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Discretionary Clauses in ERISA Health and Disability Plans—Are They Still Viable?

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Overview

Following the Supreme Court's issuance of *Firestone Tire & Rubber Company v. Bruch*¹ in 1989, Employee Retirement Income Security Act plan administrators, including insurers that underwrite health, life and disability insurance plans subject to ERISA, have been able to insulate their decisions from exacting judicial scrutiny by including "discretionary clauses" in their plans. As of 2015, however, nearly 25 states either have or are in the process of banning discretionary clauses in insurance policies subject to ERISA. This effort to ban discretionary clauses has led to legal challenges; however, the court rulings have uniformly favored state efforts to ban discretionary clauses.

In general, a discretionary clause is a plan provision that grants the plan administrator authority to interpret the terms of the plan and to resolve all questions arising under the plan, including the determination of eligibility to receive benefits. ERISA plan administrators and insurers rely on discretionary clauses to gain deferential court review should a plan participant file a lawsuit challenging the denial of a claim for benefits.

The *Firestone* decision made it clear that in the absence of an effective discretionary clause, a court deciding a benefit disputes utilizes the de novo standard of adjudication that favors neither party. When states ban or prohibit insurers from including discretionary clauses

in their products, the discretionary standard of review, which is highly prized by insurers, is eliminated.

In 2004, the National Association of Insurance Commissioners (NAIC) promulgated a proposed rule that would ban discretionary clauses in insurance products, including policies governed by ERISA plans.² The NAIC took the position that discretionary clauses are unfair to insureds because they insulate plan insurers from meaningful judicial review. The regulatory association's effort to ban or prohibit these clauses was aimed at leveling the playing field between plan insurers and participants. Following the NAIC's lead, several state adopted some form of the proposed rule by legislation, regulation, or directive of the state insurance commissioner.

In 2009, two federal appeals courts examined state insurance laws that ban discretionary clauses and ruled in favor of the states.³ Dozens of lower court rulings in Illinois, Colorado, Washington, and most recently, in California, have likewise upheld state bans on discretionary clauses.

² NAIC Model Laws, Discretionary Clauses Prohibition Model Act, MDL-42, available at <http://www.naic.org/store/free/MDL-42.pdf>.

³ *Standard Ins. Co. v. Morrison*, 584 F.3d 837, 47 EBC 2697 (9th Cir. 2009) (upholding the Montana Insurance Commissioner's order disapproving disability policies containing discretionary clauses); *Am. Council of Life Insurers v. Ross*, 558 F.3d 600, 46 EBC 1385 (6th Cir. 2009) (upholding Michigan's regulation banning discretionary clauses)

¹ *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101, 10 EBC 1873 (1989).

As the legal scales have tipped in favor of the states, some have predicted that other states will likewise enact statutes or issue rules or regulations that prohibit discretionary clauses. Plan insurers, on the other hand, are expected to continue their opposition to the laws and argue that states run afoul of ERISA when they attempt to regulate the language in ERISA plans; however, the Supreme Court's refusal to hear an appeal from the *Morrison* ruling suggests that such efforts are unlikely to succeed.

Evolution of Discretionary Clauses

ERISA does not explicitly speak to the standard of review courts should use when examining decisions by plan insurers and administrators. The standard of review for ERISA cases has been an evolving issue that began in 1989 with the Supreme Court's decision in the *Firestone* case, where the Supreme Court ruled that courts may only utilize the "de novo" standard in reviewing a plan administrator's benefits denial decision unless the plan contains language that grants the administrator the discretionary authority to determine plan benefits.

Since the *Firestone* decision, the federal courts have typically given deferential review to ERISA plan administrators' decisions any time the plan contains the requisite language indicating that the administrator has reserved or been delegated discretionary authority by the plan sponsor or other designated plan fiduciary.

The Supreme Court has not backed down from its stance in *Firestone*, as seen in its 2008 ruling in *Metropolitan Life Insurance Co. v. Glenn*.⁴ In *Glenn*, the high court specifically said it would not overturn *Firestone* by adopting a rule that "in practice could bring about near universal review by judges de novo—i.e., without deference—of the lion's share of ERISA plan claims denials." However, the Supreme Court further recognized that when the same party both funds a benefit plan and is also responsible for determining eligibility to receive benefits, an inherent conflict of interest exists that must always be taken into consideration.

