

## Contracts Clause Unlikely To Impede Biz Interruption Laws

By **Robin Cohen** and **Patrick Pijls** (April 22, 2020, 5:44 PM EDT)

In the wake of the novel coronavirus pandemic, governments across the country, state and local, have issued orders that affect contractual relationships. These rules include restrictions on landlords' ability to evict residential tenants for nonpayment of rent.[1]

Yet behind the scenes, hundreds of thousands of businesses in the food and beverage, entertainment and retail industries face imminent insolvency and bankruptcy due to lost business. Most such businesses carry insurance that covers losses due to business interruption. Though these policies likely cover the losses due to COVID-19, an increasing number of legislatures wish to make that fact certain.

For large metropolises like New York, a wipeout of the businesses could significantly impact the residents' livelihoods. To protect their economies from wholesale devastation, legislatures have proposed bills to ensure property insurance policies are interpreted to cover losses stemming from COVID-19.[2] This legislation likely falls within the constitution's reservation of police power to the states. There are strong arguments that no federal constitutional provision likely stands in the legislatures' way, including the contracts clause.[3]



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### Contracts Clause

"The Contracts Clause restricts the power of States to disrupt contractual arrangements. It provides that 'no state shall pass any Law impairing the Obligation of Contracts.'"[4] Yet the U.S. Supreme Court has long held that the "States must possess broad power to adopt general regulatory measures without being concerned that private contracts will be impaired, or even destroyed, as a result." [5] "Otherwise," the court went on, "one would be able to obtain immunity from the state regulation by making private contractual arrangements." [6]

To balance private and public interests, the states' power to impair contracts is subject to a two-step test.[7] A party must make a threshold showing that a state law has created a substantial impairment of a contractual relationship.[8] If it makes that showing, a court conducts a means-and-ends analysis, asking "whether the state law is drawn in an 'appropriate' and 'reasonable' way to advance 'a significant and legitimate public purpose.'" [9]

The clause applies to any kind of contract, including an insurance policy.[10] Though insurers have signaled their intent to resist any action by the legislatures, a challenge to the proposed legislation would likely falter at both steps of constitutional review.

### **Substantial Impairment**

As the Supreme Court recently explained, whether impairment is substantial turns on, among other things, the degree to which the law undermines the contractual bargain and interferes with a party's reasonable expectations.[11]

Whether the legislation undermines the contractual bargain likely turns on the policy at issue. If the policy language is ambiguous, legislation mandating construction of the language in favor of the insured would be duplicative.[12] But if the policy language is not ambiguous, some proposed legislation might require coverage that the policy would otherwise not provide.

The New York bill, for example, would void any virus exclusion,[13] a move that insurers would argue substantially impairs the contractual bargain. Yet that impairment might not be substantial in the legal sense because insurance is special.

A court applying the doctrine would be required to analyze an insurer's reasonable expectations in performance of the policy. Those expectations are tempered by the states' long history of extensively regulating the insurance industry.

According to the U.S. Court of Appeals for the Fifth Circuit in *American Express Travel Related Services Inc. v. Sidamon-Eristoff*, "When a party enters an industry that is regulated in a particular manner, it is entering subject to further legislation in the area, and changes in the regulation that may affect its contractual relationships are foreseeable." [14]

Take the Supreme Court's decision in *Energy Reserves Group Inc. v. Kansas Power & Light Co.* Upholding state legislation against a contracts clause challenge, the court found it significant that the contracts at issue concerned natural gas, a heavily regulated industry — an industry regulated by 40 U.S. jurisdictions.[15]

So too with insurance, an industry regulated by every state in the country.[16] For this reason, courts have recognized that insurers' reasonable expectations in their policies are diminished.[17]

In other words, states' impairment of insurance contracts is less upsetting to the parties' expectations due to the extensive and fluid nature of insurance regulation. In a way, the law tells insurers (and insureds) *caveat emptor*. [18]

### **Means-Ends Scrutiny**

Even if a state has substantially impaired a contract, the impairment might still stand if the degree of the impairment is reasonable in relation to a legitimate purpose. As described below, insurers would be hard-pressed to argue the legislatures' means are ill-suited to legitimate ends — especially because insurers would probably bear the burden of proof on this issue.[19]

The proposed legislation seeks to prevent economy-wide fallout and possibly impairs policies of only the most vulnerable insureds. Because the states are not parties to the contracts, moreover, courts are

legally obligated to defer to legislatures in determining a reasonable response to the COVID-19 pandemic.

