

Discretionary Clauses

COMMONWEALTH OF KENTUCKY
DEPARTMENT OF INSURANCE
Frankfort, Kentucky

ADVISORY OPINION 2010-01

The following Advisory Opinion is to advise the reader of the current position of the Kentucky Department of Insurance (the "Department") on the specified issue. The Advisory Opinion is not legally binding on either the Department or the reader.

TO: ALL INSURERS AUTHORIZED TO TRANSACT BUSINESS IN KENTUCKY

FROM: SHARON P. CLARK, COMMISSIONER
KENTUCKY DEPARTMENT OF INSURANCE

RE: DISCRETIONARY CLAUSES

In Advisory Opinion 2008-05, the Kentucky Department of Insurance (Department) stated that the Insurance Code did not prohibit the use of discretionary clauses in insurance policies unless their application rendered the policy fraudulent, unsound, or illusory. The Department allowed discretionary clauses so long as the insurer construed and interpreted the benefits within the confines of the four corners of the insurance contract and did not use discretionary clauses to deny benefits promised within the terms and conditions of the contract.

Based upon developments in recent case law and in the insurance market as a whole, the Department is hereby rescinding Advisory Opinion 2008-05 and replacing it with this Advisory Opinion 2010-01. The purpose of this opinion is to set forth the Department's current position on discretionary clauses. Any insurance policy, certificate, or contract containing a discretionary clause shall be reviewed in accordance with this opinion.

Discretionary clauses are contract provisions that confer on the insurer discretionary authority to determine eligibility for benefits and to interpret the terms and provisions of the policy. The following is an example of a discretionary clause:

"[This] benefit plan gives the administrator or fiduciary discretionary authority to determine eligibility for benefits or to construe the terms of the plan."

The Department is concerned that the use of discretionary clauses functions to undermine the promise to provide benefits as set forth in the policy. If the insurer has unfettered ability to interpret and construe benefits, the insured can never be certain that they will be provided with the benefits as set forth in their policy. Further, there is an inherent conflict of interest when the payer of benefits is also afforded broad discretion to interpret eligibility for benefits. It appears that in the marketplace, these clauses are still used to deny benefits to participants that would otherwise be guaranteed under the terms of the contract.

KRS 304.14-130(1)(b) instructs the Department to disapprove any form filed if the form "contains or incorporates by reference...any inconsistent, ambiguous, or misleading clauses, or exceptions and conditions which deceptively affect the risk purported to be assumed in the general coverage of the contract." Discretionary clauses by their nature alter the risk and terms of the agreement by allowing the insurer to have final authority to interpret and construe the eligibility and benefits under the contract. It is the Department's position that discretionary clauses deceptively affect the risk purported to be assumed in any policy and as such, any forms containing discretionary clauses may be disapproved.

Any questions should be directed to Andrea Fegley, Counsel, Office of Legal Services, at 502-564-6032 or andrea.fegley@ky.gov.

/s/ Sharon P. Clark
Sharon P. Clark, Commissioner
Kentucky Department of Insurance

On this 9th day of March, 2010