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Wrong Turn:

Pennsylvania District Courts Chart New Course, Holding That Bad Faith Claims Are Not Preempted By ERISA

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Commentary**Wrong Turn: Pennsylvania District Courts Chart New Course, Holding That Bad Faith Claims Are Not Preempted By ERISA**

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I. Introduction

In Pennsylvania and throughout the country, insurance policies providing health, life, and/or disability benefits are often issued as part of employer-sponsored employee benefit plans. In the event of a denial of benefits under an insurance policy that is part of such a plan, a question arises as to whether the plan member/claimant may assert a bad faith cause of action against the insurer. Federal courts across the country have almost universally held that state law insurance bad faith claims are preempted by the Employee Retirement Income Security Act, 29 U.S.C. §1001 *et seq.* ("ERISA").¹ Pennsylvania's federal district courts within the Third Circuit were no exception: since 1990, when Pennsylvania enacted its so-called "Insurance Bad Faith Statute," 42 Pa.C.S.A. §8371, there have been more than 26 court decisions holding that bad faith claims under that statute were preempted by ERISA.²

Very recently, however, some federal district court judges in Pennsylvania have challenged ERISA's time-honored preemption of bad faith claims. This challenge has been led by Senior Judge Clarence Newcomer of the U.S. District Court for the Eastern District of Pennsylvania, who, departing from his own earlier precedent, determined in *Rosenbaum v. UNUM Life Ins. Co.*, 2002 U.S. Dist. LEXIS 14155 (E.D. Pa., July 29, 2002) ("*Rosenbaum I*"), that a statutory bad faith claim under §8371 was not preempted by ERISA due to ERISA's savings clause which protects from preemption statutes which "regulate insurance." Judge Newcomer delivered a more dramatic blow in *Rosenbaum v. UNUM Life Ins. Co.*, 2003 U.S. Dist. LEXIS 15652 (E.D. Pa., September 8, 2003) ("*Rosenbaum II*"), where, in response to the insurer's motion for reconsideration, he reaffirmed his earlier opinion and went even further, holding that Pennsylvania's bad faith statute survived both express and conflict preemption under ERISA.

Other federal district courts in Pennsylvania have recently followed this lead. In *Stone v. Disability Management Services, Inc.*, 2003 U.S. Dist. LEXIS 18413 (M.D.Pa. October 15, 2003), Judge James Munley of Pennsylvania's Middle District adopted the reasoning in the *Rosenbaum* opinions, agreeing that bad faith claims were not preempted by ERISA. Judge Michael Baylson of the Eastern District, although not expressly deciding the issue, recently suggested in a footnote in *Kollman v. Hewitt Associates, LLC*, 2003 U.S. Dist. LEXIS 18138, *8, fn. 1 (E.D.Pa., September 23, 2003), that "[a]s

to whether bad faith claims are preempted by ERISA, see [*Rosenbaum II*].” In a different context (whether medical negligence claims against HMOs are preempted by ERISA), even the venerable former Chief Judge Edward Becker has taken aim against ERISA’s broad preemptive effect, by arguing passionately in a concurring opinion that Congress and the U.S. Supreme Court should “revisit what is an unjust and increasingly tangled ERISA regime.” *DeFelice v. Aetna U.S. Healthcare*, 2003 U.S.App. LEXIS 20942, *33 (3d Cir., October 15, 2003)(Becker, J. concurring).

Do these very recent Pennsylvania federal decisions represent an aberration, a blip soon to be corrected, in the nearly unbroken string of case law holding that state law bad faith claims are preempted by ERISA? Or do these decisions represent the start of a trend which may pick up steam in the months ahead? Far from being a mere point of local interest, decisions such as those in *Rosenbaum* and *Stone* potentially have nationwide ramifications. Not only do these opinions depart from virtually all existing case law within the Third Circuit and the other ten circuit courts of appeal, the opinions take direct aim at over half a century of U.S. Supreme Court doctrine concerning conflict preemption. After reviewing the purposes and policies behind ERISA and existing case law, this article concludes that the *Rosenbaum* and *Stone* opinions represent a wrong turn on the 30-year road of ERISA jurisprudence.

