

Effective Vehicle Service Contracts for EV Manufacturers

Sep 17, 2021

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Publications

The electric vehicle (EV) market is growing faster than ever. In a recent Pew Research Center survey, 7% of U.S. adults currently drive an electric or hybrid vehicle, and 39% indicated that they were very or somewhat likely to seriously consider buying an EV the next time they are in the market for a new car.[1] As of 2020, nearly 1.8 million EVs were registered in the U.S., more than three times as many as in 2016, according to the International Energy Agency (IEA).[2] But the U.S. represents only about 17% of the world's total stock of 10.2 million EVs, according to IEA data. China has 44% of all the EVs globally (with more than 4.5 million EVs), and Europe has a total of around 3.2 million EVs, or about 31% of the market.[3] As this data shows, there is substantial room for growth in the U.S. for those in the EV marketplace. As the market continues to flourish, there are new opportunities for market participants to flourish as well.

Traditionally, car manufacturers and dealers left the risk management aspect of the car business to the big insurance companies. Manufacturers, dealers, and even aftermarket participants realize that they can provide additional services and open up new revenue streams by capitalizing on the vehicle service contract (VSC) market. With the establishment of a compliant structure, VSCs can provide a substantial new revenue stream while also giving the business another touchpoint or connection with the customer to provide excellent customer service/satisfaction and create an opportunity for potential sales.

What is a Vehicle Service Contract?

VSCs are typically utilized in tandem with the manufacturer's warranty. A vehicle service contract provides the owner/lessee of the car with certain coverage for vehicle breakdowns or repairs that occur after the expiration of the manufacturer's warranty. Normally, the VSC coverage will take the existing warranty coverage and extend it for an agreed-upon number of additional years. While the price of the vehicle includes a warranty, a VSC requires an

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additional customer payment. The make and model of the car, the length of the contract, and the coverages offered will determine the VSC price.

A VSC must meet specific regulatory requirements applicable to extended warranty/service contracts to avoid being classified as automobile insurance. Automobile insurance provides coverage for unexpected events such as car accidents, property damage, and car theft. Due to the fortuitous nature of automobile insurance-covered events, these events are classified as insurance. Generally, a VSC does not cover fortuitous events, but instead covers specific types of breakdowns caused by either normal wear and tear of the vehicle or due to a defect in the workmanship or materials of the vehicle. Additionally, a VSC can provide certain indemnity payments for incidental events caused by a covered breakdown. This includes providing emergency towing or paintless dent repair services. Vehicle service contract providers are free to pick and choose what types of service contract coverages they wish to provide if the coverages and exclusions are clearly provided to the customer in the terms and conditions of the contract.

Consumer Benefits of Vehicle Service Contracts

As consumers take substantial risks with the purchase/lease of expensive EVs, they may carefully consider the benefit provided through VSCs with protection in the event of needed repairs. Consumers understand that EVs are new to the market and that any potential breakdown may cost more than a typical repair job for an ordinary vehicle. Further, EVs are built with more complicated technology that may hinder typical do-it-yourself repairs which consumers have relied in the past. VSCs can play a huge role to provide consumers with peace of mind if well designed. Most new and used cars will come with a warranty which provides certain coverages for either a specified period or for a certain number of miles; a VSC can extend that coverage and add additional benefits for the overall consumer experience.

Business Benefits of Vehicle Service Contracts

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VSCs can provide a significant benefit for manufacturers, car dealerships, and aftermarket service providers. For manufacturers, VSCs provide a huge opportunity to capitalize on their vehicles and brand experience. Manufacturers have more information than any other entity on what ordinary breakdowns typically occur, what defects commonly appear, or other related information that will help best design appropriate VSC coverages or exclusions to be offered.

Dealerships benefit greatly from VSC programs through the continued connection with the customer. Typically, the vehicle service contract will require the repair/replacement be performed at an authorized dealership. When the customer comes in for service, the salesperson will have another opportunity to speak with the customer, show the customer any new vehicle models, and generally demonstrate good customer service that will help instill brand loyalty in the customer.