Start with the ends. The clause's limits are grounded in the states' police powers,[20] so the cases distinguish between actions tied to those powers — legislation that remedies a broad and general social or economic problem and actions not so tied — legislation that serves special interests.[21] Accordingly, legislation is legitimate when its benefit inures not for the mere advantage of particular individuals but for the protection of a basic interest of society.[22]

Similarly, legislation is illegitimate when, as in one extreme case, it is aimed at specific employers, perhaps even one particular employer.[23] The upshot is that a state may impair contracts to safeguard the vital interests of its people, a power that extends to economic needs.[24]

Rather than play favorites, the proposed legislation would deliver a pan-industry prophylactic to the types of businesses that demand coverage the most. That emergency relief could be construed as a valid use of state power.[25]

The means, too, could likely be appropriate and reasonable. When, as here, the state is not a party to the contract,[26] “courts properly defer to legislative judgment as to the necessity and reasonableness of a particular measure.”[27]

Courts have upheld emergency legislation on this basis before. After Hurricane Andrew, Florida faced immense risk to its residents' insurance policies. “To prevent the total withdrawal of insurance companies and the subsequent unavailability of insurance if companies left the Florida market, the Florida legislature passed several statutes.”[28]

One statute prohibited the nonrenewal and cancellation of policies due solely to the increased risk insurers faced.[29] Another required insurers to pay into a hurricane catastrophe reinsurance fund — call it a bailout fund.[30] Deferring to the Legislature's judgment, the U.S. Court of Appeals for the Eleventh Circuit upheld both measures.[31]

The New York bill hews closely to its goal of preventing the collapse of small businesses and the collateral effects that would thereafter infect the economy writ large. It would apply only to policies that insure against loss or damage to property.[32] It would apply only to business interruption that occurs during the period of a declared state of emergency due to COVID-19 and would require automatic renewal of the policy only during the same.[33] It would apply only to the policy limit.[34] And it would apply only to insureds with fewer than 250 employees.[35]

The legislation, then, is narrow in scope and targets small insureds, which are least likely to survive the loss of business.

## **Conclusion**

State legislators are elected to exercise their judgment in how to wield the power of the state, especially in times of crisis. Should the states deem this proposed legislation an appropriate means of responding to COVID-19, the contracts clause will likely not serve as a barrier. As Justice Oliver Wendell Holmes wrote about the clause more than a century ago, “One whose rights, such as they are, are subject to state restriction, cannot remove them from the power of the State by making a contract about them.”[36]

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[1] See, e.g., State of N.Y. Exec. Chamber, Exec. Order No. 202.8: Continuing Temporary Suspension and Modification of Laws Relating to the Disaster Emergency 2 (2020), [https://www.governor.ny.gov/sites/governor.ny.gov/files/atoms/files/EO\\_202.8.pdf](https://www.governor.ny.gov/sites/governor.ny.gov/files/atoms/files/EO_202.8.pdf); State of Cal. Exec. Dep't, Exec. Order N-28-20 2–3 (2020), <https://www.gov.ca.gov/wp-content/uploads/2020/03/3.16.20-Executive-Order.pdf>.

