Deferential review of an ERISA plan administrator’s decision on a claim for benefits is a hallmark of ERISA. Under Firestone Tire & Rubber Co. v. Bruch, 489 U.S. 101, 10 EBC 1873 (1989), if a plan grants the plan administrator discretion to interpret the plan, a court is required to uphold the administrator’s decision as long as it is reasonable, even if the court might otherwise have independently arrived at a different conclusion. This principle is rooted in trust law and promotes efficiency, predictability, and uniformity, all of which serve ERISA’s goal of encouraging employers to offer benefit plans.

In recent years, state legislatures and insurance commissioners have tried to undermine the Firestone standard by promulgating state laws that restrict or ban the use of discretionary clauses in insurance policies used to fund ERISA welfare benefit plans. This article discusses how courts have applied ERISA’s preemption principles to state law restrictions on discretionary clauses, and provides key considerations for practitioners faced with these laws.

Some state insurance commissioners oppose the use of discretionary clauses based on fears that discretionary clauses “may result in insurers engaging in inappropriate claim practices and relying on the discretionary clauses as a shield,” and that banning such clauses would reduce the supposed “conflict of interest present when the claims adjudicator also pays the benefit.”

As the Supreme Court stated: “All this is overblown.” A discretionary clause does not “shield” an administrator’s decision or permit an insurer to act in bad faith. The abuse of discretion standard protects reasonable decisions; if an administrator’s decision is unreasonable, a court will strike it down even under a deferential standard of review. Moreover, courts factor in any conflict of interest when applying the abuse of discretion standard.

Nevertheless, these perceived concerns have prompted state legislatures and regulators to enact bans or restrictions on discretionary clauses in insurance contracts in an effort to force federal courts to review benefit determinations under the de novo standard. In 2008, twelve states had limited or banned the use of discretionary clauses in insurance contracts. Since then, the number of states with similar restrictions has almost doubled.

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4 Morrison, 584 F.3d at 841.
These restrictions come in a variety of forms. For example, the Illinois law prohibits policies issued by health carriers from containing “a provision purporting to reserve discretion to the health carrier to interpret the terms of the contract[].”10 A New Jersey regulation states that a group health insurance policy may not contain a provision “purporting to reserve sole discretion to the carrier to interpret the terms of the policy or contract.”17 A Utah regulation prohibits discretionary clauses in insurance policies, but permits them in ERISA plans if their language is “substantially similar” to safe harbor language set forth in the regulation.8

**Federal Preemption of State Law Bans**

**Preemption Under ERISA § 514.** ERISA’s preemption provisions are “deliberately expansive.” ERISA § 514(a) provides that ERISA “shall supersede any and all State laws insofar as they . . . relate to any employee benefit plan.” However, ERISA also includes a savings clause, which saves state laws “which regulate[] insurance, banking or securities.” ERISA § 514(d)(2)(A).

Thus, a state law purporting to ban a discretionary clause in ERISA insurance plans is preempted unless preserved by the savings clause.

To fall under the savings clause, a state law must satisfy a two-part test set forth in Kentucky Ass’n of Health Plans, Inc. v. Miller, 538 U.S. 329, 30 EBC 1129 (2003) (63 PBD, 4/3/03; 30 BPR 778, 4/8/03). First, “the state law must be specifically directed toward entities engaged in insurance.” Second, it “must substantially affect the risk pooling arrangement between the insurer and the insured.”11

To date, plaintiffs have been successful in convincing the circuit courts that the more sweeping restrictions on discretionary clauses fall under the savings clause and are not preempted. The Sixth and Ninth Circuits have held that state laws banning discretionary clauses satisfy the first prong of the Kentucky Ass’n test because they are “specifically directed toward entities engaged in insurance.”

Regarding the second requirement, defendants have had some success in establishing that certain state laws do not substantially affect the risk pooling arrangement. “Risk pooling is the term used to describe the means by which insurers cover individuals of all risk levels across a variety of adverse event probabilities,” which permits insurers “to spread the risk that it will have to expend its resources to compensate a particular victim of an adverse event over all those paying premiums.” 12 One court recently held that a discretionary clause does not substantially affect risk pooling because it has no impact on the probability of an adverse event occurring or the spreading of that risk. Instead, it relates “only to the administrative function of interpreting the insurance plan’s terms and judicial review of the use of that administrative function.”11,13

However, the Sixth and Ninth Circuits have held that state law bans fall under the savings clause, adopting a more expansive view of what qualifies as having a “substantial effect” on risk pooling. The Ninth Circuit has held that “removing the benefit of a deferential standard of review” will likely “lead to a greater number of claims being paid. More losses will thus be covered, increasing the benefit of risk pooling for consumers.”14 The Sixth Circuit has held that “by changing the terms of enforceable insurance contracts,” state law bans “alter the scope of permissible bargains between insurers and insureds.”15

The Tenth Circuit has held that Utah’s restriction on discretionary clauses is preempted. The Utah regulation permits discretionary clauses in ERISA plans, but only if their language is “substantially similar” to safe harbor language set forth in the regulation. The Tenth Circuit held that this regulation has no impact on risk pooling because it “neither affects who gets in the risk pool nor prescribes conditions under which insurers must pay for assumed risks.”16 However, the Tenth Circuit left open the question of whether a state law that “imposed a blanket prohibition” on discretionary clauses would substantially affect risk pooling, citing the Sixth and Ninth Circuit opinions in Ross and Morrison. Id.

