

Ninth Circuit Upholds State Prohibition on “Discretionary Clauses”

By Joe Faucher and Mike Vanic

On October 27, the United States Court of Appeals for the Ninth Circuit issued a ruling that will likely have a significant impact on the way that disability and health insurers do business. The case is *Standard Insurance Company v. Morrison*, — F.3d —, 2009 WL 3429501 (9th Cir. 2009).

James Morrison—the named defendant in the case—was Montana’s Commissioner of Insurance and Securities. A Montana statute requires its insurance commissioner to disapprove insurance policies that contain terms which “deceptively” cause the policy’s coverage not to be what it is assumed to be. Mr. Morrison announced that the statute required him to disapprove any insurance contract containing a so-called “discretionary clause.”

For many years, “discretionary clauses” have been commonplace in insurance policies issued to employer-sponsored health and disability plans. Here’s why:

In 1989, the United States Supreme Court issued a decision called *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101, 111, 109 S.Ct. 948, 103 L.Ed.2d 80 (1989). *Bruch* established how lower courts were to review decisions made by ERISA plan administrators. Specifically, if a plan (or an insurance policy) conferred discretion upon an administrator to interpret the plan and to decide whether a participant is entitled to benefits, a court would only review the decision to see if the administrator abused that discretion. That is, even if the court might have come to a different conclusion than the administrator, the administrator’s decision would be upheld if it was not an abuse of discretion. Conversely, if the plan did not contain language conferring discretion on the administrator, the administrator’s benefit determination would be reviewed “*de novo*.” In other words, the court would not give any deference to the administrator’s conclusions and would decide on its own whether benefits were payable or not.

Therefore, insurance companies that issue policies to employers that sponsor benefit plans—such as long term disability benefit

plans—typically include language in their policies that confer discretion upon the insurance carrier to interpret the plan and to determine whether participants are entitled to benefits. Judges that have been called upon to review decisions of those insurers have generally been obligated to uphold the administrator’s decision—even if they disagree with the conclusion—as long as they conclude that there is at least some evidence in the file that would support the decision and there is no abuse of discretion. Insurers therefore often include “discretionary clauses” in the policies they issue to ERISA plans, recognizing that if they do so, their benefit determinations will more likely be upheld.

Discretionary clauses are therefore somewhat controversial. On the one hand, they tend to further ERISA’s purpose of keeping plan costs manageable and making plans more widely available. After all, litigation costs are typically reduced and the more likely that an insurer’s benefit decision will be upheld by a reviewing court, the more likely that the insurer will issue an arguably more affordable policy.

On the other hand, critics of discretionary clauses contend that insurers have a built-in conflict of interest. Not only do they decide whether benefits are payable, but they are financially responsible for paying those benefits. Opponents of discretionary clauses argue that they enable insurers to take unfair advantage by engaging in inappropriate claims practices and hiding behind the “shield” of a discretionary clause.

This brings us back to *Morrison*. The primary question in the case is whether the Montana state law is preempted by federal law (ERISA) as it applies to employee benefit plans that are governed by ERISA. (Generally, all employee benefit plans—including retirement plans such as 401(k) plans and welfare benefit plans such as disability plans—are governed by ERISA.) The court concluded that the state law is *not* preempted because it falls within ERISA’s “savings clause,” which saves from preemption any state law that regulates

insurance. Thus, the Montana insurance commissioner is entitled to disapprove of insurance policies containing discretionary clauses without violating ERISA.

What does this mean going forward? It's hard to say. Even the court in *Morrison* acknowledged that “[t]he effect of disapproving discretionary clauses on ERISA plans is unclear.” The insurance commissioners of several states—including California—have disapproved the use of insurance policies containing discretionary clauses. At least with respect to the states in the Ninth Circuit, *Morrison* presumably answers whether those other insurance commissioners have the power to do so.

Beyond that, it is somewhat difficult to predict exactly what the fallout from *Morrison* will be. According to the court in *Morrison*, the National Association of Insurance Commissioners (NAIC) opposes the use of discretionary clauses and a dozen states had limited or barred their use as of 2008. The decision in *Morrison* and in an earlier decision by the United States Court of Appeals for the Sixth Circuit which reached a similar conclusion [*American Council of Life Insurers v. Ross*, 558 F.3d 600 (6th Cir. 2009)] may portend even more widespread prohibition of discretionary clauses.

The bigger questions involve the extent to which insurers will continue to make disability insurance available to those employers who want to offer that benefit to their employees and, if so, the cost at which it will be offered. Since it is foreseeable that administrative and litigation costs will increase, it is reasonable to assume that the cost of disability insurance will also go up, at least in those states whose insurance commissioners disapprove

of the use of discretionary clauses. Another result of *Morrison* will likely be that large employers with operations in multiple states will ultimately purchase different types of insurance policies for employees in different states—*i.e.*, one type of policy in states that allow discretionary clauses and another type of policy in states that do not allow discretionary clauses.

Interestingly, the decisions in *Morrison* and *Ross* do not directly affect so-called “self-funded” plans. State insurance laws do not reach plans whose benefits are paid, for example, not by an insurance policy but through a trust funded by employee contributions. Very large employers in states where discretionary clauses are disapproved may turn in increasing numbers to these “self-funded” benefit plans, rather than rely upon a policy of insurance to fund benefits. That may not be a practical answer for small and medium sized employers, because the pool of employees funding the benefits may simply be too small. For those employers, the only options may be to (1) purchase insurance at a likely increased price, (2) purchase insurance that provides lesser benefits, or (3) decline to offer disability benefits at all.

The insurance company in the *Morrison* case may seek rehearing before the panel of judges that rendered the decision or before the full Ninth Circuit. It may also seek a writ of certiorari before the United States Supreme Court, which has yet to rule on this important issue of ERISA preemption.

We will continue to monitor the decision in *Morrison* and other cases like it. In the meantime, if you have any questions, please feel free to contact us. ❖

Any tax advice contained in this communication (including any attachments) is neither intended nor written to be used, and cannot be used, to avoid penalties under the Internal Revenue Code or to promote, market or recommend to anyone a transaction or matter addressed herein.

©2009 Reish & Reicher, A Professional Corporation. All rights reserved. This bulletin is published as a general informational source. Articles are general in nature and are not intended to constitute legal advice in any particular matter. Transmission of this report does not create an attorney-client relationship. Reish & Reicher does not warrant and is not responsible for errors or omissions in the content of this report.