STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE
EXECUTIVE OFFICE
45 FREMONT STREET, SUITE 2300
SAN FRANCISCO, CA 94105
(415) 538-4375
(415) 904-5889(FAX)
coheng@insurance.ca.gov

John Garamendi, *Insurance Commissioner*

February 26, 2004

Teresa S. Renaker, Esq.
Lewis and Feinberg, P.C.
436 – 14th Street, Suite 1505
Oakland, CA 94612

Re: Letter opinion per CIC §12921.9 : Discretionary Clauses

Dear Ms. Renaker:

On December 5, 2003, you requested a letter opinion pursuant to California Insurance Code (CIC) §12921.9. You asked whether "discretionary clauses" in disability insurance policies were "appropriate under California law." The particular clause in question was:

> "When making a benefit determination under the policy, Unum [the insurer] has the discretionary authority to determine your eligibility for benefits and to interpret the terms and provisions of the policy."

In addition to your letter, we have requested and received comment from the industry. It is this Department's position that all such discretionary clauses in disability insurance contracts violate California law and deprive insureds of protections to which they are entitled. Moreover, concurrently with the issuance of this letter, the Department will withdraw any approval of any disability forms known to contain such discretionary clauses. Such withdrawal of approval is authorized under CIC §10291.5(f) and §12957. We define "discretionary clauses" as any contract provisions or language that purport to confer on the insurer discretionary authority to determine eligibility for benefits or to interpret the terms or provisions of the contract. We note that "disability" insurance includes coverage types classified under CIC §106 such as disability income insurance and health insurance.

Discretionary Clauses render the contract "fraudulent or unsound insurance" within the meaning of CIC §10291.5. Although the contract contains the insurer's promise to pay benefits under the stated conditions, the discretionary clause makes those payments contingent on the unfettered discretion of the insurer, thereby nullifying the promise to pay and rendering the contract potentially illusory.

Because the discretionary clause effectively negates operative terms of the contract, the contract becomes unintelligible, uncertain, ambiguous, abstruse and likely to mislead the insured, in

violation of CIC § 10291.5(b)(1). The commissioner is prohibited from approving such contracts or provisions. CIC § 10291.5 (b). The discretionary clause may cause California insureds to believe the insurer's decision to be final and to accept an unjustified denial of benefits.

Under CIC § 10291.5(b)(13), a disability insurance contract may not be approved "if it fails to conform in any respect with any law of this state." Therefore, insureds may not be deprived of the protections of California insurance law, including the covenant of good faith and fair dealing, the principles of contract interpretation such as the rule of reasonable interpretation or the law of adhesion contracts under which ambiguities are resolved in favor of the insured.

In the case of group, employer-sponsored disability contracts that are governed by ERISA, the presence of a discretionary clause has the legal effect of limiting judicial review of a denial of benefits to a review for abuse of discretion. An insurer's denial of benefits will not be overruled by the court unless the insurer's decision is found to be "arbitrary and capricious". This standard of review deprives California insureds of the benefits for which they bargained, access to the protections in the Insurance Code and other protections in California law.

It has sometimes been argued that ERISA requires all benefit determinations under ERISA-governed insurance contracts to be discretionary. There is, however, no such requirement in the statute. Under ERISA, states are free to determine the contents of insurance contracts. Specifically, the states' authority to address the issue of discretionary clauses in insurance contracts is unencumbered by ERISA. Through ERISA's savings clause, §514(b)(2)(A), states are entrusted with the regulation of insurance. The Supreme Court "has repeatedly held that state laws mandating insurance contract terms are saved from preemption." *Unum v. Ward,* 526 U.S. 358, 375-376 (1999), citing *Metropolitan Life Ins. Co. v. Massachusetts* 471 U.S. 724, 758 (1985). The Supreme Court has acknowledged that states indirectly regulate ERISA plans through the regulation of the plan's insurer and the plan's insurer's insurance contracts. *FMC Corp. v. Holliday,* 498 U.S. 52, 64 (1990). In *Rush Prudential HMO, Inc. v. Moran,* 122 S. Ct. 2151 (2002), the Supreme Court stated, "Nothing in ERISA, however, requires that these kinds of decisions be so 'discretionary' in the first place; whether they are is simply a matter of plan design or the drafting of an [insurance] contract." The *Moran* court went on to say that a state law may prohibit "designing an insurance contract so as to accord unfettered discretion to the insurer to interpret the contract's terms. As such, it does not implicate ERISA's enforcement scheme at all, and is no different from the types of substantive state regulation of insurance contracts we have in the past permitted to survive preemption…" *Moran, at 2170.* For these reasons, ERISA does not preclude California's authority to prohibit the use of discretionary clauses in insurance contracts.

In 2002, the National Association of Insurance Commissioners (NAIC), adopted Model Act 42 titled "Prohibition on the Use of Discretionary Clauses Model Act" which recommends that each member state initiate legislation prohibiting insurance contract clauses which purport "to reserve discretion to the health carrier to interpret the terms of the contract, or to provide standards of interpretation or review that are inconsistent with the laws of the state." The stated purpose of the Model Act is "to assure that

health insurance benefits are contractually guaranteed, and to avoid the conflict of interest that occurs when the health carrier has unfettered authority to decide what benefits are due."

Although the insurance industry has argued that the NAIC Model Act is intentionally limited to health insurance (implying that discretionary clauses should be permissible in other insurance contracts, such as disability income insurance), we are satisfied it was not the intention of the NAIC to exclude disability income and other coverages from the prohibition. The committee drafting the model had a limited charge in the area of health insurance and the NAIC is currently considering expanding the scope of the Model Act to include other non-health coverages, specifically disability income insurance. Moreover, it is our opinion that the reasoning supporting the NAIC's prohibition against discretionary clauses is equally applicable to any insurance contract.

It is this Department's position that discretionary clauses have great legal significance because they act to nullify the bargained contract provisions and create an illusory contract. In the ERISA context, they place a severe burden on insureds and effectively shield insurers who deny meritorious claims. Under ERISA law, state insurance regulation is exempt from federal preemption thereby permitting states to prohibit discretionary clauses if they violate state law. Under California law, discretionary clauses violate the rights of the insured and render the insurance contract "fraudulent or unsound insurance."

Sincerely,

Gary M. Cohen
General Counsel

GMC:el