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The Erosion of ERISA Preemption of Bad Faith Liability Actions

The Employee Retirement Income Securities Act (ERISA) is a 1974 federal statutory scheme which was designed to protect against the fiduciary looting of company or union pension plans, which had left thousands of retired Americans stripped of pension benefits they had accumulated after decades of work.

(Shaw v. Delta Air Lines, Inc., 463 U.S. 8590 (1983); Marshall v. Bankers Life & Casualty Co., 2 Cal.4th 1045, 1051 (1992); 29 U.S.C. §1001(b). Determining whether a bad faith action against an insurance company or HMO is preempted by ERISA is critically important in light of the limited nature of the remedies available under ERISA. The courts have generally concluded that the remedies available under an ERISA-preempted insurance policy, healthcare plan, or self-insured benefit plan, are limited to the recovery of the benefits owed and, in the court's discretion, reasonable attorney's fees. Thus, most courts hold that no consequential damages, emotional distress damages, or punitive damages are recoverable in such a case. And, a jury trial is not available in an ERISA preempted action.

1. ERISA PREEMPTION AND EXCEPTIONS

Under ERISA's preemption clause , all state laws that relate to an employee benefit plan are preempted (29 U.S.C. section 1144(a)), except those state laws regulating insurance under the savings clause, (29 U.S.C. section 1144(b)(2)(A)). Because most people obtain healthcare coverage through their employee benefit plan, determining whether a case is preempted by ERISA is a common question that arises. The first step in the analysis is to determine if the claimant is simply statutorily exempt from ERISA's expansive preemption provision. For example:

An independent contractor is not an employee for ERISA purposes and is therefore not subject to ERISA preemption. (Nationwide Mut. Ins. Co. v. Darden, 503 U.S. 319, 327, 112 S.Ct. 1344, 1350 (1992).) However, if the independent contractor obtains insurance benefits through the same group plan that covers employees of the company, the court may determine that the independent contractor's claims are also subject to ERISA preemption as a participant. (See, e.g., Harper v. American Chambers Life Ins. Co., 89 F.2d 1432, 1434 (9th Cir. 1990).

A government employee or the employee of a public agency is exempted. (29 U.S.C. section 1003(b); 29 U.S.C. section 1002(32).) However, most federal government employees are covered under the Federal Employee Health Benefits Act (5 U.S.C. section 8902), which has remedy limitations similar to ERISA's. But ERISA's government plan exemption does exclude other public employees, including judges, teachers, district attorneys, and the like, from ERISA preemption and their normal state-law based causes of action remain actionable.

Employees of churches or church-operated businesses. (29 U.S.C. section 1003(b).) A plan qualifies as a "church plan" if:

It is exempt from tax under 26 U.S.C. section 501; and,

Is "controlled by or associated with a church or a convention or association of churches." An entity is "associated with" a church, etc., if "it shares common religious bonds and convictions with that church"

A self-employed person is exempt from ERISA, so long as the business does not provide benefits under the policy to a common-law employee.

In *Kennedy v. Allied Mutual Ins. Co.*, 952 F.2d 262 (9th Cir. 1991), two owners of the company set up a pension plan which they intended to comply with ERISA requirements, and therefore be subject to ERISA regulation. When the financial advisor to the plan caused losses of approximately \$1.8 million, the plan sought recovery under a fidelity bond issued to the plan, which was only effective if the plan qualified as an ERISA plan. The insurer therefore moved for a summary judgment to establish that the plan was not an ERISA plan. The District Court granted the motion on the grounds that the only participants vested in the plan were the owners of the business. When the owners later claimed that one other employee was vested, the Ninth Circuit remanded the action for further findings by the District Court on the issue of whether and when the other employee was indeed vested.

In so ruling, the Ninth Circuit made clear that where the only plan participants are the owners of the business, ERISA does not regulate the plan. The Kennedy court based its holding on Department of Labor regulations, promulgated under 29 U.S.C. §1135. Pursuant to 29 C.F.R.

§2510.3-3(b):

"For purposes of Title I of the Act and this chapter, the term 'employee benefit plan' shall not include any plan, fund or program, other than an apprenticeship or other training program, under which no employees are participants covered under the plan For example, a so-called 'Keogh' or 'H.R. 10' plan under which only partners or only a sole proprietor are participants covered under the plan will not be covered under Title I. However, a Keogh plan under which one or more common law employees, in addition to the self-employed individuals, are participants covered under the plan, will be covered under Title I. Similarly partnership buyout agreements described in section 736 of the Internal Revenue Code of 1954 will not be subject to Title I."

