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Opinion No. 10-85

Contracts for home stabilization following damage from vertical settlement

QUESTIONS

1. Whether the proposed contract to perform home stabilization upon future damage from vertical settlement to be performed by Company B in the fact pattern described below would constitute a contract of insurance under Tennessee law?

2. Whether the proposed contract to perform home stabilization upon future damage from vertical settlement to be performed by Company A in the fact pattern described below would constitute a contract of insurance under Tennessee law if Company A were to perform the home stabilization for existing business customers for whom it did not perform piering work?

OPINIONS

1. Yes.

2. Yes.

ANALYSIS

This opinion request concerns whether certain contracts to perform home stabilization upon the occurrence of future damage from vertical settlement constitute contracts of insurance under Tennessee law. The following fact pattern is presented for consideration:

> There is a company ("the Company" or "Company A") in Middle Tennessee that is primarily engaged in the business of foundation stabilization and earth retention systems. It performs both residential and commercial services throughout Middle Tennessee. The Company currently provides a lifetime, transferable warranty against vertical settlement in the area piered by the Company for all residential work completed by the Company. The warranty is transferable to all future owners of the home at no cost.
>
> The Company would like to expand their business by establishing a separate warranty company that would warrant against future damage when no repair work has been done by the Company. The Company plans to establish a separate company ("Company B") to offer expanded services and warranty coverage. The type of warranty coverage that would be offered through Company B would be

against settlement of the perimeter of the structure. Company B would perform a detailed inspection of the home in connection with offering the warranty. The inspection consists of visual contact with the structure, a set of digital images of the foot and walls (both close up and global), establishing reference points around the perimeter of the house, taking measurements by laser level from those points and making a diagnostic diagram of the footprint of the structure. The warranty would essentially be warranting the quality of the inspection services performed by Company B. The consumer would pay for the detailed inspection services and then receive the warranty against settlement of the perimeter of the structure either in a lump sum payment or payments over time.

If the creation and operation of Company B is not feasible under the analysis of whether Company B would be considered to be offering an insurance product, the second option is to make the expanded warranty program incidental to Company A services. In this scenario, Company A would also perform a detailed inspection of the areas of the home it did not perform repair work for. The additional inspection services and additional warranty would be a separate transaction and separate fee.

The proposed warranty for Company B would read substantially as follows:

Residential Foundation Limited Warranty

A. Warrant against vertical settlement of load-bearing portions of the home. Load-bearing portions are the structural elements that transfer the load to the supporting ground.

   The covered load-bearing portions of the home are:

   1. Exterior Footings (concrete)
   2. Exterior Stem walls (concrete and/or masonry)

B. Vertical settlement is identified as:

   Actual physical damage to the designated load-bearing portions of a home.

C. Responsibilities of [Company A or B], under the limited warranty, is to stabilize the area of settlement. Remove and replant ground coverings as close to conditions just prior to settlement as practical, but no[t] necessarily to a “like new” condition. The design, method, and manner of such repair are within the sole discretion of [Company A or B].

D. Filing a Claim

If you observe foundation settlement at your home, you must contact [Company A or B] in writing or email. The claim must be filed before the expiration of the warranty period.

After [Company A or B] receives the claim form, an appointment will be set for an inspection by a [Company A or B] representative or a qualified construction professional. After [Company A or B] has completed its investigation, you will be notified in writing as to the warranty coverage.

E. Alternative Dispute Resolution

If a claim is in dispute, it shall be submitted to mediation where the parties will endeavor to resolve the dispute in an amicable manner. The mediator's compensation fee, administrative fee and all expenses charged by the mediator and/ or the mediation service shall be borne equally by the mediating parties.

F. Warranty Period

[The warranty period may be limited for a specified period of time with the option for renewals to occur.]

The opinion request further states:

All homeowners policies exclude losses caused directly or indirectly (regardless of any other cause or event contributing concurrently or in any sequence) by earth movement, sinking, rising or shifting. Earthquake is also excluded, but can be purchased through a policy endorsement. The warranty would exclude damage from earthquake since it can be an insured risk. Thus, the warranty in question does not infringe on the insurance market.

Accordingly, for purposes of this opinion, we assume that damage from vertical settlement caused by earth movement for any reason other than earthquake would be covered under the proposed contracts.