How are Vehicle Service Contracts Regulated?

VSCs are regulated on a state-by-state basis. Each state can determine what forms of regulations are applicable to entities providing vehicle service contracts. There is a wide range of applicable regulatory structures. While VSC regulation does vary across U.S. jurisdictions, the National Association of Insurance Commissioners (NAIC) promulgated an existing model law in 1997. This law, and variations thereof, has been adopted in several U.S. jurisdictions and provides a good example of what typical VSC regulation may require. These general regulatory requirements include:

- Licensing of the entity who is contractually obligated on the VSC.
- Demonstration of financial adequacy by the VSC provider to ensure that customer claims are handled appropriately. The approved methods for this demonstration are:
- Obtaining a contractual liability insurance policy which insures the VSCs sold by the provider;

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- The placement of a security deposit in the form of a surety bond (or other eligible securities) with the jurisdiction along with the requirement of maintaining certain claim reserves for the contracts sold; or
- Demonstration that the VSC provider (or its parent company) maintains a net worth in excess of $100 million.
- The inclusion of certain disclosures in the contract terms and conditions to ensure that consumers understand the coverages and exclusions of the vehicle service contract.

While a majority of U.S. jurisdictions substantially follow this model law, there are some significant variations of which companies should be aware when setting up a national program. Some jurisdictions exempt VSCs from regulations and place no additional requirements upon providers other than ensuring that their contract does not provide coverages outside what is permitted by law. Other states treat VSC providers like insurance companies and require more substantial information during the entity licensing process, the filing and approval of contracts prior to issuance, and regarding financial disclosures and restrictions on who is allowed to sell or administer the vehicle service contracts.

What to Know Before Entering into the VSC Marketplace?

A careful review and understanding of the applicable laws and regulations are required prior to establishing or selling a new VSC program. The first step will be to determine how the VSC program will be structured, and the financial and regulatory requirements of the entity to be liable on the contracts. Many states maintain either full or limited exemptions for manufacturers. By structuring a new VSC program to allow the manufacturer to issue the contracts to customers, companies may be able to claim an exemption and avoid compliance with otherwise applicable regulatory requirements.

Companies should determine what coverages and exclusions they may wish to offer and prepare the VSC terms and conditions. With EVs, it must be clear what components of the battery are intended to be covered and the contract must clearly state any exclusions to

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avoid unnecessary confusion with the customer. Many states require that mandatory regulatory language be included in the contract.

The company should determine the most feasible method of demonstrating financial adequacy to state regulators. Larger companies may be able to utilize the net worth option to easily meet this requirement. Smaller companies may need to partner with insurance companies to obtain a contractual liability insurance policy to provide financial backing in the applicable U.S. jurisdiction. A review of what is best for the company should be conducted to make any nationwide program rollout as seamless as possible.

Takeaways

As EVs become more and more popular across the U.S., consumers will seek to protect their investments by considering the benefit and protections offered through vehicle service contract coverage. These contracts can provide peace of mind to the consumer by ensuring coverage of any covered breakdown due to a defect in the materials or workmanship or caused by normal wear and tear. While a VSC can provide consumers with a substantial benefit, the sale of the VSC by the industry can provide for a critical new revenue stream to those companies already operating in the EV market. EV manufacturers, or other EV components manufacturers should give careful consideration of offering a VSC program. While companies will need to be mindful of the varying compliance requirements and operational concerns, those involved in the EV will work with regulatory counsel to create new VSC programs specifically tailored to their EV customer and add to the overall customer experience and brand loyalty.

For more information, please contact Matt R. Wagner or any attorney with Frost Brown Todd's Insurance Regulation & Risk Management practice group or Automotive industry team.

**This article originally appeared in Law360 Expert Analysis on Sept 10, 2021*

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[1] https://www.pewresearch.org/fact-tank/2021/06/03/electric-vehicles-get-mixed-reception-from-american-consumers/
[2] https://www.iea.org/reports/global-ev-outlook-2021
[3] https://www.iea.org/data-and-statistics/charts/global-electric-car-registrations-and-market-share-2015-2020

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