Extended Service Contracts (ES) – Issues and Considerations for Hospitals, Medical Facilities and Labs

Problem: Commercial Extended Service Contracts are poorly regulated and can/do fail. Such a failure can leave a medical facility with a significant financial loss. A facility manager must be diligent in verifying the financial strength of their service provider. A failure could show a lack of due diligence and cause a D&O situation for the facility, the owners or investors in addition to the aforementioned financial loss due to a vendor failure.

Definition: An **Extended Service Contract:** is a contract or agreement for a separately stated consideration and/or for a specific duration (Authors note: usually 3 or 5 years in the medical equipment industry) that obligates one party (the obligor) to perform/provide service remedies. Such remedies may include the: repair, replacement or maintenance of property or indemnification for repair, replacement or maintenance, for operational or structural failure due to a defect in materials, workmanship or normal wear and tear, with or without additional provision for incidental payment or indemnity under limited circumstances. *1

Consideration – what are Medical facilities ES options?

1. Self-Funding – Typically large hospitals that have a robust biomed department will choose to service their medical equipment and will forgo purchase of ES except for very expensive pieces of equipment.
2. Purchase ES from the Original Equipment Manufacturer (**OEM**)
3. Purchase ES from an Independent Service Organization (**ISO**)
4. Purchase ES from a third party backed by an insurance company.
5. Purchase a combination of 2,3, & 4.

Problem – Is my ES legal?

The National Association of Insurance Commissioners (NAIC) works with all the State Insurance Commissioners to provide technical guidance. They establish accounting & reporting statutory accounting principles and financial regulation. They establish compliance guidelines and NAIC model laws. They also provide Special Studies and White Papers to NAIC members.

The NAIC introduced the Service Contracts Model Act (#685) aimed at the regulation of the ES industry under the umbrella of state insurance regulators. The NAIC stated rationale was that ESs "should be regulated and that while not insurance, could be most efficiently regulated by the State Insurance Departments" (Alabama, 2005). The Act was intended to protect consumers and most states have adopted the #685 in varying and patchwork degrees. States have promulgated administrative rules and regulations to supplement their version of the Act and how they regulate such. Most states have modified the language and expanded the scope of regulation over ES. The Act is found here: https://www.naic.org/store/free/MDL-685.pdf The NAIC abstract to the insurance departments is found here: https://www.naic.org/documents/prod_serv_jir_JIR-ZA-33-03-EL.pdf The state codes are where businesses related ES will usually be addressed. Be aware that if you are a multi-state facility, you will need to be familiar with each state's laws. The NAIC abstract references state codes in the back of the publication.

State Insurance Commissioners view of ES. The Model Act asks ES providers to show either: A. A Reimbursement Insurance Policy to back their contracts. B. Financial Security Deposits (cash, bond, LOC or other instruments) with the insurance commissioner and a funded Reserve Account. C. Maintain a net worth of not less than $100M and file 10K's with the office.

The levels of regulation vary by state. There are 10 states that have no insurance department regulation on any service contracts, possibly regulated by other governmental departments and laws. The state code sections are typically where business ES would be addressed.

What are the options to consider when purchasing ES contracts?

OEMs. Most OEMs are large companies and can meet the financial requirements established in the states to sell ES.

Special Note: General Electric – Recently, GE stock valuation has dropped significantly. In three years, GE's enterprise value has fallen by 66% at the time of this writing (11/2018) and over 80% from their all-time high. The SEC and DOJ have expanded their investigations into GE's accounting practices. In June 2018, it was announced that GE would separate its health care business. GE Healthcare also provides third party ES on equipment that they do not manufacture. This may be problematic in some states.

Recommendation: Proceed with caution with the OEMs. You may want to ask if they have a Reimbursement Insurance Policy and obtain a copy or certification of such. Check with your state insurance commissioner to see if they regulate ES contracts and your OEM. Check their financials as many will show reserves for potential ES liabilities

ISOs. Chances are very slim that ISOs are filed with the insurance commissioner's department. Many ISO's have questionable reserving practices with no actuarial viability. Many reserves are simply the equivalent of a Ponzi Scheme. It is unlikely that they will share their financials. Because ISO's will rarely file with insurance departments or purchase Reimbursement Insurance, the departments don't know that the ISO exist.

Recommendation: We recommend that one steers clear from purchasing ES contracts from ISOs unless they can prove adequate reserves or state oversight. ISO contracts should be avoided without proper documentation.

Insurance Backed ES. Insurance Companies are regulated by each state insurance commissioner's department where they conduct business. The are also graded by companies such as A. M. Best Company that publish their financial information which is considered the industry financial strength measurement standard. Their financials are usually available and graded by multiple third-party sources.

Recommendation: An insurance policy can be purchased by the medical facility as an alternative to purchasing ESs from the OEM or ISO. Instead of paying the OEM or ISO's directly, one would pay the insurance company who would mirror the OEM/ISO ES onto their policy. The insurance backed ES will usually cost the same or less than what the OEM/ISO will charge. The insurance company pays the servicing OEM/ISO vendors their time and material costs while bearing the risk (insurance) of a major parts failure.

Most medical facilities onboard their OEM/ISO ES contracts to the Insurance Backed ES at their expiration. That said, if a facility has a contract that is out of compliance with the state, the medical facility could probably void the contract and move to the insurance model immediately.

Ref. 1 NAIC Service Contracts Model Act (#685)

Additional reading: 2014 NAIC Journal of Insurance Regulation JIR-ZA-33-03 and Warranty Weekly an on-line publication addresses Medical & Scientific Equipment Warranties.

White Paper and opinions provided by Andy Gastley, an insurance broker with A. G. Roth Insurance, the exclusive representative of FaciliGuard. Consult an attorney if you wish to have a full legal review.

FaciliGuard offers Insurance Backed ES underwritten and backed 100% by one of the largest P&C (in top 10 with A rating) insurance companies in the USA. The insurance carrier/program is approved in all states, Puerto Rico and D.C. and Canada.

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