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## California's ban on discretionary clauses in disability and life insurance policies

California Insurance Code section 10110.6:

When it applies and how it stands up to ERISA preemption

Litigating an ERISA case is challenging and, at times, frustrating. One of the biggest challenges an individual claimant faces is when their adversary, the insurance company, has been granted "discretion" in the insurance policy governing the claim. The U.S. Supreme Court has acknowledged that discretionary clauses are features "highly prized" by insurers, meaning they will fight hard to retain discretionary language. (See *Rush Prudential HMO, Inc. v. Moran* (2002) 536 U.S. 355, 384.)

The typical discretionary clause grants the insurer discretion to determine eligibility for benefits and to interpret the policy. In practice, this grant of discretion changes the standard of review at trial and affects the type of discovery that can be conducted. If there is a grant of discretion, a reviewing court will employ an "abuse of discretion" review at trial. It has been said that under this standard of review, a claim decision will not be overturned unless it is "illogical, implausible, or without support in inferences that may be drawn from the facts in the record." (*Salomaa v. Honda Long Term Disability Plan* (9th Cir. 2011) 642 F.3d 666, 676.)

It is not surprising that there are a number of cases which have held that the weighty burden of the abuse of discretion review required a finding for the insurer, although a de novo or non-differential standard of review may have yielded a different result. (*Brigham v. Sun Life of Canada* (1st Cir. 2003) 317, F.3d 72, 85-86 ("[I]t seems counterintuitive that a paraplegic suffering serious muscle strain and pain, severely limited in his bodily functions, would not be deemed totally disabled," but upholding the termination of disability benefits because the question was "not which side we believe is right....");

*Curtis v. Kansas City Life Ins. Co.* (W.D. Ky. 2011) 2011 WL 901992 \*7 ("If the standard of review was de novo, the Court would be inclined to find for Plaintiff. However, that is not the applicable standard. The arbitrary and capricious standard and existing case law indicate to the Court that Plaintiff's claim should be denied. Although the Court does not necessarily like this result, the Court believes it has reached the correct decision applying the law applicable to this case.").) A survey of cases performed in 2004 observed that consumers filing group disability lawsuits had a significantly lower chance of winning their case (28 percent versus 68 percent) when the insurance contract contained a valid discretionary clause.

### National movement to eliminate discretion

In 2004, the National Association of Insurance Commissioners issued a Model Act banning the use of discretionary clauses in health policies. Later that year, the Model Act was amended to extend the ban to include disability policies. In advocating for the adoption, Commissioner Sandy Praeger of the Kansas Insurance Department described the effect of discretionary clauses:

These clauses give considerable discretion to insurers to interpret the benefits and other terms of the policy and lead to court decisions favoring insurers unless the insured can show the decisions by the insurer were arbitrary and capricious. This is a huge burden for the insured....

Subsequent to the issuance of the Model Act, at least 16 states have enacted legislation, or issued insurance regulations, banning the inclusion of discretionary clauses in certain types of insurance policies.

### California's efforts on banning discretionary clauses

In 2004, California's then Commissioner of Insurance, John Garamendi, issued a Notice of Withdrawal to all disability carriers selling policies within the state withdrawing approval of certain policy forms. The forms in question contained discretionary clauses, which Commissioner Garamendi had determined rendered the policies "unintelligible, uncertain...and likely to mislead." Commissioner Garamendi also specified certain policy forms which could no longer be utilized in California unless the discretionary clauses were removed. Commissioner Garamendi's actions were laudable, but had a short-lasting effect. This was because insurers subsequently settled with the Department of Insurance and, for various reasons, the Ninth Circuit has refused to enforce the Commissioner's action as a state ban on the enforceability of discretionary clauses. (See *Saffon v. Wells Fargo & Co. Long Term Disability Plan* (9th Cir. 2008) 522 F.3d 863, 867; *Stephan v. Unum Life Ins. Co. of America*, (9th Cir. 2012) 697 F.3d 917, 924-28.)

