansion of insurance regulation to palpably unacceptable limits.

The court's final attempt to distinguish warranties from insurance was through resort to the Uniform Commercial Code, the warranties

<sup>53</sup> See note 6 *supra* & text accompanying.

<sup>54</sup> See note 29 *supra* & text accompanying.

<sup>55</sup> *Ismert-Hincke Milling Co. v. American Credit Indem. Co.*, 224 F.2d 538, 542 (8th Cir. 1955); *Schenfeld v. Norton Co.*, 391 F.2d 420, 422 (10th Cir. 1968); *Tri-State Cas. Ins. Co. v. Loper*, 204 F.2d 557, 558 (10th Cir. 1953); *Equitable Life Assur. Soc. of United States v. Pettid*, 40 Ariz. 239, 248, 11 P.2d 833, 836 (1932); *Peterson v. Hudson Ins. Co.*, 41 Ariz. 31, 34, 15 P.2d 249, 251 (1932); *Brown v. Hall*, 221 So. 2d 454, 458 (Fla. App. 1969); *Dean v. Union Nat. Fire Ins. Co.*, 301 So. 2d 925, 926 (La. App. 1974); *Caruso v. John Hancock Mut. Life Ins. Co.*, 25 N.J. Misc. 318, 320, 53 A.2d 222, 223, *aff'd*, 136 N.J.L. 597, 57 A.2d 359 (1947); *Perfecting Serv. Co. v. Product Dev. & Sales Co.*, 261 N.C. 660, 669, 136 S.E.2d 56, 63 (1964); *Chappell v. Boram*, 159 Mo. App. 442, 447, 141 S.W. 19, 20 (1911); *F.M. Sibley Lumber Co. v. Schultz*, 297 Mich. 206, 216, 297 N.W. 243, 246 (1941). *Cf. O'Brien v. Comstock Foods, Inc.*, 125 Vt. 158, 160, 212 A.2d 69, 70 (1965).

<sup>56</sup> The word "contingency" seems applicable to both insurance and warranties to describe that happening or occurrence which triggers the contractual obligation of the promisor to the promisee. With insurance, the meaning of "contingency" is very much bound up with the concept of risk, which one text has spoken of as the "possibility of loss," referring to financial loss as "a decline in or disappearance of value due to a contingency." C. ELLIOTT & E. VAUGHAN, *FUNDAMENTALS OF RISK AND INSURANCE* 12 (1972).

This sense of the word "risk" as used in insurance is, of course, simplified. Nonetheless, even if one argues that the word "contingency" in insurance is understandable only with the concept of risk in mind, a clear differentiation of "contingency" as used in insurance from "contingency" as it can be used with warranties is not achieved. For clearly, a warranty protects against the possibility of loss and, in particular, the possibility of financial loss. This much is evident from the standard measure of damages for breach of warranty: the difference between the value of the property with its warranty breached

of which are not subject to insurance regulation.<sup>57</sup> Since the Uniform Commercial Code imposes warranties only upon the sellers of goods,<sup>58</sup> and since Guaranteed Warranty did not sell the televisions it warranted, the court reasoned that "a true warranty contract does not exist. Guaranteed Warranty is neither the manufacturer nor the seller of the television sets or picture tubes."<sup>59</sup>

This approach is troublesome. On the one hand, the court apparently assumes that a manufacturer's warranty is not properly subject to regulation. Nevertheless, its language implies that a manufacturer is not a seller within the meaning of the Uniform Commercial Code.<sup>60</sup> On this assumption, the court would have to conclude that a manufacturer should be regulated as an insurer. The court therefore offers no basis upon which to distinguish a manufacturer's warranty from an insurance policy.

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and the value of the property if the warranty had not been breached. A warranty has, in other words, the same function as property insurance: to prevent the promisee from suffering financial loss or a disappearance of value on his property due to the occurrence of a contingency.

<sup>57</sup> That warranties under the Uniform Commercial Code are not subject to regulation as insurance would seem to be self-evident. If such warranties were subject to regulation, retailer sellers giving warranties of merchantability or fitness for a particular purpose would be insurers. Not only is it questionable whether any state would have the power, even under a liberal interpretation of its insurance code, to treat such sellers as insurers, it is also clear that regulating the Code's warranties as insurance is unnecessary since most sellers under the Code do not present to the public those evils which insurance regulation is intended to eliminate.