[2] Louisiana, Massachusetts, New Jersey, New York, Ohio, Pennsylvania, and South Carolina all have bills pending related to business interruption due to COVID-19. See State Action on Coronavirus (COVID-19), Nat'l Conf. St. Legislatures, <https://www.ncsl.org/research/health/state-action-on-coronavirus-covid-19.aspx> (last visited April 14, 2020); Mass. SB 2888 (2020), <https://malegislature.gov/Bills/191/SD2888> (last visited April 7, 2020); Ohio HB 589 (2020), <https://www.legislature.ohio.gov/legislation/legislation-summary?id=GA133-HB-589> (last visited April 7, 2020).

[3] Our federal system generally allows states to afford stronger protection to rights, through state constitutions or otherwise, than the U.S. constitution requires. Yet New York, for example, long ago repealed its Contracts Clause. See N.Y. const. art. 1, §15 (repealed 1962). And California's Contracts Clause is coextensive with the U.S. Clause, thus obviating the need for separate analyses. See *Retired Employees Ass'n of Orange Cty., Inc. v. City of Orange*, 610 F.3d 1099, 1102 (9th Cir. 2010); Cal. Const. art. I, §9. Any practitioner, as always, must carefully analyze federal, state, and local law.

[4] *Sveen v. Melin*, 138 S. Ct. 1815, 1821 (2018); see U.S. const. art. I, §10, cl. 1.

[5] *U.S. Tr. Co. of N.Y. v. New Jersey*, 431 U.S. 1, 22 (1977).

[6] *Id.*; see *Energy Reserves Grp., Inc. v. Kan. Power & Light Co.*, 459 U.S. 400, 410 (1983) (“Although the language of the Contract Clause is facially absolute, its prohibition must be accommodated to the inherent police power of the State ‘to safeguard the vital interests of its people.’”).

[7] *Sveen*, 138 S. Ct. at 1821.

[8] *Id.* at 1821–22.

[9] *Id.* at 1822.

[10] *Id.*

[11] *Id.*

[12] See, e.g., *Anderson Bros. v. St. Paul Fire & Marine Ins. Co.*, 729 F.3d 923, 932 n.10, 936 (9th Cir. 2013) (holding that legislation that defined a term—a term used but not defined by the policy—did not

violate the Clause when retrospectively applied to the policy because “if a contractual term is found to be ambiguous, it is generally interpreted against the insurer”).

[13] N.Y. HB 10226-A, §1(c) (2020), [https://nyassembly.gov/leg/?default\\_fld=&leg\\_video=&bn=A10226&term=0&Summary=Y&Text=Y](https://nyassembly.gov/leg/?default_fld=&leg_video=&bn=A10226&term=0&Summary=Y&Text=Y) (last visited April 14, 2020).

[14] *Am. Exp. Travel Related Servs., Inc. v. Sidamon-Eristoff*, 669 F.3d 359, 369 (3d Cir. 2012); see *Lipscomb v. Columbus Mun. Separate Sch. Dist.*, 269 F.3d 494, 510 (5th Cir. 2001) (“With increasing state regulation, regulated private parties’ expectations of being freed from future regulations by contract with the state becomes less reasonable.”).

[15] 459 U.S. at 413, 413 n.15.

[16] See Nat’l Ass’n Ins. Comm’rs, 2020 Membership List (2020), [https://www.naic.org/documents/members\\_membership.pdf](https://www.naic.org/documents/members_membership.pdf); see also Lee R. Russ & Thomas F. Segalla, 1 *Couch on Insurance* §2.1 (3d ed. 1995) (“Insurance is a highly regulated industry due to its well-recognized importance to the public interest, rendering it a proper subject of regulation and control by the states through the exercise of their police powers.”).

[17] See, e.g., *Campanelli v. Allstate Life Ins. Co.*, 322 F.3d 1086, 1098 (9th Cir. 2003) (“The severity of the impairment is significantly mitigated, however, by the fact that the California insurance industry is heavily regulated.”).