After *Firestone*, most insurers underwriting health and disability plans governed by ERISA wrote discretionary language into their policies in order to ensure that if a plan participant or beneficiary files an ERISA lawsuit, the court will be required to give deference to the administrator's decision. While the inclusion of discretionary clauses does not guarantee a "win" for the administrator, the clauses make it more difficult for plan participants to persuade a court to upset the administrator's decision because the burden on the claimant is to prove not only that the insurer made a wrong decision, but that the decision was so wrong that it was without reason.

⁴ *Metropolitan Life Insurance Co. v. Glenn*, 128 S. Ct. 2343, 43 EBC 2921 (2008).

NAIC's Stand and the States' Response

In an attempt to give participants an even playing field when they take their cases to federal court, the NAIC in 2002 adopted the Prohibition on the Use of Discretionary Clauses Model Act⁵. Subsequently, the NAIC has actively urged state insurance commissioners to adopt the model law in their own jurisdictions.

When the NAIC originally adopted the model act, it prohibited the use of discretionary clauses in health insurance products. According to an NAIC amicus brief,⁶ the NAIC adopted the act because its members believed that discretionary clauses in insurance contracts were inequitable, deceptive, and misleading to consumers. In 2004, the NAIC expanded the model act to encompass disability insurance.

The statewide effort to ban discretionary clauses was slow at first, as only a handful of states immediately took steps to ban the clauses. However, more states have taken action since 2008—a chart listing the states that ban discretionary clauses in one way or another is contained in an appendix to this article.

However, some states that have banned discretionary clauses still allow ERISA-governed policies to contain such clauses, although such clauses must be highlighted and disclaimers included.

The Argument Against Discretionary Clauses: An Uneven Playing Field

There is considerable support for the banning of discretionary clauses among those in the ERISA plaintiffs' bar who argue that plaintiffs are not given a fair chance when plans use such clauses. From an ERISA plaintiff's perspective, discretionary clauses create an "uneven playing field" that favors the plan or plan insurer. Some of the arguments against discretionary clauses include:

- Discretionary clauses trigger an "arbitrary and capricious" standard of review under which the claimant has to prove not only that the benefit was wrongly denied, but that the denial is downright unreasonable.
- The "arbitrary and capricious" standard also precludes normal trial procedures, including the conducting of discovery, which means the courts will not consider any evidence beyond the claim record, which is often characterized as an administrative record.
- Use of the "arbitrary and capricious" standard essentially means that as long as the plan administrator had some reason for denying the claim the claimant will have no recourse, even if the result is wrong. In the health insurance context, for some participants this

⁵ NAIC Model Laws, Discretionary Clauses Prohibition Model Act, MDL-42, available at <http://www.naic.org/store/free/MDL-42.pdf>.

⁶ National Association of Insurance Commissioners amicus brief, *Fontaine v. Metro. Life Insurance Co.*, U.S. Court of Appeals for the Seventh Circuit, No. 14-1984 (filed October 14, 2014), available at http://www.naic.org/documents/legal_amicus_2014_fontaine_v_metlife.pdf.

could literally mean the difference between life and death if lifesaving treatment is denied; and in the disability and pension context, it could result in economic devastation for the claimant.

One example of a situation where a deferential standard of review can lead to unfair results may be the First Circuit's decision in *Brigham v. Sun Life of Canada*.⁷ In that case the First Circuit applied a deferential standard of review and upheld a plan administrator's determination that a paraplegic was not disabled. The court said it would have found otherwise had there not been a discretionary clause in the policy, but that it was required to defer to the plan administrator's judgment. Opponents of discretionary clauses argue that this result defies common sense and logic.