Finally, the opinion request refers to the recent opinion of the Court of Appeals in *H & R Block Eastern Tax Services, Inc. v. State, Dep't of Commerce & Ins.*, 267 S.W.3d 848 (Tenn. Ct. App. 2008), *p.t.a. denied* (2008) (hereinafter "*H & R Block*") and Op. Tenn. Att'y Gen. 08-159 (October 8, 2008), wherein this Office opined that a termite protection plan was not a contract of insurance based upon an analysis of *H & R Block.* The opinion request then asks the following two questions: (1) Whether the proposed warranty of Company B would be treated in the same manner as the October 8, 2008, Attorney General's Opinion; (2) In the alternative, whether Company A could offer the proposed warranty incidental to its existing business customers for

whom it did not perform piering work and still fall within the October 8, 2008, Attorney General's Opinion. We have rephrased the questions posed, as reflected at the outset of this opinion, since the pertinent inquiry is whether the particular contracts at issue constitute contracts of insurance. *See* 43 Am.Jur.2d *Insurance* § 8 (2009) (whether a contract is one of insurance is to be determined by a consideration of the real character or promise or of the act to be performed, and by a consideration of the exact nature of the agreement in the light of occurrence, contingency, or circumstances under which the performance becomes requisite, and not by what it is called); *see, e.g*., *Garrett v. Forest Lawn Mem'l Gardens, Inc*., 505 S.W.2d 705, 707-711 (Tenn. 1974) (court considered the aspects of funeral and burial plans in determining whether the plans constituted contracts of insurance); *H & R Block*, 267 S.W.3d at 850-52, 863-66 (court considered the aspects of H & R Block's Peace of Mind program in determining whether the program constituted a contract of insurance).

A "contract of insurance" is defined by Tennessee statute as "an agreement by which one party, for a consideration, promises to pay money or its equivalent, or to do some act of value to the assured, upon the destruction or injury, loss or damage of something in which the other party has an insurable interest[.]" Tenn. Code Ann. § 56-7-101(a). In *H & R Block*, the Court of Appeals determined that this statutory definition is ambiguous; it found the statutory definition of a "contract of insurance" inherently circular, reasoning as follows:

> Included in its definition of a "contract of insurance" is a requirement that the contract cover "something in which the other party has an *insurable interest*." Tenn. Code Ann. § 56-7-101(a) (emphasis added). The statute does not specify what types of interest are "insurable," which is surely a crucial question in determining what constitutes "insurance."

H & R Block, 267 S.W.3d at 858.

The issue in *H & R Block* was whether H & R Block's "Peace of Mind" program ("POM program") constitutes a contract of insurance. H & R Block offers the POM program to its customers who hire H & R Block to prepare their tax returns. Essentially, H & R Block offers its customers the option of purchasing, for an additional fee, an enhanced version of H & R Block's basic guarantee of the accuracy of its tax-preparation services. H & R Block promises customers who purchase the POM program that, in the event H & R Block makes an error that results in the customer's tax liability being initially underestimated, it will pay up to $5,000 of the customer's newly revealed tax liability. *Id*. at 849.

After the Court determined that the statutory definition of a "contract of insurance" is ambiguous, it considered the legislative history of Tenn. Code Ann. § 56-7-101 and prior case law interpreting the definition. *Id*. at 859-60. Finding neither helpful to the issue before it, the Court turned to three Tennessee Attorney General opinions that had considered whether extended warranties and future service contracts were contracts of insurance.

The first opinion noted by the Court of Appeals was Op. Tenn. Att'y Gen. 85-038 (Feb. 19, 1986), which addressed automobile warranties. In that opinion, this Office opined that such warranties did not constitute insurance under Tenn. Code Ann. § 56-7-101 because they failed

the service-indemnity test.[1] *Id.* at 860. The Court next observed that an earlier Attorney General opinion stated that "indemnity and contingency are 'essential elements of insurance'" and that it is "appropriate to consider the elements of a contract which mark it as one of insurance" when considering whether a contract for future services constitutes insurance. *Id.* (citing Op. Tenn. Att'y Gen. No. 79-254 (May 23, 1979)). Similarly, the Court observed that the Attorney General had stated in another opinion that "[i]t is necessary to determine whether the basic elements of insurance – contingency and indemnity – are dominant in the particular contract." *Id.* (citing Op. Tenn. Att'y Gen. No. 81-068 (Jan. 30, 1981)). The Court emphasized that the 1979 and 1981 Attorney General opinions had acknowledged that not all future service contracts are contracts of insurance. *Id.*

While the Court of Appeals disagreed with the Attorney General's application of the service-indemnity test in the 1986 opinion, the Court agreed that the test was an "excellent common-sense gauge of whether or not a contract is insurance." *Id.* at 862. The Court also agreed with the statements in the 1979 and 1981 Attorney General opinions that the element of contingency is an important consideration when determining whether a contract is insurance. *See id.* at 865 ("element of contingency [is] central to any common-sense definition of insurance").