[18] See, e.g., *Colonial Penn Ins. Co. v. Heckler*, 721 F.2d 431, 441 (3d Cir. 1983) (“The company chose...to write policies in an area subject to heavy regulation. Thus, in addition to the normal incident of risk of injury to its policyholders, the company freely chose to chance a change in the...law.”); *Am. Econ. Ins. Co. v. State*, 87 N.E.3d 126, 138 (N.Y. 2017) (applying federal law) (holding that a contract is not substantially impaired merely because it has become “less profitable,” which is “a risk inherent in the insurance market”).

[19] When a substantially impaired contract is private rather than public, the burden of proof on the means-ends scrutiny falls on the aggrieved party. See *In re Seltzer*, 104 F.3d 234, 236 (9th Cir. 1996) (“The burden is placed on the party asserting the benefit of the statute only when that party is the state.”); see also *United Auto., Aerospace, Agr. Implement Workers of Am. Int’l Union v. Fortunato*, 633 F.3d 37, 42 (1st Cir. 2011) (holding that a plaintiff-challenger bears the burden of proof on the means-ends scrutiny even for public contracts); *Buffalo Teachers Fed’n v. Tobe*, 464 F.3d 362, 365, 370 (2d Cir. 2006) (same).

[20] See *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 241 (1978).

[21] See *Energy Reserves Grp., Inc.*, 459 U.S. at 412.

[22] See *Home Bldg. & Loan Ass’n v. Blaisdell*, 290 U.S. 398, 445 (1934).

[23] See *Energy Reserves Grp., Inc.*, 459 at 412, 412 n.13 (discussing *Allied Structural Steel Co.*).

[24] *Veix v. Sixth Ward Bldg. & Loan Ass’n of Newark*, 310 U.S. 32, 38–39 (1940).

[25] Cf. *Campanelli*, 322 F.3d at 1099 (holding in the wake of the Northridge Earthquake that “[p]rotecting the rights of victims” was a “significant and legitimate public purpose”); *Vesta Fire Ins. Corp. v. Florida*, 141 F.3d 1427, 1429, 1434 (11th Cir. 1998) (holding in the wake of Hurricane Andrew that “protection and stabilization of the Florida economy, particularly the real estate market,” was a “significant and legitimate public purpose”); *State v. All Prop. & Cas. Ins. Carriers Authorized & Licensed To Do Bus. In State*, 937 So. 2d 313, 326 (La. 2006) (holding in the wake of Hurricane Rita that “legislative extension of the prescriptive period for damage claims is based upon a significant and legitimate public purpose”); cf. also *Welch v. Brown*, 551 F. App’x 804, 811 (6th Cir. 2014) (collecting cases for the proposition that “addressing a fiscal emergency is a legitimate public purpose”).

[26] Indeed, the fact that the States are not parties to the insurance policies would amplify courts’ deference. See, e.g., *United Steel Paper & Forestry Rubber Mfg. Allied Indus. & Serv. Workers Int’l Union AFL-CIO-CLC v. Virgin Islands*, 842 F.3d 201, 212 (3d Cir. 2016) (“[W]hen a State is a contracting party, its ‘legislative judgment is subject to stricter scrutiny than when the legislation affects only private contracts.’”). Under this heightened scrutiny, the state must show that the impairment was “reasonable in light of changed circumstances” and that no “less drastic modification would be sufficient.” *Id.* So parties to private contracts, like insureds here, face the lowest hurdle.

[27] *Energy Reserves Grp., Inc.*, 459 at 412–13; see *Blaisdell*, 290 U.S. at 447–48 (“Whether the legislation is wise or unwise as a matter of policy is a question with which we are not concerned.”).

[28] *Vesta*, 141 F.3d at 1429.

[29] *Id.*

[30] *Id.*

[31] *Id.* at 1434.

[32] N.Y. HB 10226-A, §1(a).

[33] *Id.* §1(b), (d).

[34] *Id.* §1(d).

[35] *Id.* §1(e).

[36] *Hudson Water Co. v. McCarter*, 209 U.S. 349, 357 (1908) (Holmes, J.).