Similarly, 29 CFR section 2510.3-3(c) defines employees as follows:

"(2) A partner in a partnership and his or her spouse shall not be deemed to be employees with respect to the partnership." (Emphasis added.)

However, if the partnership or business has a common law employee covered under the same policy, the owner/partner will be considered a participant under the plan and subject to ERISA preemption. (*Peterson v. American Life & Health Insurance*, 48 F.3d 404 (9th Cir. 1995).)

Finally, the Department of Labor's safe harbor provisions (29 C.F.R. 2510.3-1(j)) permit exemption of a plan where:

The employer does not endorse the program;

Employee participation is completely voluntary;

Premiums are paid entirely by the employee;

The employer's sole function is to collect the premiums through payroll deductions and to remit the premiums to the insurer; and,

The employer receives no consideration. However, reasonable compensation for administrative services provided by the employer in connection with collecting and remitting the premiums is permitted.

In order to fall within these safe harbor provisions, however, case law requires that all the criteria be present. (*Kanne v. Connecticut Gen. Life Ins. Co.*, 867 F.2d 489, 492 (9th Cir. 1988); *Qualls v. Blue Cross of*

Calif., 22 F.3d 839, 843 (9th Cir. 1994).)

2. THE EROSION OF ERISA PREEMPTION

Even if a case does not fall within one of the statutory exceptions to ERISA, there are other escapes from preemption. The preemption clause under ERISA provides that:

except as provided in the [savings clause] the provision of this title . . . shall supersede any and all State laws insofar as they . . . relate to any employee benefit plan . . . (29 U.S.C. §1144(a)).

The savings clause , in turn, provides that:

. . . nothing in this title shall be construed to exempt or relieve any person from any law of any State which regulates insurance . . . (29 U.S.C. §1144(b)(2)(A) (emphasis added)).

In *Pilot Life Ins. Co. v. Dedeaux*, 481 U.S. 41, 107 S.Ct. 1549 (1987), the insured brought an action against his disability insurer for tortious breach of contract under Mississippi State law. First, the United States Supreme Court noted that there is no dispute that the common law causes of action asserted in Dedeaux's complaint relate to an employee benefit plan and therefore fall under ERISA's express pre-emption clause. However, the question was whether the common law bad faith action against the insurer regulated insurance such that it fell within the savings clause , and therefore not preempted by ERISA.

Ultimately, the Supreme Court in *Pilot Life* found that Mississippi's law of bad faith did not regulate insurance and was therefore not saved from ERISA preemption. In arriving at its conclusion, the Supreme Court noted that the bad faith doctrine in Mississippi was not specifically directed to the insurance industry such that it regulated insurance under Mississippi law. Specifically, the Supreme Court stated:

"Certainly, a common-sense understanding of the phrase 'regulates insurance' does not support the argument that the Mississippi law of bad faith falls under the savings clause. A common sense view of the word 'regulates' would lead to the conclusion that in order to regulate insurance, a law must not just have an impact on the insurance industry, but must be specifically directed toward that industry. Even though the Mississippi Supreme Court has identified its law of bad faith with the insurance industry, the roots of this law are firmly planted in the general principles of Mississippi tort and contract law. Any breach of contract, and not merely breach of an insurance contract, may lead to liability for punitive damages under Mississippi law." (*Pilot Life*, 481 U.S. at 50) (emphasis added).

The United States Supreme Court followed its *Pilot Life* decision in the case of *UNUM v. Ward*, 526 U.S. 358, 119 S.Ct 1380 (1999). In the *Ward* case, the plaintiff brought an action pursuant to the ERISA civil enforcement provision, 29 U.S.C. §1132(a), to recover disability benefits from his insurer, UNUM. Essentially, the policy at issue required that the insured bring a claim for disability benefits within one year of the onset of disability. There was no dispute that the plaintiff became permanently disabled on May 5, 1992. While the plaintiff notified his employer, the administrator of the plan, of his disability in February or early March 1993, UNUM did not receive notice of the claim until April 11, 1994, beyond the one year period. UNUM contended that the claim was time-barred under the contract, while plaintiff contended, among other things, that under California's notice-prejudice rule, the claim to UNUM was timely.