After similar legislation was vetoed in 2010, California enacted legislation banning discretionary clauses in life, disability, health, and accidental death insurance contracts (California's Insurance Code includes health and accidental death insurance as part of disability insurance). Sponsored by Senator Ron Calderon (D-Montebello) and endorsed by Insurance Commissioner David Jones, California's ban on discretionary clauses went into effect on January 1, 2012. This self-executing law regulating insurance was codified as California Insurance Code Section 10110.6. The statute applies to all disability and life insurance

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policies providing coverage to a California resident which were offered, issued, delivered, or renewed on or after January 1, 2012. In relevant part, section 10110.6 provides that a grant of discretion in any such policy is void and unenforceable:

(a) If a policy, contract, certificate, or agreement offered, issued, delivered, or renewed, whether or not in California, that provides or funds life insurance or disability insurance coverage for any California resident contains a provision that reserves discretionary authority to the insurer, or an agent of the insurer, to determine eligibility for benefits or coverage, to interpret the terms of the policy, contract, certificate, or agreement, or to provide standards of interpretation or review that are inconsistent with the laws of this state, that provision is void and unenforceable.

(b) For purposes of this section, “renewed” means continued in force on or after the policy’s anniversary date.

(c) For purposes of this section, the term “discretionary authority” means a policy provision that has the effect of conferring discretion on an insurer or other claim administrator to determine entitlement to benefits or interpret policy language that, in turn, could lead to a deferential standard of review by any reviewing court.

As of the date of this article, the authors know of no court decision which has substantively applied or interpreted the provisions of section 10110.6. However, it is anticipated that the insurance industry will vigorously contest any attempt by the plaintiff’s bar to enforce the statute and its resulting void of discretionary clauses in group insurance contracts. This article will identify the anticipated issues that one may face when attempting to change the standard of review based on section 10110.6.

### **Does section 10110.6 survive ERISA preemption?**

It is widely known that ERISA contains a broad preemption provision, preempting “any and all State laws insofar as

they may now or hereafter relate to any [covered] employee benefit plan.” (29 U.S.C. § 1144(a).) However, at the same time, ERISA contains a “saving clause,” exempting any state law that regulates insurance from the preemption provision of ERISA. (29 U.S.C. § 1144(b)(2)(A).) Accordingly, although ERISA plans are federally regulated and enforced in federal courts, the saving clause permits states to dictate mandatory insurance-policy provisions. (*Rush Prudential HMO, Inc. v. Moran* (2002) 536 U.S. 255, 364.)

The Ninth Circuit addressed the issue of whether a state law or practice banning discretionary clauses was “saved” from ERISA’s preemption provision in *Standard Ins. Co. v. Morrison* (9th Cir. 2009) 584 F.3d 837 *cert. denied sub nom Standard Ins. Co. v. Lindeen* (2010) 130 S.Ct. 3275. The court held that the Montana Insurance Commissioner’s practice of disapproving policy forms containing grants of discretion was saved from preemption because it was specifically directed to the insurance industry and affected the risk-pooling factors of the Montana insurance industry. Among other things, it was noted that the Montana practice of disapproving discretionary clauses affected the risk pooling because it would lead to a greater number of claims being paid, increasing the benefit of risk pooling for consumers. (*Id.* at 845.) Using a similar analysis, the Sixth Circuit has held that Michigan’s ban on discretionary clauses is not preempted by ERISA. (*American Council of Life Insurers v. Ross* (6th Cir. 2009) 558 F.3d 600, 606.)

### **Does section 10110.6 apply to out-of-state contracts?**

Another tactic that insurers are expected to employ in an effort to avoid section 10110.6 is to claim that out-of-state law, rather than California’s law banning discretion, should be applied. Often insurance policies specify a place where the policy was issued or delivered. In other jurisdictions, insurers have sought to avoid local bans on discretionary clauses by arguing that a policy “issued or delivered” in another state

should not be subject to the local regulation or statute. (*Curtis v. Hartford Life and Acc. Ins. Co.* (N.D. Ill. 2012) 2012 WL 138608.) That argument is likely to be unsuccessful for insurers in California since the statute applies to policies which provide coverage to California residents.

It can also be expected that insurers will rely upon, or start including, choice-of-law provisions in their contracts specifying a governing jurisdiction other than California. In the event that the policy says it is governed by the laws of a state other than California, local courts will likely apply the Ninth Circuit’s choice-of-law rules. This is an area that has not been extensively litigated and there is scant law in the Ninth Circuit governing choice-of-law rules in the ERISA context.