<sup>58</sup> See note 7 *supra* & text accompanying.

The court also cited the following definition of "warranty":

A warranty is a statement or *representation made by the seller of goods* contemporaneously with, and as part of, the contract of sale, although collateral to the express object of it, having reference to the character, quality, or title of the goods, and by which he promises or undertakes to insure that certain facts are or shall be as he then represents them. . . .

See *Herndon v. Southern Pest Control Co.*, 307 F.2d 753, 755 (4th Cir. 1962); *Bell v. Menzies*, 110 Ga. App. 436, 437, 138 S.E.2d 731, 732 (1964); *Broer v. Dr. Fenton's Vigortone Co.*, 231 Iowa 1276, 1278, 4 N.W.2d 416, 417 (1942); *Mitchell v. Rudasill*, 332 S.W.2d 91, 95 (Mo. App. 1960).

The same criticisms of the definitional approach in general and the *Guaranteed Warranty* court's use of the Code's seller standard as a regulatory guide are applicable to this definition of "warranty."

<sup>59</sup> 23 Ariz. App. 327, 330, 533 P.2d 87, 90 (1975).

<sup>60</sup> The assumption that a manufacturer is not a seller within the meaning of the Code is, for many purposes, indefensible. If a manufacturer sells directly to the consumer, he has the status of a seller under the Code. Furthermore, since "under . . . the Uniform Commercial Code, the same warranties are implied as to both the manufacturer and retailer," the manufacturer is often a seller thereunder. 2 FRUMER & FRIEDMAN, *PRODUCTS LIABILITY*, § 19.01(1) (1975).

This does not mean, of course, that in every case both the retailer and manufacturer will have made the same warranties. Assuming that the same law applies . . . , the warranty of merchantability should be the same. However, the retailer may make an express warranty or a warranty of fitness for a special purpose may be implied, by reason of the dealings between the retailer and the purchaser, which is not binding upon the manufacturer. Conversely, *e.g.*, the manufacturer

The major difficulty with the court's attempt to distinguish an insurer from a warrantor through resort to the Uniform Commercial Code's "seller" standard is that such an approach is as analytically useless as a definition: it takes no account of the policies underlying insurance regulation. It is, moreover, questionable whether the Uniform Commercial Code should be taken as the exclusive authority in deciding whether a legitimate warranty exists. The draftsmen of the Code virtually concede as much when they note that the Code's sections on sales were not designed to disturb case law recognizing that warranties need not be confined either to sales contracts or the parties privy to such a contract.<sup>61</sup>

In short, contrary to the holding in *Guaranteed Warranty*, the legitimacy of a warranty should not depend on the party who gives it. To hold that only a seller may give a warranty discourages new sources of warranty protection. Such a restriction conflicts with the best interests of the consumer, for it does not stimulate product differentiations in the market for warranty protection offered on products. Furthermore, like a definitional approach, it disables the courts from addressing the policies which are properly relevant to the decision whether to impose insurance regulation.

#### CONCLUSION

Neither the Uniform Commercial Code nor a definition of insurance furnishes the most satisfactory guide to deciding whether a business activity constitutes the sale of insurance under state law. The best approach to the problem is policy-oriented. This approach considers the possibility of injury to the public from overreaching, fraud, unfair marketing practices, insurer incompetence or insolvency, consumer exploitation, and so on. Consideration of these factors allows a court to make a principled distinction between warranties and insurance. If a warrantor does not present the public with those evils which insurance regulatory statutes are designed to eliminate, then it should not be regulated even though its business satisfies some definition of insurance. The courts should recognize that imposing a whole body of insurance regulation in marginal cases such as *Guaranteed Warranty* may frustrate the growth of socially desirable industries with no apparent compensating social gain.

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may make an express warranty by advertising which is not necessarily binding upon the retailer.

2 FRUMER & FRIEDMAN, PRODUCTS LIABILITY, § 19.01(1) n. 2.3 (1975).

<sup>61</sup> 1 R. ANDERSON, UNIFORM COMMERCIAL CODE 478 (2d ed. 1970).