

**INSURANCE  
DEPARTMENT OF BANKING AND INSURANCE  
DIVISION OF INSURANCE**

**Actuarial Services  
Prohibition of Discretionary Clauses**

**Proposed New Rule: N.J.A.C. 11:4-58**

Authorized by: Steven M. Goldman, Commissioner, Department of Banking and Insurance

Authority: N.J.S.A. 17:1-8.1, 17:1-15(e), 17B:25-18(h), 17B:25-18.1, 17B:26-1h(2), 17B:27-74(e), 17B:27E-10, 17:29B-1 et seq., and 26:2S-12c.

Calendar Reference: See Summary below for explanation of exception to calendar requirement.

Proposal Number: PRN 2006-268

Submit comments by October 20, 2006 to:

Robert Melillo, Chief  
Legislative & Regulatory Affairs  
20 West State Street  
PO Box 325  
Trenton, NJ 08625-0325  
Fax: 609-292-0896  
Email: [LegsRegs@dobi.state.nj.us](mailto:LegsRegs@dobi.state.nj.us)

The agency proposal follows:

**Summary**

A discretionary clause is any provision in an insurance policy or contract or an annuity contract that purports to confer on the carrier sole discretionary authority to determine eligibility for benefits or to interpret the terms or provisions of the policy or contract. These types of clauses became popular after the United States Supreme Court decided *Firestone Tire and Rubber Co. v. Bruch*, 489 U.S. 101 (1989), which held that a court should review a decision by a self-funded employee benefit plan without a discretionary clause independently (de novo), not giving deference to the plan administrator. The Court noted that had the plan included a discretionary clause, the

plan administrator's decision could have been overturned only if it was arbitrary and capricious. The Court's ruling applied to all employee group health benefits plans subject to Federal Employee Retirement Income Security Act (29 U.S.C. §§1001 et seq.) (ERISA) regulation, regardless of whether they were offered through insurance or self-funded by the sponsor. The "arbitrary and capricious" standard is a difficult one for consumers to meet when challenging eligibility, benefit or contract interpretation decisions in court. Consequently, carrier decisions are frequently upheld in legal actions involving policies that contain discretionary clauses. Without providing a court the opportunity to fully review a claim, a consumer has little chance of success.

The Department believes that the inclusion of discretionary clauses in policies and contracts - life, health, long-term care and annuity -- may nullify a carrier's promise to pay, and may deny insureds and contractholders benefits to be provided pursuant to the terms and conditions of the policy or contract. Under a discretionary clause, the insured's or contractholder's expectations may become illusory, thereby denying them protections afforded by this State's insurance and other laws. Accordingly, for several years the Department has been disapproving the inclusion of discretionary clauses in all life and health insurance policies and contracts, including disability income coverage policies and contracts; all long-term care insurance policies and contracts; and all annuity contracts.

New Jersey's Health Care Quality Act (HCQA), N.J.S.A. 26:2S-1 et seq., applicable to all insurance companies, health service corporations, hospital service corporations, medical service corporations and health maintenance organizations authorized to issue health benefits plans in this State, provides that individuals covered under a health benefits plan that uses one or more utilization management features have a right to appeal a denial, reduction or termination of covered services

by a carrier. Each carrier that uses utilization management is required to have a two-stage internal appeal mechanism for the benefit of its covered individuals, and must provide covered individuals with a written explanation of how to access this mechanism. In addition to these internal appeal programs, a covered individual has the right to an external appeal process involving an independent utilization review organization (IURO). The IURO may uphold, reverse or modify the utilization management decision of a carrier, and an adverse decision is binding on the carrier. Because IUROs are able to reverse carriers' medical necessity decisions and arbitrators and courts can reverse carriers on contractual issues other than medical necessity, carriers clearly do not have sole discretion to interpret their policies or contracts, and those policies or contracts that include discretionary clauses are disapproved by the Department.

In 2004, the National Association of Insurance Commissioners (NAIC) adopted Model Act 42, titled "Prohibition on the Use of Discretionary Clauses," the stated purpose of which was "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." While the New Jersey Legislature has not adopted Model Act 42, the Department has continually rejected the inclusion by carriers of discretionary clauses in health insurance and long-term care policies and contracts on the basis that such clauses are inequitable, unfair, and contrary to this State's laws and public policy.