Support For Discretionary Clauses: Rising Premiums and Litigation Costs

While those in the plaintiffs' bar have long expressed concern about the unfairness of discretionary clauses in ERISA plans, plan insurers and administrators believe that such clauses are an essential element of ERISA plans. The insurance industry has often advanced the argument that discretionary clauses in ERISA plans help contain costs, but publicly-available research does not show that insurance costs will face any sort of dramatic increase if discretionary clauses are prohibited.⁸

Those who oppose the states' bans and prohibitions on discretionary clauses argue that such prohibitions will:

- result in more lengthy litigation, including more discovery, which drives up premium costs for all policyholders;
- disrupt the administration of ERISA plans, interfering with patients' ability to consistently and uniformly determine the benefits for which they are eligible, and with employers' ability to provide more affordable, reliable health care coverage to their employees;
- cause the courts to be overwhelmed with ERISA cases because of the entitlement to de novo review;

⁷ *Brigham v. Sun Life of Canada*, 317 F.3d 72, 29 EBC 2694 (1st Cir. 2003).

⁸ In November 2005, America's Health Insurance Plans commissioned a report by Milliman Inc., "Impact of Disability Insurance Policy Mandates Proposed by the California Department of Insurance," that examined the impact California's discretionary clause ban would have on disability insurance. The report dispelled, in many ways, the argument that removing discretionary clauses from disability plans would cause plan premiums to jump. In the report, Milliman estimated that premiums for disability insurance policies sold in California would increase by only 3-4 percent if discretionary clauses were removed. The report also said that a "more litigious environment" could result in disability insurers being "overly cautious" in managing claims and allowing some insureds to remain on disability even when they are long longer disabled. The Milliman study is available at <http://www.erisa-claims.com/library/Milliman%20Report.pdf>.

- subject health plans to variable interpretations depending on the particular judge and the federal circuit in which the case is heard;

- interfere with employers' ability to operate the plans in an efficient and effective manner, and administrators' ability to apply policies and review claims with consistency; and

- result in employers offering fewer benefits.

One of the largest disability insurers in the country, Metropolitan Life Insurance Co., echoed these positions in a 2009 regulatory update monograph.⁹ The update asserted that efforts to ban discretionary clauses would actually hurt consumers because the bans have the potential to cause uncertainty and expense for employers that sponsor disability plans. MetLife stated that the current system of deferential review in most ERISA cases keeps litigation "faster and less expensive." Banning discretionary clauses would require courts to employ de novo judicial review, which "will increase the cost of obtaining insurance to fund disability income plans, both to employers, and to employees who contribute to that cost," MetLife said in the update.

MetLife also made the argument that under a regime where courts use de novo review, participants will be harmed because judges often lack the experience to make benefit determinations and courts are likely to render inconsistent determinations. "Inconsistent decisions are significantly reduced if the benefit determination rests on the judgment of the claim administrator with knowledge of the particular plan for all claims that are filed under it," MetLife said.

The ERISA Hurdle

One of the biggest potential roadblocks facing states that implement discretionary clause bans is the breadth of ERISA preemption. Insurers and administrators of ERISA plans take the position that states are powerless to regulate the language contained in ERISA plans, and have mounted legal challenges to discretionary clause bans in the states that have adopted such plans.

Those who advocate banning discretionary clauses have argued, on the other hand, that ERISA does not preempt these state laws because ERISA specifically carves out a preemption exception that allows states to regulate insurance.¹⁰ ERISA's savings clause expressly exempts from ERISA preemption any state law that (1) is specifically directed toward entities engaged in insurance and (2) substantially affects the risk-pooling arrangement between the insurer and the insureds.¹¹

These legal challenges culminated in two major decisions rendered in 2009 by federal appeals courts, and by a third decision issued in 2015.

⁹ "Regulatory Update - The Battle Over Discretionary Clauses," MetLife Disability Insights, Issue No. 2, January 2009, available at <http://op.bna.com/pen.nsf/r?Open=jmer-82jpsb>.

¹⁰ ERISA § 514(b)(2)(A), 29 U.S.C. § 1144(b)(2)(A).

¹¹ *Kentucky Ass'n of Health Plans v. Miller*, 538 U.S. 329, 123 S. Ct. 1471, 30 EBC 1129 (2003).

Sixth Circuit Reviews Michigan Law

In March 2009, the U.S. Court of Appeals for the Sixth Circuit became the first federal appeals court to take up a legal challenge to a state's effort to ban discretionary clauses in ERISA plans. In *American Council of Life Insurers v. Ross*,¹² the Sixth Circuit turned back a challenge to Michigan's ban on discretionary clauses.

