Coronavirus, Contracts and the Constitution

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Plaintiff lawyers want insurance companies to absorb the cost to business of the Covid-19 pandemic -- and they've had some early successes. A federal judge in Kansas City, Mo., last week allowed salon and restaurant owners to proceed with a lawsuit claiming that Covid shutdowns constituted "direct physical loss or damage" covered by business-interruption policies. California lawmakers introduced legislation in June that would establish a presumption that Covid-19 qualifies for such coverage.

Yet however sympathetic their clients, the lawyers' efforts are unconstitutional and dangerous. They threaten to bankrupt the insurance industry, on which American businesses and consumers depend.

Most commercial policies include coverage for business interruption caused by physical damage to the business assets. If a car dealership suffers tornado damage to its roof, it can recover repair costs and losses incurred while the premises are closed. But disease isn't "physical loss or damage," as that phrase is ordinarily understood or typically intended in insurance contracts. Most such contracts expressly exclude such losses. That's because losses associated with communicable diseases -- like those from war or nuclear accident -- aren't insurable. The risks are unknowable, preventing the calculation of a premium sufficient to cover the losses if the event occurs.

As the Supreme Court observed in Los Angeles Department of Water and Power v. Manhart (1978), "drastic changes" in the legal rules governing insurance policies can "jeopardize the insurer's solvency and, ultimately, the insureds' benefits." If the Kansas City lawsuit and hundreds like it succeed in redefining "direct physical loss" to include Covid-induced business closures, insurers would be forced to cover losses that were never underwritten. The industry has enough reserves to pay up to $800 billion for losses covered by home, auto and business policies. Uncovered Covid-19 losses are estimated in the trillions.

Fortunately, there are significant constitutional limits on the ability of either courts or legislatures to change private insurance contracts. The Constitution forbids the states to "impair the obligation of contracts." As Chief Justice John Marshall observed in Ogden v. Saunders (1827), the power of contract impairment "had been used to such an excess by the state legislatures, as to break in upon the ordinary intercourse of society and destroy all confidence between man and man." The effect was "not only to impair commercial intercourse and threaten the existence of credit, but to sap the morals of the people and destroy the sanctity of private faith."

The Contracts Clause has been invoked less frequently since the ratification of the 14th Amendment, whose Due Process Clause has become the preferred vehicle for challenging state regulatory actions. But the justices made clear in Allied Structural Steel Co. v. Spannaus (1978) that it still "limits the power of a State to abridge existing contractual relationships." In that case, Minnesota rewrote pensions, requiring an employer to pay $185,000 to nine employees who were terminated before their benefits vested under the company's plan. The court struck down the law as a "severe" and "unreasonably conditioned" retroactive alteration of agreed-upon obligations. Sveen v. Melin (2018), another Minnesota case, upheld a state-mandated invalidation of life-insurance beneficiary designations on divorce -- but only because the impairment of the parties' contractual obligations was minimal. The policyholder could redesignate the former spouse and "reverse the effect of the . . . statute with the stroke of a pen."

Even during the Depression, the high court was skeptical of state laws that impaired private contracts. Home Building & Loan Association v. Blaisdell (1934) upheld a state law that extended the time allowed for redeeming real property from foreclosure under existing mortgages, but only because the redemption extension was a reasonable temporary condition.

State legislatures that attempt to abridge commercial insurance contracts today may argue that they are meeting a Depression-caliber economic emergency. Yet although the court reaffirmed in Spannaus that states' ability to impair contract obligations is greater during an emergency, it also held that such laws must be "tailored to the emergency that it is designed to meet" and impose only "reasonable" conditions. Legislative changes establishing liability for Covid-19 losses would completely abrogate existing contracts and impose immediate, permanently binding, ruinous contractual obligations that the parties specifically contracted not to cover. They would almost certainly be struck down under the Contracts Clause.

Federal efforts to impose new contracts on insurance companies would also be unlikely to survive a constitutional challenge. The Fifth Amendment's Due Process Clause prohibits Congress from imposing retroactive liabilities that, as the court put it in Landgraf v. USI Film Productions (1994), "increase a party's liability for past conduct, or impose new duties with respect to transactions already completed." In Eastern Enterprises v. Apfel (1998), the court struck down a law imposing new pension liabilities on employers based on decades-old contracts. The justices couldn't agree on a rationale for their ruling: A plurality saw it as an unconstitutional taking without just compensation. But in a concurring opinion, Justice Anthony Kennedy argued that it violated due process. He noted that political pressures tempt lawmakers "to use retroactive legislation as a means of retribution against unpopular groups or individuals."

Businesses, especially small ones, have suffered terribly because of the Covid-19 virus. Many likely won't survive. But shifting the burden to the insurance industry by either judicial rewriting or legislatively abrogating insurance contracts would be unconstitutional, especially since the losses have been largely caused by government decrees. Congress has already provided enormous financial assistance to American businesses -- the appropriate means of compensating losses suffered from the government's shutdown of the economy.

Because the litigation threat is existential, the insurance industry should do more than defend specific lawsuits. It should seek declaratory judgments now, establishing the limits of their potential liability. It also should work to convince federal and state lawmakers that they neither should nor constitutionally could abrogate and rewrite private insurance contracts.

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