The parties in *Ward* agreed that California's notice-prejudice rule related to an employee benefit plan and thus fell within ERISA's preemption clause (29 U.S.C. §1144(a)). However, the dispute hinged on whether California's notice-prejudice rule regulated insurance such that it fell within the savings clause (29 U.S.C. §1144(b)(2)(A)). To that end, the Supreme Court set forth the framework for the analysis as follows:

First, we ask whether, from a common-sense view of the matter', the contested prescription regulates insurance [citations]. Second, we consider three factors employed to determine whether the regulation fits within the business of insurance' as that phrase is used in the McCarran-Ferguson Act [citations]: first, whether the practice has the effect of transferring or spreading a policyholder's risk; second, whether the practice is an integral part of the policy relationship between the insurer and the insured; and third, whether the practice is limited to entities within the insurance industry. (Ward, 119 S.Ct. at 1386) (emphasis added).

In going through the first prong of this analysis, the Supreme Court found that in California, the notice-prejudice rule was specifically directed to the insurance industry and only applicable to insurance contracts. Thus, the Supreme Court found that the notice-prejudice rule regulated insurance under a common sense analysis. Specifically, the Supreme Court stated:

". . .notice-prejudice is a rule of law governing the insurance relationship distinctively. We reject UNUM's contention that the rule merely restates a general principle disfavoring forfeitures and conclude instead that notice-prejudice, as a matter of common sense, regulates insurance." (Ward, 119 S.Ct. at 1389) (emphasis added).

The Supreme Court then turned to the second prong of the analysis and went through the three factors used to determine whether California's notice prejudice rule regulated the business of insurance within the meaning of the McCarran-Ferguson Act. Importantly, the Ward decision made clear that the plaintiff did not need to show that all three factors were met in order to find that a law regulated insurance under the ERISA savings clause. In going through the three factors, the Court found that the second factor (whether the notice-prejudice rule formed an integral part of the relationship between the insurer and the insured) existed stating:

The [notice prejudice] rule dictates the terms of the relationship between the insurer and the insured, and consequently, is integral to that relationship. (Ward, 119 S.Ct. at 1389).

The Court also found that the third factor (whether the notice-prejudice rule was limited to entities within the insurance industry) also existed, and referred back to its earlier finding in the first prong of the analysis:

As earlier explained, California's notice-prejudice rule focuses on the insurance industry. The rule does not merely have an impact on the insurance industry; it is aimed at it. (Ward, 119 S.Ct. at 1389) (emphasis added).

Based on these findings, the Supreme Court concluded that California's notice-prejudice rule regulated insurance and therefore fell within the savings clause of ERISA.

Following the Supreme Court's decision in Ward, a Federal District Court decision from the N.D. of Oklahoma, in Lewis v. Aetna U.S. Healthcare, 78 F.Supp.2d 1202, was issued. In Lewis, the core issue was whether the plaintiff's second cause of action for bad faith against her insurer "regulated insurance" and thus fell within the ERISA "savings clause". The Lewis decision then followed the analytical framework provided in Ward and concluded that Oklahoma's bad faith law "regulated insurance" and was thus "saved" from preemption.

As to the first prong of the analysis, the Lewis decision concluded that under a "common sense" view of the matter, Oklahoma's bad faith law "regulated insurance" based on the fact that "[bad faith] law arises out of the special relationship between insured and insurer. Accordingly, the Oklahoma Supreme Court has limited the cause of action at all times exclusively to insurance contracts." (Lewis, 78 F.Supp.2d at 1202) (emphasis added). In arriving at this conclusion, the Lewis Court distinguished the Pilot Life decision as follows:

the difference between the Oklahoma tort and the Mississippi tort are manifest. First, as discussed above, the [bad faith] tort is 'firmly planted' in Oklahoma statutory policy concerns specific to the insurance industry' [citation] not in the general principles of [state] tort and contract law.' Furthermore, this tort does not exist outside the insurance industry, and therefore is not available for any breach of contract'. Thus, Pilot Life is inapposite. (Lewis, 78 F.Supp.2d at 1202) (emphasis added).