The ban was issued in 2007 when the Michigan Office of Financial and Insurance Services put in place a set of administrative rules that prohibited insurers and non-profit health care corporations from issuing, advertising, or delivering to any person in Michigan a policy, contract, rider, endorsement, certificate, or similar contract document that contained a discretionary clause.

The American Council of Life Insurers, AHIP, and the Life Insurance Association of Michigan filed a lawsuit against the commissioner of the Michigan Office of Financial and Insurance Services alleging that the discretionary clause rules could not be enforced against ERISA-governed plans because the rules were preempted by ERISA. The federal district court ruled against the industry groups, finding that ERISA did not preempt the discretionary clause rules because the rules were "saved" from ERISA preemption as laws that regulate insurance.

The Sixth Circuit affirmed, finding that the Michigan insurance rules were "saved" from ERISA preemption because the rules are aimed at the insurance industry and substantially affect the risk-pooling arrangement between insurers and insureds. In so ruling, the appeals court rejected the industry groups' contention that the Michigan insurance rules were preempted by ERISA because they "squarely conflicted" with ERISA's policy of ensuring a set of uniform rules for adjudicating cases under ERISA. The court observed that by removing plan insurers' discretionary authority that would otherwise invoke a deferential standard of review, Michigan simply created a de novo standard of review that is already the default standard in ERISA cases. In addition, the court rejected the industry groups' argument that allowing Michigan to remove discretionary clauses would mean the state could "dictate the standard of review" for all ERISA benefit claims.¹³

Ninth Circuit Examines Montana's Ban

Later in 2009, the U.S. Court of Appeals for the Ninth Circuit joined the Sixth Circuit in ruling that ERISA does not preempt state efforts to ban discretionary clauses.

At issue in the case of *Standard Insurance Co. v. Morrison*,¹⁴ was a "practice" implemented by Montana Insurance Commissioner John Morrison to disapprove of any insurance contract that contained a discretionary clause.

Morrison argued that he had the power to disapprove the sale of policies in Montana containing discretionary clauses by virtue of Mont. Code Ann. § 33-1-502, which provides that the state insurance commissioner "shall disapprove" any [insurance] form . . . [that] contains or incorporates by reference, any inconsistent, ambiguous, or misleading clauses or exceptions and conditions."

Standard Insurance Co. challenged Morrison's ability to implement this practice of prohibiting discretionary clauses, arguing that ERISA permits these clauses and that Morrison's actions were preempted by ERISA. In February 2008, the Montana district court ruled in favor of Morrison. It found that ERISA did not prevent Morrison from implementing the discretionary clause ban because Morrison's practice was aimed at the insurance industry and as such the practice was "saved" from ERISA preemption.¹⁵

The Ninth Circuit affirmed the lower court after finding that Morrison's practice fell under ERISA's savings clause. The appeals court rejected Standard's contention that Morrison's practice of disapproving discretionary clauses was not specifically directed at insurance companies because it was instead directed at ERISA plans and procedures.

In addition, the court said Morrison's practice met ERISA's savings clause test because the practice affected the risk-pooling arrangement between insurers and their insureds. The court said that by removing the benefit of a deferential standard of review from insurers, it was likely that Morrison's practice would lead to a greater number of claims being paid.

Following the Ninth Circuit's decision, Standard Insurance filed a petition asking the Supreme Court to review the decision, which was denied.

The Tenth Circuit Reviews Utah's Rule

The Sixth and Ninth Circuits are not alone in analyzing ERISA preemption of discretionary clause bans. The U.S. Court of Appeals for the Tenth Circuit also weighed in on the issue, although the Tenth Circuit's decision has a much more limited scope than the decisions of the Sixth and Ninth Circuits.

At issue in *Hancock v. Metropolitan Life Ins. Co.*,¹⁶ was Utah Administrative Code Rule 590-218. The rule imposes a ban on discretionary clauses in insurance policy forms, but it authorizes such clauses for ERISA-governed plans if they contain certain "safe harbor" language. The rule requires that ERISA plans highlight discretionary clauses by using a particular font. The state laws at issue in the Sixth and Ninth Circuit cases did not contain a carve-out for ERISA plans.

An individual who was insured under an accidental death benefit plan insured by Metropolitan Life Ins. Co. argued that MetLife could not rely on its plan's discretionary clause because MetLife had not complied with

¹² *American Council of Life Insurers v. Ross*, 558 F.3d 600, 46 EBC 1385 (6th Cir. 2009).