II. Background: The ERISA Statute

In 1974 the United States Congress enacted ERISA in response to a national crisis involving the widespread abuse of pension funds by employers, which left many U.S. workers without the retirement benefits they had been promised and for which they had spent much of their lives laboring. The purposes of ERISA were to promote employer sponsored benefit and pension plans, provide appropriate remedies to plan participants, and give ready access to the federal courts. See *Firestone Tire and Rubber Co. v. Bruch*, 489 U.S. 101 (1989). Most importantly, ERISA was meant to “assure American workers that they may look forward with anticipation to a retirement with financial security and dignity, and without fear that this period of life will be lacking in the necessities to sustain them as human beings within our society.” S. Rep. No. 93-127, 93D Cong. 2d. Sess. (1974). Reprinted in U.S. Code Cong. and Admin. News 4849 (1974).

In passing the ERISA statute, Congress intended to regulate employee welfare benefit plans in a comprehensive way. ERISA’s civil enforcement remedies have been recognized as a “comprehensive civil enforcement scheme” whose “remedies were intended to be exclusive.” *Pilot Life Ins. Co. v. Dedeaux*, 481 U.S. 41, 54 (1987). The remedies for improper benefit denials set forth in ERISA do not include damages for bad faith, such as punitive damages.

In addition, the ERISA statute contains a preemption clause, §514(a), which provides that the provisions within ERISA “shall supersede any and all state laws insofar as they may now or hereafter relate to any employer benefit plan. . . .” Under §514(a) state laws do not apply to disputes arising out of the administration of benefits under an employee benefit plan. However, ERISA also contains a “savings clause,” which exempts certain laws from the preemption clause. Specifically, §514(b) of the statute provides that “nothing in this subchapter shall be construed to exempt or relieve any person from any law of any state which regulates insurance, banking, or securities.” 29 U.S.C. §1144(b)(2)(a).

III. Pilot Life v. Dedeaux

One of the earliest, and most important, cases to address the issue of ERISA preemption of bad faith claims was *Pilot Life Ins. Co. v. Dedeaux*, 481 U.S. 41 (1987). In this case the United States Supreme Court held unanimously that ERISA preempted common law tort and contract actions, including bad faith claims, asserting the improper processing of a benefit claim under an ERISA-governed employee benefit plan.

Pilot Life involved a claim for breach of contract and bad faith brought under Mississippi common law in connection with the termination of disability benefits under an employer-sponsored benefit plan. *Pilot Life* asserted that the state law claims were preempted by ERISA. The Court began its analysis with the preemption clause, observing that if a state law "relates to" an employee benefit plan, it is preempted. Next, the Court addressed whether the Mississippi laws fell within ERISA's savings clause, which exempts from preemption state laws that "regulate insurance."

When determining whether or not a state law regulates insurance, the Court adopted a two-part test. First, the state law is examined through the lens of a "common-sense" understanding of the phrase "regulates insurance." Second, the state law is examined against the three criteria that have been used to determine whether a practice falls under the "business of insurance" for purposes of the McCarran-Ferguson Act, 15 U.S.C. §1011 et seq. The three criteria were specified as follows: (1) whether the practice has the effect of transferring or spreading a policyholder's risk; (2) whether the practice is an integral part of the policy relationship between insurer and insured; and (3) whether the practice is limited to entities within the insurance industry.

The Court held that a common-sense view of the phrase "regulates insurance" meant that a law must not only have an impact on the insurance industry, but must be specifically directed at the industry. The Court held that the Mississippi law of bad faith failed this test because its "roots are firmly planted in the general principles of Mississippi tort and contract law." *Id.* at 54. Similarly, the Court held that the McCarran-Ferguson factors did not support the position that the law "regulates insurance." The Court reasoned that the law did not effect a spreading of policyholder risk, its connection to the insurer-insured relationship was attenuated in that it did not define the terms of the relationship, and, although associated with the insurance industry, the law had developed from general principles of tort and contract law available in any Mississippi breach of contract case.