**Preemption Based on Conflict With Objectives of ERISA.** The Supreme Court has held that even if a state law regulating insurance falls under the savings clause, it may still be preempted if it conflicts with the objectives of ERISA.17 Bans on discretionary clauses undermine Congress’ objectives in enacting ERISA: efficiency, predictability, and uniformity. The Supreme Court has explained that “[d]eference promotes efficiency by encouraging resolution of benefits disputes through internal administrative proceedings rather than costly litigation.”18 It “promotes predictability, as an employer can rely on the expertise of the plan administrator rather than worry about unexpected and inaccurate plan interpretations that might result from de novo judicial review.”19 “Moreover, Firestone deference serves the interest of

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14 Id. at 342.
17 Id. at *6. 18 Morrison, 584 F.3d at 845. 19 Ross, 558 F.3d at 607.
21 John Hancock Mutual Life Ins. Co. v. Harris Trust & Sav. Bank, 510 U.S. 86, 100, 17 EBC 1657 (1993) (“State law governing insurance generally is not displaced, but where that law stands as an obstacle to the accomplishment of the full purposes and objectives of Congress, federal preemption occurs.”).
22 Conkright, 130 S.Ct. at 1649.
23 Id.
uniformity, helping to avoid a patchwork of different interpretations of a plan . . . that covers employees in different jurisdictions.[20]

To date, the circuit courts have rejected arguments that this conflict is sufficient to preempt state law bans on discretionary clauses. They have reasoned that such bans do not undermine or displace ERISA’s remedial scheme because they do not authorize relief in state courts or serve as an alternate enforcement mechanism outside of ERISA. In addition, these courts found it significant that the text of ERISA does not mandate a deferential standard of review, and that de novo review is the default standard under Firestone.[21]

Ross and Morrison also relied on the Supreme Court’s opinion in Rush Prudential HMO, Inc. v. Moran, 536 U.S. 355, 27 EBC 2921 (2002) (120 PBD, 6/21/02; 29 BPR 1801, 6/25/02), which upheld a state law mandating independent and binding arbitration of a denial of benefits by a third-party physician whenever a patient’s doctor and HMO disagreed about the medical necessity of a procedure. But the Supreme Court made clear in Rush Prudential that it did “not mean to imply that States are free to create other forms of binding arbitration to provide de novo review of any terms of insurance contracts,” and emphasized that its decision was based on “our recognition that the disuniformity Congress hoped to avoid is not implicated by decisions that are so heavily imbued with expert medical judgments.”[22]

The recent wave of state law restrictions on discretionary clauses are not narrowly targeted to cases imbued with expert medical judgments, and they squarely implicate “the disuniformity Congress hoped to avoid.” As the Supreme Court explained in Conkright: “Uniformity is impossible . . . if plans are subject to different legal obligations in different states.”[23]

**Key Considerations for Practitioners**

While the preemption issues continue to be sorted out by the courts, below are some additional considerations for practitioners faced with a state law restriction on discretionary clauses.

- **Not All State Law Restrictions Are Created Equal.** Even if a state law restriction is not preempted by ERISA, a careful read of the regulation may reveal that it does not apply to an ERISA plan in the first place. For example, New Jersey’s regulation prohibits clauses “purporting to reserve sole discretion to the carrier to interpret the terms of the policy or contract[.]”[24] The Third Circuit has held that the New Jersey regulation does not apply in the ERISA context because plan administrators do not have “sole” discretion under ERISA, given that their decisions are subject to judicial review.[25]

  - **Check the Effective Date of the State Law and the Date of the Policy.** Several courts have held that state law restrictions do not apply retroactively.[26]

  - **Consider Whether the Discretionary Clause Is in the Insurance Policy or the Plan.** Some state law restrictions apply to policies “issued in” the state “by an” insurer that purported to “reserve” discretion to the insurer.[27] However, in many ERISA plans, the discretionary clause is not contained in the policy or certificate of insurance issued by the insurer. Instead, it is contained in a plan document issued by the employer, and the employer has delegated discretionary authority to the insurer. Carriers have pointed out that in this situation, the policy should not be subject to the state regulation because the policy actually issued by the insurer does not contain a discretionary clause and the insurer has not “reserved” to itself any discretionary authority. The Seventh Circuit is currently considering this issue in Fontaine v. Metropolitan Life Ins. Co., Nos. 14-1984 and 14-2302 (7th Cir.).

  - **A Choice of Law Clause May Apply.** Many plans include a choice of law provision that may render the state law restriction inapplicable. For example, in Morrison v. Unum Life Ins. Co. of Am., 730 F. Supp. 2d 699, 704, 2010 BL 311858 (E.D. Mich. 2010), the court held that a Michigan regulation purporting to void discretionary clauses did not apply because the contract provided that Maine law should govern disputes between the parties.[28]

  - **State Law Restrictions May Not Apply to Self-Funded Plans.** Many employers elect to fund their own ERISA welfare benefit plan rather than funding the plan through the purchase of an insurance contract. ERISA’s “deemer clause” provides that states cannot “deem” a self-funded ERISA plan to be an insurer for purposes of ERISA’s savings clause. ERISA § 514(b)(2)(B). Thus, any state law that would purport to restrict discretionary clauses in a self-funded plan should be preempted under ERISA § 514(a).

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[20] Id. See, e.g., Baker v. Hartford Life Ins. Co., 2010 BL 119895 (D.N.J. May 28, 2010) (voiding discretionary clause “would in effect change the standard of review of every civil enforcement action under ERISA within the state of New Jersey . . . This would directly violate the purpose of ERISA to provide a uniform regulatory regime over employee benefit plans.”) (quotation and citation omitted).

[21] Ross, 558 F.3d at 608; Morrison, 584 F.3d at 846.

[22] Id. at 386 n.17.

[23] 130 S.Ct. at 1651.


[26] See, e.g., Golden v. Guardian Life Ins. Co. of Am., 2010 BL 404208 (N.D. Ill. Oct. 4, 2010) (“For insurance plans issued prior to the effective date, the bar on discretionary clauses does not apply.”).