The proposed new rules codify the Department's long-standing practice of disallowing the inclusion of discretionary clauses in all individual and group life, health and long-term care insurance policies and contracts, and all annuity contracts. Proposed N.J.A.C. 11:4-58.1 sets forth the purpose and scope of the subchapter, and

proposed N.J.A.C. 11:4-58.2 contains definitions used throughout the subchapter. Proposed N.J.A.C. 11:4-58.3 contains the language prohibiting the use of discretionary clauses, but permitting carriers to make an initial interpretation concerning the terms of their policies or contracts so long as that interpretation can be reversed by an internal utilization review organization, a court of law, arbitrator or administrative agency having jurisdiction. Proposed new N.J.A.C. 11:4-58.4 would deem any such policy and contract forms currently in use that contain discretionary clauses withdrawn as of January 1, 2007, and bar the delivery, issuance, execution or renewal of those forms.

A 60-day comment period is provided for this notice of proposal; therefore, pursuant to N.J.A.C. 1:30-3.3(a)5, the proposal is not subject to the provisions of N.J.A.C. 1:30-3.1 and 3.2 governing rulemaking calendars.

### **Social Impact**

The proposed new rules will have a favorable impact on consumers. The prohibition on discretionary clauses creates a level playing field, and ensures that consumers have the benefit of a fair and impartial standard of review applied by courts or arbitrators to their policies and contracts, rather than the "arbitrary and capricious" standard applied when a discretionary clause is included in a policy or contract. Application of a de novo standard of review better assures that consumers will be able to receive the benefits for which they have contracted in their policies and contracts. The new rules may have an unfavorable impact on carriers only insofar as it codifies an existing prohibition on the inclusion of discretionary clauses in policies and contracts. Disallowing such clauses removes unfettered discretion from carriers

to interpret the terms and conditions of their policies and contracts, and make determinations regarding the payment of benefits.

### **Economic Impact**

The prohibition of the use of discretionary clauses may have a favorable impact on consumers if a de novo standard of review is applied by a court or other arbitrator in interpreting a policy or contract, instead of an arbitrary and capricious standard, and such de novo review results in payment of benefits that would not otherwise have been paid. Conversely, prohibiting the use of discretionary clauses in policies and contracts could unfavorably impact carriers if they are required to pay benefits that they would not otherwise have paid under old policy and contract forms that contained discretionary clauses. Codifying the Department's current policy of disapproving discretionary clauses will, however, economically benefit insurers by providing general notice of this policy, thereby enhancing the efficiency of the form preparation and filing process.

### **Federal Standards Statement**

A Federal standards analysis is not required because the Department's proposed new rules are not subject to any Federal standards or requirements.

### **Jobs Impact**

The Department does not anticipate that the proposed new rules will result in the generation or loss of jobs.

### **Agriculture Industry Impact**

The proposed new rules will have no agriculture industry impact.

### **Regulatory Flexibility Analysis**

This proposed new rules as described in the Summary above may apply to some carriers that constitute "small businesses" as that term is defined in the Regulatory Flexibility Act, N.J.S.A. 52:14B-16 et seq. The proposed new rules, however, in prohibiting the inclusion of discretionary clauses in life and health insurance policies and contracts, annuity contracts, and long-term care policies and contracts, would not impose any reporting or recordkeeping requirements on small businesses, would not require small businesses to use any professional services, and places no additional administrative burden on small businesses to comply with the rule. The rules would require carriers to remove discretionary clause language from currently-used policy and contract forms, but the cost for doing so would be minimal. As stated in the Economic Impact above, a prohibition on the use of discretionary clauses in policies and contracts may result in carriers having to pay benefits that they otherwise would not have been required to pay on policy or contract forms introduced years ago that contain discretionary clauses. However, as stated in the Summary, the proposed new rules are codifying the Department's long-standing prohibition on the use of such clauses and must be applied consistently to all carriers issuing life and health insurance policies and contracts, annuity contracts and long-term care policies and contracts in this State to ensure the protection of New Jersey consumers. Thus, no exception can be made for small businesses.

### **Smart Growth Impact**

The proposed new rules will have no impact on the achievement of smart growth and the implementation of the State Development and Redevelopment Plan.

**Full text** of the proposed new rules follows:

#### **SUBCHAPTER 58. DISCRETIONARY CLAUSES**

##### 11:4-58.1 Purpose and scope

(a) The purpose of this subchapter is to prohibit the use of discretionary clauses in all life, health and long-term care insurance policies and contracts, and all annuity contracts, to assure that all benefits provided under the policy or contract are contractually guaranteed, and to avoid the conflict of interest that occurs when the carrier responsible for providing benefits has sole discretionary authority to decide what benefits are due.

(b) This subchapter shall apply to all individual and group health insurance policies and contracts; all individual and group life insurance policies and contracts; all individual and group long-term care insurance policies; and all annuity contracts delivered or issued for delivery in this State.