Even more than its savings clause analysis, *Pilot Life* became significant for its language suggesting that ERISA's remedial scheme is exclusive. Specifically, the Court held that the Mississippi bad faith claim was preempted because Congress had established §502(a) of ERISA as the exclusive remedy for rights under ERISA. The Court held that section 502(a) created a "comprehensive civil enforcement scheme" which represented "a careful balancing of the need for prompt and fair claim settlement procedures against the public interest in encouraging the formation of employee benefit plans." *Id.* at 54. The Court described the notion of remedy exclusivity as follows:

The policy choices reflected in the inclusion of certain remedies and the exclusion of others under the federal scheme would be completely undermined if ERISA plan participants and beneficiaries were free to obtain remedies under state law that Congress rejected in ERISA The deliberate care with which ERISA's civil enforcement remedies were drafted and the balancing of policies embodied in its choice of remedies argues strongly for the conclusion that ERISA's civil enforcement remedies were intended to be exclusive.

Id. at 54. Because it conflicted with ERISA's exclusive remedial scheme, Mississippi's bad faith law was preempted.

IV. Cases After Pilot Life

In 1999 the United States Supreme Court revisited the subject of preemption in *UNUM Life Ins. Co. v. Ward*, 526 U.S. 358 (1999). The *Ward* claimant submitted a claim under an ERISA-governed disability plan. The disability insurer denied the claim based on a timeliness violation of the plan's proof of claim clause. The claim arose in California, which subscribes to the notice-prejudice rule that an insurer's defense of late notice of claim requires the insurer to prove that it suffered actual prejudice, which is not presumed. The claimant argued that because the insurer

could not show prejudice, the claim should not have been denied. The insurer argued that ERISA preempted application of the state rule.

The *Ward* parties agreed that the notice-prejudice rule fell under the ERISA preemption clause as a state law that "relates to" an employee benefit plan. The dispute was whether or not the rule "regulates insurance" and thus escaped preemption under the savings clause. The Court, in a unanimous opinion authored by Justice Ginsburg, held that California's notice-prejudice rule was a law which "regulates insurance" and was therefore saved from ERISA preemption.

First applying the *Pilot Life* "common sense" test, the *Ward* Court held that the notice prejudice rule regulated insurance because it was a rule firmly applied to insurance contracts as well as a rule grounded in policy concerns specific to the insurance industry. Turning to the McCarran-Ferguson factors, the Court rejected the insurer's argument that a state regulation must satisfy all three McCarran-Ferguson factors in order to "regulate insurance" under ERISA's savings clause. Instead, the Court held that the three McCarran-Ferguson factors were simply "considerations to be weighed" in determining whether a state law regulates insurance and that none of the three was necessarily determinative by itself. *Id.* at 373.

The *Ward* Court chose not to analyze the first factor (whether the rule has the effect of transferring or spreading a policyholder's risk) "because the remaining McCarran-Ferguson factors, verifying the common-sense view, are securely satisfied." *Id.* at 374. The Court held that the second factor (whether the practice is an integral part of the policy relationship between insurer and insured) was met because the rule changed the bargain between insurer and insured by essentially creating a mandatory contract term that requires the insurer to prove prejudice before enforcing a timeliness-of-claim provision. Similarly, the third factor (whether the rule is limited to entities within the insurance industry) was met because the notice-prejudice rule focused on the insurance industry and was grounded in policy concerns specific to the insurance industry. Accordingly, the Court concluded that California's notice-prejudice rule was saved from ERISA preemption.

The subject of ERISA preemption came before the Supreme Court again three years later in *Rush Prudential HMO, Inc. v. Moran*, 526 U.S. 355 (2002). The state law at issue in *Rush* was an Illinois statute that provided recipients of ERISA-governed HMO health coverage a right to an independent medical review of certain benefit denials. The Court held that the statute was not preempted by ERISA. As in *Ward*, there was no serious dispute that the law related to employee benefit plans; the key issue was whether the law would be saved from preemption if found to "regulate insurance" under the savings clause.

Applying *Pilot Life's* "common sense inquiry," the Court noted that virtually all commentators on the American health system describe HMOs as a combination of insurer and provider. Accordingly, the Court held that the Illinois statute was "a law 'directed toward' the insurance industry, and an 'insurance regulation' under a common-sense view." *Id.* at 373. Turning to the McCarran-Ferguson factors, the Court reiterated the view expressed in *Ward* that because the factors were "guideposts," a state law was "not required to satisfy all three McCarran-Ferguson criteria to survive preemption." *Id.* at 373. Bypassing the first factor, the Court held that the second and third factors were satisfied. The Court wrote that it is "obvious enough" that the independent review requirement regulated an integral part of the policy relationship between insurer and insured, because it "adds an extra layer of review when there is internal disagreement about an HMO's denial of coverage." *Id.* at 373. The Court held that the third McCarran-Ferguson factor was satisfied in that the law was limited to entities within the insurance industry. Thus, the Court concluded that the law regulated insurance and was saved from preemption.

