

## **The Iceberg Is Melting: ERISA Preemption and How to Avoid It**

**A state court judge bemoans the fact that he cannot impose punitive damages against an insurer even though "there is overwhelming evidence of bad faith in this case" and "the actions of [the insurer] and [its adjuster] shocked my conscience".**

(1) He proclaims that "this case is a poster child for the need for exemplary damages in these cases" and "for Congressional hearings on why [the unavailability of such damages] should change"(2) -- and laments that he lacks the power to award the insured anything but unpaid benefits and attorney's fees.

A federal court judge is "appalled by how [the insurer] handled [the insured's] claim", and declares that the insurer's "disturbing", "unscrupulous" denial of coverage "was made on such clearly pre-textual bases that it is impossible to avoid the conclusion that it [was] made in bad faith".(3) He adds that "the need to deter insurance companies from behaving in this [manner] is why 'bad faith' liability exists under almost all state laws" -- and bewails that "the only recovery permitted to the claimant is the amount of the benefit"(4) the insurer failed to pay, plus attorney's fees.

What are those frustrated judges talking about? What is causing all of their exasperation? Of course, it could only be one thing: ERISA. As those judges -- and insured employees throughout the nation -- are all too aware, remedies in connection with an ERISA-preempted insurance policy, healthcare plan or self-insured benefit plan are limited to the benefits owed and, in the court's discretion, reasonable attorney's fees. No matter how egregiously the insurer treated its insured, that insured cannot recover consequential damages, emotional distress damages or punitive damages if his suit is subject to ERISA [Mass. Mut. Life Ins. Co. v. Russell (1985) 473 U.S. 134, 142-144, 105 S.Ct. 3085, 3090; Mertens v. Hewitt Assoc. (1983) 508 U.S. 248, 113 S.Ct. 2063, 2069].(5)

Because the remedies available under ERISA are so limited [29 U.S.C. 1132], the determination of whether an action is subject to ERISA preemption is obviously critical. The following highlights several approaches that may prove useful in your efforts to avoid the chilling effects of ERISA and preserve your client's right to recover civil damages from his insurer.

### What Are Some of the Ways to Escape ERISA Preemption?

To assess whether a policy is subject to ERISA preemption, it must first be determined whether there is any plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that such plan, fund or program was established or is maintained for the purpose of providing . . . benefits in the event of sickness, accident, disability, death or unemployment . . . [29 U.S.C. section 1002(1)].

The insurer has the burden of proving the facts necessary to establish the existence of an ERISA plan. Kanne v. Connecticut General Life Insurance Co. (9th Cir. 1988) 867 F.2d 489, 492, n. 2, cert. denied, 492 U.S. 906 (1989); see also Zavora v. Paul Revere Life Ins. Co. (9th Cir. 1998) 145 F.3d 1118, 1120, n. 2. As a practical matter, though, most courts will determine that a benefit is part of an ERISA plan if the benefit is provided through employment.

That does not mean, however, that there are no potential ways to circumvent ERISA. Here are a few:

An independent contractor is not an employee 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); Barnhart v. New York Life (9th Cir. 1998) 141 F.3d 1310.(6)]

A government employee or the employee of a public agency is exempt from ERISA [29 U.S.C. section 1003(b); 29 U.S.C. section 1002(32)].

Employees of churches or church-operated businesses are exempt from ERISA [29 U.S.C. section 1003(b)]. Sole proprietors, partners, and their spouses are exempt, so long as the business does not provide benefits under the policy to a common-law employee [See 29 C.F.R. sections 2510.3-3(b)(1) and (c)(1)]. In *Robertson v. Alexander Grant & Co.* (5th Cir. 1986) 798 F.2d 868, the Court relied on those regulations in "[f]inding ERISA inapplicable to plans covering only partners". Similarly, in *Meredith v. Time Insurance Co.* (5th Cir. 1993) 980 F.2d 352, the court held that "an insurance plan purchased by a sole proprietor, covering only herself and her spouse, [does not] constitute . . . an 'employee welfare benefit plan' as that term is defined in ERISA".(7) Further, in *Fugarino v. Hartford Life & Acc. Ins. Co.* (6th Cir. 1992) 969 F.2d 178, the Court held that a business owner is exempt from ERISA, stating that "a plan whose sole beneficiaries are the company's owners cannot qualify as a plan under ERISA". And in *Slamen v. Paul Revere Life Insurance Co.* (11th Cir. 1999) 166 F.3d 1102, 1104, the Court stated that "in order to establish an ERISA employee welfare benefit plan, the plan must provide benefits to at least one employee,(8) not including an employee who is also the owner of the business in question", and thus that ERISA does not apply where "the disability insurance policies at issue were for the sole interest and benefit of the plaintiff, and not his employees".

