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Client Alert

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Key Points

- The California Supreme Court clarifies application of the "principal object and purpose" test, finding that a self-storage operator's indemnification plans are not subject to regulation under the Insurance Code.
- Insurance companies—including insurtech startups—take note that informal DOI staff opinions are not binding on the DOI and that DOI opinions are not binding on the California courts.

California Supreme Court Declines to Defer to Department of Insurance, Finds Self-Storage Protection Plan Not Regulated Insurance

On April 23, 2018, the California Supreme Court issued its opinion in *Heckart v. A-1 Self-Storage, Inc.*, Case No. S232322 (2018), holding unanimously that a self-storage company's "protection plan," in which the company indemnified its customers for up to $2,500 damage to stored goods, was not subject to regulation under the Insurance Code. In so holding, the court found that the interpretation of the Department of Insurance (DOI)—which first blessed the storage company's business model via a staff attorney opinion, but later argued that the same attorney's opinion should be disregarded—carried little weight.

Though the ruling is relevant to both insurance and noninsurance companies of all sizes, it has special significance for young insurtech companies, which often rely on communications with the DOI when seeking to introduce new technology or business models.

Some background on the issues underlying the *Heckart* case is helpful.

The California Insurance Code's definition of "insurance" is incredibly broad, defining it as any "[c]ontract under which one undertakes to indemnify another against loss, damage, or liability arising from a contingent or unknown event." Interpreted literally, it would cover any contract containing an indemnification clause. As a result, California courts often apply the "principal object and purpose" test to limit the types of contracts that constitute **regulated** insurance. Under the test, if the principal purpose of a contract is to, for example, provide services, then the inclusion of a clause to apportion risk between the parties will not transform the contract into regulated insurance.

In *Heckart*, A-1 Storage operated storage facilities in California. Deans & Homer was an insurance underwriter and broker licensed to sell insurance in California, including self-storage insurance. Deans & Homer provided A-1 with a template for a "protection plan" that was significantly similar to its own storage insurance policies, which protection plan A-1 then offered to its tenant customers as part of its storage agreement. The protection plan allowed a storage customer, at the customer's option, to pay an additional $10 per month in exchange for A-1 retaining liability for damage to the customer's stored property up to $2,500. If the customer opted out of the protection plan but then failed to provide proof of other insurance within 30 days, the storage agreement provided that the customer would automatically be enrolled in the protection plan.

Plaintiff signed a rental agreement with A-1 and was automatically enrolled in the protection plan after he failed to provide proof of insurance. Thereafter, plaintiff brought an action against A-1, Deans & Homer, and others for, among other things, civil conspiracy and the unlicensed sale of insurance.

The trial court dismissed plaintiff's complaint, concluding that the protection plan was not insurance under the principal object and purpose test. Importantly, the trial court granted defendants' request for judicial notice of (1) a letter from Deans & Homer to the DOI requesting an opinion on whether a program structured like the protection plan would be subject to regulation as insurance; and (2) two letters from the DOI to Deans & Homer opining that the DOI "did not believe that such contracts between landlords and tenants [were] insurance contracts for purposes of statutory regulation" and that the "primary purpose of the contract [was] rental of the premises."

The appellate court affirmed, reasoning that "[a]llowing parties to shift the risk of property damage does not turn an agreement, whose primary objective is storage rental[,] into insurance" and adding that it "also [gave] deference" to the DOI's interpretation of the Insurance Code as evidenced by the Deans & Homer and DOI letters.

After the California Supreme Court agreed to hear the case, the DOI reversed course, with Insurance Commissioner Dave Jones filing an amicus brief arguing that the court should not give deference to the DOI's earlier staff attorney opinions, that the protection plan at issue constituted regulated insurance, and that the court should "give weight to his official, considered views of the law . . ." (The Commissioner's brief, as well as the rest of the briefing at the California Supreme Court, can be found here. The full oral argument can be found here.)

The California Supreme Court, however, declined to provide deference to either the Commissioner's current interpretation or the DOI staff attorney's earlier opinion.

As to the Commissioner's current interpretation, the court noted that, "unlike quasi-legislative regulations adopted by an agency to which the Legislature has confided the power to 'make law,' . . . the binding power of an agency's *interpretation* of a statute or regulation is contextual: Its power to persuade is both circumstantial and dependent on the presence or absence of factors that support the merit of the

interpretation." Given this, the court explained that it disagreed with the Commissioner's interpretation and that "the expansion of insurance regulation is a task for the Legislature."

As for the DOI staff attorney's original opinion blessing the arrangement, the court opined that such communications should be given "little weight," noting that the opinion was "not disseminated as an annotation by the Department to be considered by anyone other than the recipient, and there is no information regarding how carefully the issue was considered."

For companies operating in the insurance space, especially young insurtech companies that regularly interact with the DOI before launching new products or business models, the *Heckart* opinion provides two lessons. First, the informal opinion of a staff attorney is not binding and, in fact, may not be honored by the DOI itself when issues arise in the future. Second, even if a company receives an opinion from a DOI staff attorney and that opinion is later honored and adopted by the DOI, there is no guarantee that California courts will defer to that opinion in the event of a dispute. Given this situation, while there is often little alternative to engaging with the DOI to promote regulatory compliance, companies should be aware that such informal interactions are not a silver bullet against regulatory risk down the road, and indeed should ensure that they are appropriately evaluating that risk as they move forward—even with DOI approval in hand.

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