Significantly, in the latter portion of the *Rush* opinion the Supreme Court reiterated its *Pilot Life* conclusion that Congress intended ERISA's remedial scheme under §502(a) to be exclusive. According to the *Rush* Court, additional remedies would "violate ERISA's policy of inducing employers to offer benefits by assuring a predictable set of liabilities, under uniform standards of primary

conduct and a uniform regime of ultimate remedial orders and awards when a violation has occurred." *Id.* at 379. The *Rush* Court found that the Illinois statute did not run afoul of this policy because it provided no new state law cause of action or remedy and authorized no new form of ultimate relief.

The Supreme Court's savings clause analysis received a face-lift in the 2003 decision in *Kentucky Association of Health Plans v. Miller*, 2003 U.S. LEXIS 2710 (2003). In this case a unanimous court concluded that the three-prong McCarran-Ferguson analysis caused confusion, failed to provide clear guidance to lower courts, and added little to the relevant analysis. Accordingly, the Court replaced the McCarran-Ferguson analysis with the following test:

Today we make a clean break from the McCarran-Ferguson factors and hold that for a state law to be deemed a "law which regulates insurance" under 29 U.S.C. § 1144(b)(2)(A), it must satisfy two requirements. First, the state law must be specifically directed toward entities engaged in insurance Second, . . . the state law must substantially affect the risk pooling arrangement between the insurer and the insured.

Id. at *21.

In *Miller*, the state statutes at issue required a health insurer to acknowledge the services of any health care provider willing to abide by the insurer's plan, thus precluding HMOs from limiting their provider networks as necessary to reduce patient costs. The HMOs argued that the statutes were preempted as laws which relate to ERISA plans. In response the Kentucky Insurance Commissioner argued that the statutes were saved from preemption under the savings clause because they were laws which regulated insurance.

According to the Court, the statutes at issue in *Miller* were specifically directed toward entities engaged in insurance, regardless of the fact that the statutes also had the effect of prohibiting providers from entering into limited network contracts with the HMOs. Secondly, the Court held that despite the statutory focus on the relationship between the HMOs and third-party providers, the statutory prohibition substantially affected the type of risk pooling arrangement that the HMOs could offer and thus constituted regulation of the business of insurance. Therefore, the Court unanimously held that the Kentucky statutes satisfied the new two-part test, did regulate insurance, and thus were not preempted.

V. The Rosenbaum v. Unum Life Opinions

A. Savings Clause Analysis

In a departure from his own prior opinion in *Zimnoch v. ITT Hartford*, 2000 U.S. Dist. LEXIS 2846 (E.D. Pa. 2000), Judge Newcomer in *Rosenbaum I* (decided in July 2002) held that a claim under Pennsylvania's insurance bad faith statute (42 Pa.C.S.A. §8371) was *not* preempted by ERISA. The plaintiff instituted suit after being denied long term disability benefits under an employee benefit plan. It was undisputed that the plan was governed by ERISA and the insurer moved to dismiss plaintiff's state law claims. The plaintiff conceded that all of the state law claims were preempted by ERISA *except* the §8371 bad faith claim. Judge Newcomer denied the insurer's motion to dismiss with respect to the bad faith claim.

At the outset of his opinion, Judge Newcomer suggested that a "new trend in the federal law," led by the Supreme Court's decisions in *UNUM Life v. Ward* and *Rush Prudential v. Moran*, warranted "a re-examination of this important question." 2002 U.S. Dist. LEXIS 14155 at *2. Applying the two-prong approach in determining whether the Pennsylvania bad faith statute "regulates insurance" for purposes of ERISA's savings clause, the court first applied the "common sense" test. According to Judge Newcomer, under the common-sense view, Pennsylvania's bad faith statute