##### 11:4-58.2 Definitions

The following words and terms, when used in this subchapter, shall have the following meanings unless the context clearly indicates otherwise:

"Annuity" means a contract not included within the definition of life insurance or health insurance, as set forth in this section, under which an insurer obligates

itself to make periodic payments for a specified period of time, such as for a number of years, or until the happening of an event, or for life, or for a period of time determined by any combination thereof. A contract which includes extra benefits, of the kinds set forth in the definitions of life insurance or health insurance, as set forth in this section, shall nevertheless be deemed to be an annuity if such extra benefits constitute a subsidiary or incidental part of the entire contract.

"Carrier" means an insurance company, health service corporation, hospital service corporation, medical service corporation or health maintenance organization authorized to issue health benefits plans in this State; any person or persons, corporation, partnership or company authorized or admitted to transact the business of life insurance or annuities in this State pursuant to Title 17B of the New Jersey statutes; and an insurance company, health service corporation, hospital service corporation, medical service corporation or fraternal benefit society authorized to issue long-term care insurance in this State.

"Commissioner" means the Commissioner of the New Jersey Department of Banking and Insurance.

"Department" means the New Jersey Department of Banking and Insurance.

"Discretionary clause" means a clause included in a life or health insurance policy or contract, a long-term care insurance policy or contract, or an annuity contract, that provides the carrier with sole discretionary authority to determine eligibility for benefits under the policy or contract and to interpret the terms and provisions of the policy or contract.

"Health insurance" means a contract or agreement whereby a carrier is obligated to pay or allow a benefit of pecuniary value with respect to the bodily injury, disablement, sickness, death by accident or accidental means of a human being, or



because of any expense relating thereto, or because of any expense incurred in prevention of sickness, and includes every risk pertaining to any of the enumerated risks. Health insurance includes disability income protection coverage. Health insurance does not include workers' compensation coverage.

"Life insurance" means a policy or contract whereby an insurer is obligated to pay or allow a benefit of pecuniary value with respect to the cessation of human life. Life insurance also includes the granting of endowment benefits and optional modes of settlement of proceeds of life insurance, as well as provisions for additional benefits in the event of death by accident or accidental means or in the event of dismemberment or loss of sight; or safeguarding such insurance against lapse or giving a special surrender value, or special benefit or annuity in the event that the insured shall become totally and permanently disabled, whether such provisions are incorporated in a policy or contract of life insurance or in a policy or contract supplemental thereto. Life insurance does not include worker's compensation coverage.

"Long-term care insurance" means any insurance policy, certificate or rider advertised, marketed, offered or designed to provide coverage for not less than 12 consecutive months for each covered person on an expense incurred, indemnity, prepaid or other basis, for one or more necessary or medically necessary diagnostic, preventive, therapeutic, rehabilitative, maintenance or personal care services, provided in a setting other than an acute care unit of a hospital. The term includes group and individual annuities and life insurance policies or riders which provide directly or which supplement long-term care insurance. The term also includes a policy or rider which provides for payment of benefits based upon cognitive impairment or the loss of functional capacity. The term shall also apply to qualified long-term care insurance contracts. Long-term care insurance may be issued by insurers; fraternal benefit

societies; health, hospital, or medical service corporations; prepaid health plans; or health maintenance organizations. Long-term care insurance shall not include any insurance policy that is offered primarily to provide basic Medicare supplement coverage, basic hospital expense coverage, basic medical-surgical expense coverage, hospital confinement indemnity coverage, major medical expense coverage, disability income or related asset-protection coverage, accident only coverage, or limited benefit health coverage. With regard to life insurance, this term does not include life insurance policies which accelerate the death benefit specifically for one or more qualifying events, and which provide the option of a lump-sum payment for those benefits and in which neither the benefits nor the eligibility for the benefits is conditioned upon the receipt of long-term care. Notwithstanding the foregoing, any product advertised, marketed or offered as long-term care insurance shall be subject to the provisions of this subchapter.

#### 11:4-58.3 Discretionary clauses prohibited

No individual or group health insurance policy or contract, individual or group life insurance policy or contract, individual or group long-term care insurance policy or contract, or annuity contract, delivered or issued for delivery in this State may contain a provision purporting to reserve sole discretion to the carrier to interpret the terms of the policy or contract, or to provide standards of interpretation or review that are inconsistent with the laws of this State. A carrier may include a provision stating that the carrier has the discretion to make an initial interpretation as to the terms of the policy or contract, but that such interpretation can be reversed by an internal utilization review organization, a court of law, arbitrator or administrative agency having jurisdiction.

11:4-58.4 Noncomplying forms

As of January 1, 2007, forms previously filed, approved or acknowledged by the Commissioner that contain provisions not in compliance with this subchapter shall be deemed withdrawn and shall not be delivered, issued, executed or renewed.

inoregs/bbdisclaue