¹³ *Id.*

¹⁴ *Standard Insurance Co. v. Morrison*, 584 F.3d 837, 47 EBC 2697 (9th Cir. 2009).

¹⁵ *Standard Insurance Co. v. Morrison*, 537 F.Supp.2d 1142, 43 EBC 1289 (D. Mont. 2008).

¹⁶ *Hancock v. Metropolitan Life Ins. Co.*, 590 F.3d 1141, 48 EBC 1741 (10th Cir. 2009).

Rule 590-218. The Utah district court rejected this argument, finding that ERISA preempted Rule 590-218 and thus the rule could not be enforced against MetLife.¹⁷

The Tenth Circuit agreed with the lower court and found that Rule 590-218, as applied to MetLife's ERISA-governed plan, was preempted by ERISA and could not be enforced against MetLife. The appeals court found that the rule was not "saved" from ERISA preemption because the rule did not affect risk pooling in that it did not remove the option of insurer discretion, but instead authorized discretionary clauses so long as they disclosed certain information and conformed to a font requirement.

What the Future Holds

In the wake of the decisions by the Sixth and Ninth Circuits, it is likely that more states will adopt laws

banning discretionary clauses. The unanimous court rulings findings that such laws are not preempted by ERISA remove at least one of the barriers to state insurance commissioners enacting such prohibitions. When these cases are read together, it is evident that state insurance laws banning discretionary clauses do not fall within ERISA's broad preemption of state laws that relate to employee benefit plans. Thus, complete bans prohibiting the use of discretionary clauses in insured ERISA plans easily pass muster with the courts.

It must be noted, however, that discretionary clause bans apply only to insurance. Large companies may be able to avoid the issue by using self-funded plans rather than insured plans. By doing so, large companies are not subject to insurance laws because states are powerless to alter the terms of self-funded ERISA plans.

¹⁷ *Hancock v. Metropolitan Life Ins. Co.*, No. 2:06-CV-00882DAK, 44 EBC 2714 (D. Utah August 1, 2008).

Appendix

STATE EFFORTS TO BAN OR LIMIT DISCRETIONARY CLAUSES

State	Summary
Alaska	The state uses a "checklist" for insurers that issue policies containing "discretionary clauses." The checklist references Alaska Statutes 21.42.130 and 21.36. These two provisions prohibit insurers from including in insurance products any "inconsistent, ambiguous, or misleading clause."
Arkansas	Arkansas Rule 054-00-101 (2013) banning discretionary clauses
California	Cal. Ins. Code § 10110.6 bans discretionary clauses in policies issued or renewed that are delivered to insureds in California.
Colorado	Colo. Rev. Stat. § 10-3-1116 bans discretionary clauses in health and disability insurance policies.
Connecticut	Bulletin HC-67, Use of Discretionary Clauses (Conn. Dept. of Insurance March 19, 2008)(although discretionary clauses not banned, the Department of Insurance will monitor inappropriate uses of discretionary clauses).
Hawaii	The Hawaii Insurance commissioner in a 2004 Memorandum stated that discretionary clauses violate Hawaii Revised Statutes § 431:13-102, which prohibits unfair or deceptive acts or practices in the business of insurance. The commissioner said that Hawaii's ban on discretionary clauses applies to both ERISA and non-ERISA plans.
Idaho	Through Idaho Department of Insurance Rule 18.01.29 issued in May 2009, the state restricts health insurers from placing discretionary clauses in insurance products. The rule applies to all insurance contracts issued or renewed after May 1, 2009. When the department was in the process of rulemaking, it stated that the rule would not apply to ERISA plans, but the final rule does not mention this exclusion.
Illinois	Effective July 1, 2005, 50 Ill. Admin. Code § 2001.3 prohibits discretionary clauses in health and accident insurance policies or certificates issued or delivered in Illinois. The law provides that such policies cannot contain a provision purporting to reserve discretion to the insurer to interpret the terms of the policy or to provide standards of interpretation or review that are inconsistent with Illinois law.
Indiana	In Bulletin 103 from May 2001, the state insurance commissioner prohibited all insurance companies that offer group health insurance from including "full and final" discretion clauses in their products. The bulletin states, however, that insurers can continue including the clauses in ERISA-governed plans.
Maine	Maine Revised Statutes Title 24-A, Section 4303 prohibits insurers from using or enforcing "absolute discretion clauses." The state added this provision to its insurance code in 1995, making it perhaps the first state to ban discretionary clauses.
Maryland	Md. Code Ann. Ins. § 12-211 prohibits disability policies from containing clauses reserving sole discretion to the insurer.