Some courts have suggested that a plan is not "established or maintained" by an employer [29 U.S.C. section 1002(1)] unless the employer intended to create an ERISA plan.(9) Other courts have indicated that an employer has "established or maintained" an ERISA plan only if it actively participated in the design and operation of the plan, directly controlled the day-to-day operation of the plan, exercised substantial discretion over the plan, and/or established a separate administrative scheme to manage the plan.(10) Still others have found that the "established or maintained" requirement may not be met even if the employer was significantly involved in the administration of the plan.(11) Certain others have indicated that an ERISA plan has not been "established" where the insurer failed to comply with ERISA's reporting and disclosure requirements and failed to mention ERISA in policy documents, brochures and letters.(12) And a few others have held that the "is maintained" requirement implies that the plan must be in current operation,(13) and thus that ERISA does not apply where the former employer has sold his business and stopped contributing to the plan(14) or has gone bankrupt and ceased any involvement in the plan.(15)

Plans that fall under the Department of Labor's safe harbor regulations [29 C.F.R. 2510.3-1(j)] are exempt from ERISA. The regulations generally state that ERISA is inapplicable where (1) the employer does not endorse the program;(16) (2) employee participation is completely voluntary; (3) premiums are paid entirely by the employee;(17) (4) the employer's sole functions are to permit the insurer to publicize the program, collect the premiums through payroll deductions, and remit the premiums to the insurer; and (5) the employer receives no consideration, except reasonable compensation for collecting and remitting the premiums. Significantly, however, some courts have found the safe harbor regulations applicable despite employer activities far beyond those permitted by the regulations. See *Garrett and Johnson*, supra.

What is the Impact of the Sole Owner of a Disability Policy Providing Other Benefits to Employees?

An insurer sometimes concedes that the insured is a partner or other non-employee and that the disability policy covers only him, but argues that his claims are nevertheless subject to ERISA because his policy is part of an overall company benefit plan that included other policies which did cover employees.

This argument was made -- and soundly rejected -- in a recent opinion by the same court that rendered the

landmark decision in *Donovan v. Dillingham* (11th Cir. 1982) 688 F.2d 1367. In *Slamen v. Paul Revere Life Insurance Co.* (11th Cir. 1999) 166 F.3d 1102, the Court was faced with a dentist who purchased a disability policy covering only himself and health and life insurance policies covering both himself and his employees. The Court held that the disability policy was not an ERISA plan because it only covered the dentist. Significantly, the Court was "not persuaded by Paul Revere's argument that ERISA applies here because Slamen had in place other insurance for his employees & Non-ERISA benefits do not fall within ERISA's reach merely because they are included in a multibenefit plan along with ERISA benefits".

Equally helpful is *Rand v. The Equitable Life Assur. Society of the U.S.* (E.D.N.Y. 1999) 49 F.Supp.2d 111, wherein the plaintiff was a partner who purchased various disability and BOE policies. In addition, his partnership provided a group health insurance policy for all its employees. The Court held that "the plaintiff's disability insurance policies, which are not covered by ERISA, are not converted into an ERISA plan merely because the plaintiff's employees received unrelated health insurance".(18)

Also of note is *Robertson v. Alexander Grant & Co.* (5th Cir. 1986) 798 F.2d 868, cert. denied, 479 U.S. 1089, 107 S.Ct. 1296, in which one of the parties argued that a retirement plan for partners (who, as discussed above, are not employees) was nevertheless an employee benefit plan subject to ERISA because it was so similar to a retirement plan for principals (whom the company considered to be employees) that the two separate plans [were] really one plan. However, the court rejected this attempt to merge the two retirement plans into one, because "the plans, however similar, are two separate plans". Based thereon, the court concluded that ERISA did not apply to the partners' retirement plan despite the companion plan for employees.(19)

## Conclusion

It is hardly surprising that insurers are aggressively denying claims subject to ERISA, since the most an insured can recover in an ERISA action (assuming he prevails) is the benefits the insurer should have paid in the first place and -- if the court is feeling generous -- reasonable attorney's fees. Indeed, the courts are expressly recognizing that "it is entirely predictable that insurers will go overboard to minimize claims" that are preempted by ERISA, since they are "without any statutory or other legal deterrent"(20) to act to the contrary.

