

Discretionary Clauses

COMMONWEALTH OF KENTUCKY
OFFICE OF INSURANCE
Frankfort, Kentucky

ADVISORY OPINION
2008-05

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

TO: ALL INSURERS AUTHORIZED TO TRANSACT BUSINESS IN KENTUCKY

FROM: JOHN BURKHOLDER, ACTING EXECUTIVE DIRECTOR
KENTUCKY OFFICE OF INSURANCE

RE: DISCRETIONARY CLAUSES

The Kentucky Office of Insurance (Office) has learned that some insurance companies are writing into their contracts a provision that gives the company full and final discretion in interpreting benefits and administering the contract. The Office is concerned with the insurance companies' varying interpretations of these "discretionary clauses." Thus, the purpose of this advisory opinion is to apprise insurers of the Office's interpretation of discretionary clauses. Any insurance policy, contract, or certificate containing a discretionary clause will be interpreted in accordance with the opinion expressed herein.

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:

The company has full, exclusive, and discretionary authority to determine all questions arising in connection with the policy, including its interpretation, and when making a benefit determination under the policy, the company has the discretionary authority to determine your eligibility for benefits and to interpret the terms and provisions of the policy.

The Office has learned that some insurers interpret such clauses to give them unfettered authority to decide what benefits are due. Consequently, such an interpretation may unreasonably or deceptively affect the risk purported to be assumed under the policy. Hence, the Office finds the above interpretation or similar interpretations to be objectionable and in violation of Kentucky's insurance code. Specifically, KRS 304.14-180(2) provides, "[n]o insurer or its representative shall make any insurance contract or agreement relative thereto other than as is plainly expressed in the policy." In

addition, KRS 304.12-010 prohibits any person from engaging in “an unfair method of competition or any unfair or deceptive act or practice in the business of insurance.”

To be clear, the Office is not prohibiting the use of discretionary language in insurance policies. Rather, the Office finds it necessary to communicate to insurers its interpretation of discretionary clauses to ensure that an insurance contract is not, in effect, rendered fraudulent, unsound, or illusory. Thereby, the Office opines that under state law, an insurance policy is subject to the same rules of interpretation and construction as other contracts. Accordingly, although an insurance company may determine eligibility for benefits and may interpret the terms and provisions of its policy, the insurer must do so within the four-corners of the policy. In other words, the insurer shall not make benefit determinations that are beyond the terms and conditions of the insurance contract. The discretionary clause will not be construed to allow insurers to deny benefits otherwise granted under the terms of the insurance contract. Furthermore, in keeping with case law, if any terms of the contract are ambiguous, the Office shall construe the terms liberally in favor of the insured.

Any questions should be directed to Nyra Shields, Counsel, Office of Legal Services, at 502-564-6032 or Nyra.Shields@ky.gov.

s/ John Burkholder

John Burkholder, Acting Executive Director

Kentucky Office of Insurance On this 5th day of June, 2008