8/10/16 Draft
New Section for ERISA Handbook
*Note that footnote numbering will adjust in final document

Can states prohibit the use of discretionary clauses in insurance policies that provide ERISA benefits?

After the Supreme Court suggested in *Firestone* that ERISA plan administrators could avoid *de novo* judicial review if the plan documents grant them discretionary powers, many insurers responded by adding clauses to their policies that purported to give them discretionary authority to interpret the terms of the policy and to pay or deny claims. Many states, through regulatory action or legislation, refused to permit such clauses, and the NAIC has adopted the *Prohibition on the Use of Discretionary Clauses Model Act,*[1] which prohibits the use of discretionary clauses in disability income and medical insurance policies.

The prohibition is based on the recognition that discretionary clauses are contrary to the nature and purpose of insurance. Discretionary clauses, as the *Firestone* Court recognized, are a feature of certain types of trusts, and the Court relied on the distinction between trust law and contract law. More specifically, as the Court subsequently explained in *Varity Corp. v. Howe,*[2] "The common law of trusts recognizes the need to preserve assets to satisfy future, as well as present, claims and requires a trustee to take impartial account of the interests of all beneficiaries." Discretion is not inherent in all fiduciary relationships – no one would dream, for example, of allowing a bank the discretion to decide whether to keep or return deposited funds. But it is common to grant a trustee the discretion to choose between multiple deserving claims when a limited trust corpus has been set aside and every dollar that is paid to one beneficiary is a dollar that is unavailable to pay to any other beneficiary.

Insurance presents the opposite situation. It is appropriate for states to apply contract law to insurers, even if the policyholder is an employer with an ERISA plan, because insurance is a contract. An insurance policy is not an arrangement where an entity with a mission to help deserving people obtain health care has the discretion to decide who are the most deserving and how they can best be helped.[3] An insurance policy is an irrevocable commitment, made by a company that is in the business of assuming risk, to pay the specified benefits whenever a covered loss occurs during the policy term. The insurer does not have the discretion to decide the terms of that commitment after it has accepted the premium.

Nevertheless, some advocates contend that state laws prohibiting discretionary clauses are preempted by ERISA. One argument that has been made is that discretion is so fundamental to the obligations of ERISA fiduciaries that an implicit exception to the saving clause must be inferred in order to allow insurers to fulfill their fiduciary responsibilities. This is "[p]ure

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[1] NAIC Model Law No. 42, adopted 2002, amended 2004 to extend scope to include disability insurance.

[2] 516 U.S. 489, 514 (1996), *citing* RESTATEMENT (SECOND) OF TRUSTS §§ 183, 232.

[3] Actually, neither is a self-funded health plan. Implicitly recognizing this reality, Congress has now prohibited the enforcement of discretionary clauses in health benefit plans. *See* ERISA § 715; PHSA § 2719(b)(2)(B) (requiring self-insured ERISA plans to submit disputed claims to independent external review).

applesauce."[4] It is an argument the Supreme Court emphatically rejected in *Firestone*, holding that any grant of discretionary power must be explicit and the default presumption is that no such power has been granted.[5]

Another argument is that because the Supreme Court made a "clean break" with the *MetLife* "common sense" methodology in *Kentucky Health Plans v. Miller*, common sense must now be disregarded entirely, and the saving clause must be interpreted so narrowly that laws prescribing the provisions of insurance policies do not really "regulate insurance." However, three federal Circuit Courts of Appeals have considered that argument, and all three have rejected it and upheld the states' authority to prohibit discretionary clauses,[6] observing that the Supreme Court made clear in *Kentucky Health Plans* that a law that "dictates to the insurance company the conditions under which it must pay for the risk that it has assumed" is one of the paradigmatic examples of the type of law that regulates insurance because it substantially affects risk pooling.[7]

The courts also rejected other techniques designed to bring discretionary clauses outside the scope of the saving clause. For example, in *Fontaine v. MetLife*, the Seventh Circuit dismissed an argument that the Illinois regulation "is not specifically directed toward entities engaged in insurance because it prohibits a plan sponsor, like Mayer Brown, from delegating discretionary authority to the insurer of an employee benefit plan.[8] The argument is too clever, and without merit."[9] In that case, the discretionary clause appeared in a side agreement between the employer and the insurer in its capacity as plan administrator, rather than in the terms of the policy itself, but the court held that relying on that distinction was "another too-clever argument" that if taken seriously would "virtually read the saving clause out of ERISA" and "nullify the evident purpose" of the state regulation.[10] As the Sixth Circuit summarized the underlying issue in *ACLI v Ross*, "If, as *Glenn* reaffirms, there is a conflict of interest when the same plan administrator decides the merits of a benefits plan and pays that claim, and if, as *Glenn* also holds, it is consistent with ERISA to account for that conflict of interest in reviewing a plan

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[4] *King v. Burwell*, 135 S.Ct. 2480, 2501 (2015),

[5] *See supra* page -----; *see also ACLI v. Ross*, 558 F.3d 600, 608 (6th Cir. 2009); *Standard Ins. Co. v. Morrison*, 584 F.3d 837, 846 (9th Cir. 2009) ("While it is true that the Commissioner's practice will lead to *de novo* review in federal courts, this is hardly foreign to the ERISA statute. Indeed, *de novo* review is the default standard of review in an ERISA case.")

[6] *Fontaine v. Met. Life Ins. Co.*, 800 F.3d 883 (7th Cir. 2015); *Standard Ins. Co. v. Morrison*, 584 F.3d 837 (9th Cir. 2009) (upholding administrative practice not expressly required by state law), *cert. denied sub nom. Standard Ins. Co. v. Lindeen*, 560 U.S. 904 (2010); *ACLI v. Ross*, 558 F.3d 600 (6th Cir. 2009); *accord, Ravannack v. United HealthCare Ins. Co.*, 2015 U.S. Dist. LEXIS 63922 *5 (E.D. La. 2015) (in a case that did not involve a preemption challenge, noting that 'every federal decision that this Court could locate has enforced state law bans on discretionary clauses against ERISA plans'"). These three cases were also cited in *Adele E. v. Anthem Blue Cross and Blue Shield*, 2016 U.S. Dist. LEXIS 57055 (D. Me. 2016), where an insurance policy had a discretionary clause but the court conducted *de novo* review after concluding that the clause violated the Maine Insurance Code.

[7] *See Fontaine*, 800 F.3d at 888; *Standard v. Morrison*, 584 F.3d at 845; *ACLI v. Ross*, 558 F.3d at 607, *all quoting Kentucky Health Plans v. Miller*, 538 U.S. at 339 n.3.

[8] Furthermore, that argument begs the question because a policyholder never has any discretion over insurance claims that it could "delegate" to the insurer – no insurer would ever write a policy on such terms.

[9] 800 F.3d at 887.

[10] *Id.* at 887, 891–92 *(citations and internal punctuation omitted)*.

administrator's decision, it is difficult to understand why a State should not be allowed to eliminate the potential for such a conflict of interest by prohibiting discretionary clauses in the first place."[11]

[11] 558 F.3d at 609.