Thus, it is imperative that consumer lawyers persist in their efforts to melt the ERISA iceberg. Only if insurers are faced with the prospect of bad faith liability and punitive damages will they have any deterrent against treating their insureds unfairly and inequitably. And only if attorneys continue to trumpet the inequities of ERISA will the courts conclude that preemption provides insurers with the wrong incentive -- the incentive to minimize or deny valid claims by their insureds.

And the signs are certainly encouraging. In addition to the cases discussed above, there is a recent indication by the United States Supreme Court that it will be receptive to arguments against ERISA preemption. In *UNUM Life Insurance Co. of America v. Ward* (1999) 526 U.S. 358, 119 S.Ct. 1380, 1390, n. 7, the Court noted that the Solicitor General of the United States -- on whose brief the Court had based its ruling in *Pilot Life*(21) that ERISA is the exclusive remedy for state law causes of action for bad faith -- had changed its position on that issue. Although the Court concluded in *Ward* that it "need not address the Solicitor General's current argument" because *Ward* was suing under ERISA (for benefits due) rather than trying to circumvent it, the case at least suggests that the Court may be open to reconsidering its decision in *Pilot Life*. Indeed, a Colorado federal district court judge recently relied on *Ward*(22) in ruling (in an unpublished order) that ERISA does not preempt a bad faith cause of action by an insured under a group insurance policy.(23)

Obviously, these decisions give considerable cause for optimism. But it is equally obvious that insurers will continue to hide behind the veil of ERISA for as long as the courts will let them. For the present, we hope that that the cases and arguments discussed in this commentary will prove helpful in your battle to elude ERISA

and preserve your client's right to recover civil damages from his insurer.

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(1) Patrick v. UNUM Life Ins. Co. of America, San Mateo County (California) Superior Court, Case No. 388506, July 21, 1999 Reporter's Transcript of hearing on attorney's fees, p. 23:1-7.

(2) Id., p. 23:8-15.

(3) Dishman v. UNUM Life Ins. Co. of America (C.D. Cal. 1997) 1997 WL 906146

(4) Id.

(5) However, one line of cases has held that damages are properly recoverable under ERISA based on language in the U.S. Supreme Court's opinion in *Ingersoll-Rand Co. v. McLendon*, 498 U.S. 133, 139, 111 S.Ct. 478, 483. In that case, an employee sought compensatory and punitive damages for his employer's tortious termination of his employment just before his plan benefits would have vested [498 U.S. at 136, 111 S.Ct. at 481]. The Supreme Court stated that "[I]t is clear that the relief requested here is well within the power of federal courts to provide" [498 U.S. at 145, 111 S.Ct. at 486]. This language was authored by Justice O'Connor, the same Justice who only three years earlier penned the landmark decision in *Pilot Life Ins. Co. v. Dedeaux* (1987) 481 U.S. 41, 107 S.Ct. 1549 [which held that ERISA applies to all employee benefit "plans", including health care coverage benefits, even when there is no formal "plan" established and even when the health care benefits are provided through the purchase of a group insurance policy]. Based on *Ingersoll-Rand*, some courts have concluded that consequential and punitive damages are meant to be recoverable under ERISA [see., e.g., *Weems v. Jefferson-Pilot Life Ins. Co., Inc.* (Ala. 1995) 663 So.2d 905, 911, *Haywood v. Russell Corp.* (Ala. 1991) 584 So.2d 1291, *East v. Long* (N.D. Ala. 1992) 785 F.Supp. 941, 944; *International Union, United Auto., Aerospace & Agricultural Implement Workers v. Midland Steel Prods. Co.* (N.D. Ohio 1991) 771 F.Supp. 860, and *Lawrence v. Jackson Mack Sales, Inc.,* (S.D. Miss. 1992) 837 F.Supp. 771]. At present, however, that is far from the majority view.

(6) But if the independent contractor obtains insurance benefits through the same group plan that covers employees of the company, the court may determine that he is a "participant" and that his claims are preempted [See *Harper v. American Chambers Life Ins. Co.* (9th Cir. 1990) 89 F.2d 1432, 1434].