STATE EFFORTS TO BAN OR LIMIT DISCRETIONARY CLAUSES (Continued)

State	Summary
Michigan	Effective Feb. 23, 2007, Michigan through Administrative Code Rule 500.2202 bans discretionary clauses in health and disability insurance products. The rule states that the clauses are “unjust, unfair, inequitable, misleading, deceptive, and encourages misrepresentation of the coverage.” The rule was challenged and the U.S. Court of Appeals for the Sixth Circuit said the rule could be enforced because it was not preempted by ERISA.
Minnesota	Minn. Stat. § 62Q.107 prohibits health plans from containing provisions that specify a standard of review. Also, Minn. Stat. § 62A.241 (eff. Jan. 1, 2016) prohibits disability income policies from containing provisions specifying a standard of judicial review.
Montana	Montana’s insurance commissioner issued a rule interpreting Montana Code Annotated Section 33-1-502 as giving the commissioner the authority to ban all discretionary clauses. The rule states that the commissioner can disapprove any insurance that contains “inconsistent, ambiguous, or misleading clauses or exceptions.”
New Hampshire	New Hampshire Insurance Regulation 401:03(1) provides that the state insurance department will only approve discretionary clauses in life, accident, or health plans if the clauses are (1) contained in a separate endorsement containing no other language, terms, or provisions, (2) offered on an optional basis to the plan sponsor, and (3) with respect to ERISA plans, the clause must disclose that discretionary authority will affect the standard of review that a court may use. The regulation sets out explicit language that must be included in ERISA plans.
New Jersey	By administrative rule (N.J.A.C. 11:4-58), New Jersey bars absolute discretionary clauses in life, health, long-term care, and annuity plans that purport to reserve sole discretion to the insurer to interpret the plans. The rule was adopted in April 2007 and provides that an insurer can include a provision stating that it has the discretion to make an initial interpretation of policy terms, but that such interpretation can be reversed by a court or arbitrator.
New York	In Circular Letter No. 14 (2006), the New York Insurance Department said it was in the process of drafting regulations that would prohibit the use of discretionary clauses in all new and existing accident and health insurance policies, life insurance policies, and annuity contracts. The department further said that it would review health and accident policies to determine whether their discretionary clauses complied with state law, and that it was rejecting any life insurance policy or annuity contract that contained a discretionary clause.
Oregon	Oregon adopted a regulation effective March 12, 2015, OAR 836-010-0026, prohibiting any new or renewal policies, contracts or agreements from containing a discretionary clause that grant deference to the insurer in court proceedings.
Rhode Island	R.I. Gen. Laws § § 27-18-79, 27-34.2-22 prohibits discretionary clauses in new or existing policies.
South Dakota	South Dakota Insurance Code Chapter 20:06:52:02 provides that discretionary clauses are not permitted in any individual or group health policy. The rule applies to any health insurance policy issued or renewed after June 30, 2008. The provision also applies to third-party plan administrators.
Texas	Tex. Admin Code § 3.1203 bans discretionary clause in health and disability insurance policies.
Utah	In Utah Adm. Code Section 590-218 (2003), the state bars discretionary clauses that purport to give an insurer full and final discretion in interpreting benefits in an insurance contract. The rule applies to accident, health, life, and annuity insurance contracts; however, it does not apply to policies governed by ERISA.
Washington	Wash. Admin. Code § 284-44-015 bans discretionary clauses in insurance policies.
Wyoming	Effective July 1, 2009, Wyoming Statute 26-13-304 prohibits all health carriers from including discretionary clauses in their policies. However, the law allows for policies issued to ERISA-governed plans to contain discretionary clauses so long as they are highlighted and contained in at least 12 point type. The statute also states that any policy containing a discretionary clause must also contain a provision permitting de novo court review.

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