Service-Indemnity Test

Under the service-indemnity test, the *H & R Block* Court stated that "the focus should be on what 'proportion *of the business*' indemnity occupies, 'in the context of the plan as a whole.'" *Id.* at 862 (citing *Roddis v. California Mut. Assoc.*, 68 Cal.2d 677, 68 Cal.Rptr. 585, 441 P.2d 97, 101) (1968) (emphasis original). The focus should not simply be whether the benefit that the company provides to the customer is a "service" or pure "indemnity," *i.e.*, money.[2] *Id.* In fact, the Court said, the nature of the benefit to the customer – service or money – is arguably not relevant at all because Tenn. Code Ann. § 56-7-101 states that insurance involves the payment of "money or its equivalent, or . . . some act of value." *Id.* at 863. Therefore, it is possible to have an insurance contract where the benefit to the customer is purely service, not money. *Id.* Consequently, the Court concluded that the proper question is "whether the *contract*, as a whole, is primarily a service guarantee or a promise of indemnity." *Id.* (emphasis original). Thus, to properly apply the service-indemnity test, the core essence of the contract must be examined to make this determination. *Id.*

The Court then applied the service-indemnity test to the POM program and found it to be a service guarantee, as opposed to a promise of indemnity, reasoning as follows:

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[1] The service-indemnity test and this 1986 Attorney General opinion are further discussed later in this opinion.

[2] The Court found that this had been the focus in the 1986 Attorney General opinion. In that opinion, the Attorney General determined that an automobile parts warranty is a promise of service because the purchaser is entitled to have a malfunctioning automobile part replaced or fixed. Thus, the opinion reasoned that the purchaser does not receive a payment, *i.e.*, indemnity, if the part is not replaced or fixed. Accordingly, the 1986 Attorney General Opinion concluded that automobile warranties do not constitute insurance. The Court found the Attorney General's focus on what the contract provides to the purchaser – service or payment – to be too narrow. *H & R Block*, 267 S.W.3d at 862.

> The POM program, which guarantees the accuracy of Block's tax-preparation services, is *inextricably linked* to those services. The fact that a customer desiring the POM guarantee must pay a separate fee to Block, above and beyond the normal tax-preparation fee that it pays to Block, does not divorce the POM program from its broader context - namely, Block's preparation of the customer's tax returns. If Block were not providing tax services, there would be nothing for its POM program to guarantee. Indeed, the stipulated facts specify that a customer cannot purchase the POM guarantee for taxes prepared by someone else; the program is available only to customers who have their taxes prepared by Block. Furthermore, the customer's "separate" payments to Block - the tax-preparation fee and the POM fee - must in fact be simultaneous: customers must purchase the POM program *at the same* time that they purchase the tax-preparation services. These characteristics make the POM program similar to a typical extended product warranty at an electronics retailer: both are optional add-ons, both cost extra money, yet neither can sensibly be viewed as independent of the underlying purchase that they guarantee, because they can only be obtained in connection with that larger purchase.

Id. at 863-64 (emphasis original) (footnote omitted). Consequently, the Court found the POM program to be on the "service" side of the service-indemnity test because the core essence of the program is that of a tax-preparation service with an added guarantee. *Id*. at 864.

Contingency

The Court also found the element of contingency lacking because the POM program provides protection against only H & R Block's errors, not errors committed by the taxpayer or a third party. *Id*. at 865. If the guarantee were offered by an entity independent of H & R Block in the event of a mistake by H & R Block, the Court said an entirely different question would be present because the guarantee would truly be independent of the tax-preparation service. Similarly, if the guarantee covered more than just H & R Block's own errors in preparing the customer's taxes, the Court said that it might potentially make more sense to treat it as insurance. *Id*. The stipulated facts, though, showed that the POM program covers only H & R Block's own errors; thus, the Court found the element of contingency absent. In so finding, the Court specifically referred to one of the stipulated facts that stated as follows:

> Errors in the preparation of a tax return are not uncontrollable events such as an act of God or other external contingency. Whether Block makes an error is completely within the control of the Block tax preparer. Block's obligations under the POM Program are not triggered by an external contingency.

Id.