As to the second prong of the preemption analysis set forth in Ward, the Lewis court found that Oklahoma's bad faith law satisfied the second and third factors and therefore regulated insurance and fell within the ERISA savings clause. Specifically, as to the second factor, the Court concluded that bad faith was an integral part of the policy relationship between the insurer and the insured. (Lewis, 78 F.Supp.2d at 1202). As to the third factor, the Lewis Court, just as the Ward court did, referred back to its analysis under the first prong, stating:

As discussed at length above, the Oklahoma Supreme Court has consistently declined to extend the [bad faith] tort beyond the insured-insurer relationship, recognizing that the tort, as well as its statutory underpinnings, are designed to address the uniqueness of that relationship. Thus, a [bad faith] cause of action does not merely have an impact on the insurance industry; it is aimed at it. (Lewis, 78 F.Supp.2d at 1202).

Similar to the Oklahoma bad faith law at issue in Lewis, the California Supreme Court has firmly held that the tortious breach of the implied covenant of good faith and fair dealing is a claim limited to the context of insurance. Specifically, in *Foley v. Interactive Data Corp.*, 47 Cal.3d 654 (1988) the California Supreme Court rejected an attempt to allow a tortious bad faith claim in an employment contract. In doing so, the Court noted while every contract imposes upon each party a duty of good faith and fair dealing, tort remedies are only allowed in the unique circumstances surrounding an insurance contract. Specifically, the Supreme Court stated:

"Because the covenant [of good faith and fair dealing] is a contract term, however, compensation for its breach has almost always been limited to contract rather than tort remedies. . . . As a contract concept, breach of the duty [of good faith and fair dealing] led to imposition of contract damages determined by the nature of the breach and standard contract principles. An exception to this general rule has developed in the context of insurance contracts where, for a variety of policy reasons, courts have held that breach of the implied covenant will provide the basis for an action in tort. California has a well-developed judicial history addressing this exception." (Foley, 47 Cal.3d at 684) (emphasis added).

California's limitation of a tortious breach of the implied covenant to insurance contracts was reaffirmed in *Cates Construction Inc. v. Talbot Partners*, 21 Cal.4th 28 (1999). In *Cates Construction*, the plaintiff sought to obtain tort remedies for a bad faith claim against a surety. In rejecting the extension of tort remedies for bad faith actions outside of the insurance context, the California Supreme Court noted:

compensation for [breach of the implied covenant] has almost always been limited to contract rather than tort remedies [citations]. At present, this court recognizes only one exception to that general rule: tort remedies are available for a breach of the covenant in cases involving insurance policies [citations]. In the insurance policy setting, an insured may recover damages not otherwise available in a contract action, such as emotional distress damages resulting from the insurer's bad faith conduct [citations] and punitive damages if there has been oppression, fraud, or malice by the insurer [citations]. As our decisions acknowledge, tort recovery in this particular context is considered appropriate for a variety of policy reasons. Unlike most other contracts for goods or services, an insurance policy is characterized by elements of adhesion, public interest and fiduciary responsibility [citations]. In general, insurance policies are not purchased for profit or advantage; rather, they are obtained for peace of mind and security in the event of an accident or other catastrophe

[citations]. Moreover, an insured faces a unique economic dilemma' when its insurer breaches the implied covenant of good faith and fair dealing [citations]. Unlike other parties in contract who typically may seek recourse in the marketplace in the event of a breach, an insured will not be able to find another insurance company willing to pay for a loss already incurred [citations]. (Cates Construction, 21 Cal.4th at 43-44) (emphasis added).

Following the logic of Ward and Lewis, the Foley and Cates Construction decisions make it clear that, unlike the Mississippi bad faith claim at issue in Pilot Life, which could be applied to all contracts, and not just insurance, the same tort claim in California may only be brought under an insurance contract. Thus, for the very reason that Mississippi's tort of bad faith did not regulate insurance in Pilot Life, the California tort of bad faith should be found to regulate insurance, and therefore be saved from ERISA preemption.

3. CONCLUSION

The starting point to determine whether a bad faith action is preempted by ERISA is to look to the statutory exceptions. However, even if none of those exceptions apply, under the logic of Ward, the action may still be "saved" from preemption if the particular jurisdiction limits tortious bad faith actions against insurance companies, such as Oklahoma and California.