An older case, *Wang v. Kagan* (9th Cir. 1993) 990 F.2d 1126, suggests honoring a stated choice-of-law provision in a federal-question case unless the provision is unreasonable or fundamentally unfair. Generally speaking, this is consistent with the Restatement (Second) of Conflicts of Laws, which provides that courts should not honor the choice if the chosen state has no “substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties’ choice,” or application of the chosen state’s laws would contradict the policy of a state which has a “materially greater interest” than the chosen state in issue’s determination. (Restatement (Second) of Conflicts of Laws § 187(1) (1988).) Since California has legislated public policy to protect its citizens by banning discretionary clauses in insurance policies after January 1, 2012, it would appear that it has a materially greater interest in having its own laws govern the claims of its residents.

Finally, in the event that choice-of-law-becomes an issue, it is also important to research whether the selected state has also banned discretionary clauses. A number of jurisdictions have enacted regulations, statutes, or agency opinions banning discretionary clauses, making it possible that there may be no conflict.

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## What determines if the statute applies to your client's policy?

The ban on discretionary clauses went into force on January 1, 2012. Therefore, from this date forward, discretionary clauses in life and disability insurance “offered, issued, delivered, or renewed” are rendered void and unenforceable. These first three are easy to determine: look at the applicable documents and if they are dated on or after January 1, 2012, there can be no discretion.

The statute also provides helpful guidance on the meaning of the term “renewed.” This is defined as continued in force on or after the policy’s anniversary date. Typically, the face page of the group contract will specify the anniversary date of the policy. This is the date that the terms of the policy may be modified or premiums can be adjusted. The anniversary date does not necessarily correspond with the date the insurance became effective. Common anniversary dates utilized in group policies that differ from the effective date are January 1st or July 1st of every year. In a policy that was offered, issued and delivered before January 1, 2012, with an anniversary date thereafter, the discretionary language is unaffected until the anniversary date.

## Claim submitted before January 1, 2012

The date in which the claimant submitted the claim or the date of disability is immaterial. In ERISA cases, the Ninth Circuit has held that the controlling insurance document is the one that was in effect at the time the claimant’s cause of action accrued. (*Grosz-Salomon v. Paul Revere Life Ins. Co.* (9th Cir. 2001) 237 F.3d 1154, 1160-61.) An ERISA cause of action for a denial of benefits does not accrue until a claimant has exhausted his or her administrative remedies under the

plan. Thus, if your client exhausted their administrative remedies after both January 1, 2012, and the policy’s anniversary date, you may still take advantage of section 10110.6 to argue any discretionary language is rendered void and unenforceable.

## Does applying section 10110.6 to an existing policy make it a retroactive statute?

We have heard insurers argue that section 10110.6 cannot be applied to existing contracts because to do so would be an impermissible retroactive application of the statute. This argument ignores the fact that the statute expressly applies to *renewals* of policies after its effective date. If there had been any question regarding the viability of this provision, it was recently eliminated with the Ninth Circuit’s decision in *Stephan, supra*, 697 F.3d 917.

The *Stephan* case involved the previously mentioned Notice of Withdrawal authored by Commissioner Garamendi in 2004. One insurer, Unum, subsequently entered into a settlement agreement with the Department of Insurance which banned the inclusion of discretionary clauses in “newly issued” policies. Unum’s settlement agreement mandated other policy changes to both “newly issued” and “renewed” policies. The *Stephan* court seized upon this distinction and held that the discretionary clause ban did not apply because plaintiff’s policy was not newly issued, but rather was a renewed policy which was originally issued in 1999.

However, in doing so, the *Stephan* court also provided compelling language that would defeat any argument that section 10110.6 cannot be applied to policies renewed after its effective date. The court repeated the rule that insurance

policies are governed by statutory and decisional law in effect at the time of issuance and renewal. The court stated that each renewal incorporates any changes in the law that occurred prior to the renewal. (*Id.* at 928.) Unfortunately for Mr. Stephan, the law in effect at the time of the latest renewal, which had occurred in 2007, did not include a ban on discretionary clauses. Fortunately for California insureds, after January 1, 2012, the law has been changed.

## Conclusion

Even though the statute is self-executing, it can be expected that insurers will strongly contest the elimination of the highly prized discretionary clauses in insurance contracts. Any ERISA practitioner should be prepared to utilize all available tools to “level the playing field” and ensure a fair, *de novo*, review of their client’s claim. Securing the application of section 10110.6 is a large step in the right direction. Prior to asserting that 10110.6 controls, and engaging in the inevitable motion practice on the issue, review the above questions to help you evaluate whether this new law applies to your case.

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