Contract to be performed by Company B

In analyzing the contract to be performed by Company B in the same manner that the *H & R Block* Court analyzed the POM program, it appears to be a "contract of insurance" under Tennessee law. When the service-indemnity test is applied, the contract falls on the "indemnity" side of the test. The primary "service" provided under the contract is the following:

> Company B would perform a detailed inspection of the home in connection with offering the warranty. The inspection consists of visual contact with the structure, a set of digital images of the foot and walls (both close up and global), establishing reference points around the perimeter of the house, taking measurements by laser level from those points and making a diagnostic diagram of the footprint of the structure.

Under this provision, the customer, in essence, would receive a "snapshot" of the customer's home so that reference points are established. These reference points would then ostensibly be used by Company B to determine if vertical settlement has occurred if the customer were to make a claim at a future time.

While the contract also provides that Company B will "stabilize the area of settlement" and "[r]emove and replant ground coverings as close to conditions just prior to settlement as practical, but not necessarily to a 'like new' condition," this service is the *benefit* that would be provided later to the customer for damage caused by vertical settlement. As the *H & R Block* Court stated, "the nature of the benefit to the customer – service or money – is arguably not relevant at all because Tenn. Code Ann. § 56-7-101 states that insurance involves the payment of "money or its equivalent, or . . . some act of value." *Id*. at 863. "[T]he focus should be on what 'proportion *of the business*' indemnity occupies, 'in the context of the plan as a whole.'" *Id*. at 862 (citations omitted). In considering the proportion of business that indemnity occupies in the context of this contract as a whole, it is our opinion that indemnity occupies a greater proportion of the business than service. The primary "service" is simply a "snapshot" of the customer's home to establish reference points for future claims. There is no provision for any service to prevent vertical settlement.[3] Accordingly, we believe a customer would be led to enter the contract simply for the indemnity promised under the contract.

Moreover, we think the contract clearly has a contingency element. As explained above, the *H & R Block* Court found the element of contingency lacking because the POM program provides protection against only H & R Block's errors, not errors committed by the taxpayer or a third party. *Id*. at 865. Moreover, the Court specifically noted that H & R Block's obligations under the POM program were not triggered by an act of God or other external contingency. *Id*.

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[3] This difference is the primary reason for our conclusion in Op. Tenn. Att'y Gen. No. 08-159 (Oct. 8, 2008) that the termite protection plan at issue in that opinion fell on the service-side of the service-indemnity test. Termite prevention services were provided under the plan. These services can include the removal of wood debris, the identification of ways to keep moisture away from the home, the sealing of cracks, the construction of sand barriers, and the application of a chemical treatment, if necessary. Accordingly, we viewed this plan as a service contract with an added guarantee, just as the *H & R Block* Court viewed the POM Program to be a tax-preparation service with an added guarantee. *H & R. Block*, 267 S.W.3d at 864.

Our research shows that vertical settlement is not necessarily preventable, or even predictable, and can occur for a myriad of reasons: soil conditions, construction, blasting, water, tree roots, weather, etc. Based on the information provided, it appears Company B's obligations under the contract would be triggered by any external contingency, other than earthquake. The contract's coverage of damage from these external contingencies, as well as errors not attributable to Company B's doing, mark the contract as one of insurance.[4] *See id.*; s*ee, e.g.*, *Duffy v. Western Auto Supply Co.*, 234 Ohio St. 163, 170-71, 16 N.E.2d 256, 259-60 (1938) (tire warranty found to be contract of insurance because it contained an agreement to indemnify against loss or damage resulting from perils outside of and unrelated to weaknesses inherent in the tires).

Contract to be performed by Company A

Next, we consider whether the proposed contract for home stabilization following damage from vertical settlement to be performed by Company A would constitute a contract of insurance, if Company A were to perform the home stabilization for existing business customers for whom it did not perform piering work. We think this contract would be deemed a contract of insurance, as well. While Company A apparently provides some type of service to the customer in this scenario, the contract would still be separate and unrelated to the underlying service provided to the customer. In short, the contract would not be "inextricably linked" to the service provided to the customer. *See H & R Block*, 267 S.W.3d at 863-64. Consequently, we do not believe that the analysis of whether this contract is one of insurance would differ from the analysis that we employed above with respect to the contract to be performed by Company B.

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[4] This is another distinguishing factor of Op. Tenn. Att'y Gen. No. 08-159 (October 8, 2008). The termite protection plan covered only new termite damage. Our research showed that new termite damage is generally preventable with regular inspections; thus, the plan could be viewed as one that covered the pest control company's own errors.

Requested by:

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