(7) And this result does not change simply because the sole proprietor is incorporated and pays the premiums through his professional corporation. In *Slamen v. Paul Revere Life Insurance Co.* (11th Cir. 1999) 166 F.3d 1102, 1106, n. 4, the court rejected the insurer's argument that the disability policy was preempted by ERISA because the premiums were paid by the dentist's professional corporation rather than the dentist as an individual. The Court reasoned that the professional corporation was wholly owned by the dentist, that he could not be considered an employee of the corporation he owned, and that the insurer would still "have to show that an employee other than [the dentist] received benefits under the disability insurance policy" in order to trigger ERISA. This holding was cited with approval in *Rand v. The Equitable Life Assur. Society of the U.S.* (E.D.N.Y. 1999) 49 F.Supp.2d 111.

(8) Similarly, in *Donovan v. Dillingham* (11th Cir. 1982) 688 F.2d 1367, 1371, the court held that a "plan . . . falls within [the] ambit of ERISA only if the plan . . . covers ERISA participants because of their employee status in an employment relationship."

(9) See *Kanne v. Connecticut General Life Ins. Co.* (9th Cir. 1988) 867 F.2d 489, 493; *Stanton v. Paul Revere Life Ins. Co.* (S.D. Cal. 1999) 37 F.Supp.2d 1159; *Hansen v. Continental Ins. Co.* (5th Cir. 1991) 940 F.2d 971, 978.

(10) See *Hansen*, 940 F.2d at 978; *Johnson v. Watts Regulator Co.* (1st Cir. 1995) 63 F.3d 1129, 1134; *Elco*

Mechanical Contractors. Inc. v. Builders Supply Assoc. of West Virginia (S.D. W. Va. 1993) 832 F.Supp. 1054, 1057-1058; Taggart Corp. v. Life and Health Benefits Administration, Inc. (5th Cir. 1980) 617 F.2d 1208, 1210; and Sindelar v. Canada Transport, Inc. (Neb. 1994) 520 N.W.2d 203, 207.

(11) See Zavora v. Paul Revere Life Ins. Co. (9th Cir. 1998) 145 F.3d 1118, 1121; du Mortier v. Massachusetts General Life Ins. Co., supra (C.D. Cal. 1992) 805 F.Supp. 816, 821; Garrett v. Delta Air Lines, Inc. (N.D. Ind. 1978) 1978 U.S. Dist. LEXIS 16460 and Johnson, supra, 63 F.3d 1129.

(12) See du Mortier and Johnson, supra.

(13) See Stanton, supra (S.D. Cal. 1999) 37 F.Supp.2d 1159.

(14) Loudermilch v. The New England Mutual Life Ins. Co. (S.D. Ala. 1996) 942 F.Supp. 1434.

(15) Mizrahi v. Provident Life and Accident Ins. Co. (S.D. Fla. 1998) 994 F.Supp. 1452

(16) "Endorsement of a program requires more than merely recommending it". Johnson v. Watts Regulator Co. (1st Cir. 1995) 63 F.3d 1129, 1136.

(17) The mere fact that the employer gave employees the option of using a portion of their pre-tax salary to purchase plan benefits does not mean that it contributed to the payment of plan premiums. See Hrabe v. Paul Revere Life Insurance Company (M.D. Ala. 1996) 951 F.Supp. 997, 1001.

(18) Similarly, in an unpublished memorandum opinion, the Ninth Circuit held in Zeiger v. Zeiger (9th Cir. 1997) 131 F.3d 150, that "a non-ERISA plan is not converted into an ERISA plan merely because an employer also sponsors a separate benefits plan subject to ERISA".

(19) See also Fugarino v. Hartford Life & Acc. Ins. Co. (6th Cir. 1992) 969 F.2d 178 [wherein the court found ERISA inapplicable even though the sole proprietor had several employees who were covered -- at the owner's expense -- under the group health policy at issue] and Stanton v. Paul Revere Life Ins. Co. (S.D. Cal. 1999) 37 F.Supp.2d 1159 [in which the court found that no ERISA "plan" existed even though the insured provided dental benefits to one of his employees and eye care benefits to all employees].

(20) Dishman v. UNUM Life Ins. Co. of America (C.D. Cal. 1997) 1997 WL 906146

(21) Pilot Life Ins. Co. v. Dedeaux (1987) 481 U.S. 41, 107 S.Ct. 1549.

(22) Although the order did not expressly reference the Supreme Court's decision in Ward, the order was issued in response to a motion (for leave to file an amended and supplemental complaint) that had been based solely on Ward.

(23) Hall v. UNUM Life Ins. Co. of America, U.S. District Court for the District of Colorado, Case No. 97-M-1828, November 1, 1999 Order by Chief Judge Richard S. Matsch Granting Motion For Leave To File Amended And Supplemental Complaint Adding Third Claim For Relief.