



U.S. Supreme Court Applies Long-Standing Contracts Clause Analysis to Uphold Statutory Change to Insurance Contracts

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The United States Constitution provides that [n]o state shall ... pass any ... Law impairing the Obligation of Contracts. (U.S. Const., Art. I, § 10.) Alongside state constitutional guarantees, the federal Contracts Clause protects the vested pension rights of most public employees in this country.

In June, 2018, the Supreme Court issued its first Contracts Clause decision in nearly a generation: *Sveen v. Melin* (2018) 584 U.S. _____. Importantly, the *Sveen* decision affirms the Court's commitment to the substantial impairment element of a federal Contracts Clause claim. The decision is also significant in a larger sense. An overwhelming majority of the Court decided to stick to the longstanding test of the constitutional power of states to change the obligations of contracts – despite criticism of that test from a number of sources. As state courts continue to grapple with vested rights cases in the face of political criticism, the Court's decision is perhaps a sign that changes in economic circumstances are not likely to dictate or justify a change in constitutional law.

One of the few limitations on state power embedded directly in the text of the Constitution, the Contracts Clause was designed to preclude states from enacting laws that abridge contracts as contrary to the first principles of the social compact, and to every principle of sound legislation. (*The Federalist* No. 44 (Madison).) Despite the categorical language and the apparent intent of the Framers, for the past 80 years the Supreme Court has recognized that not every modification of a contractual promise ... impairs the obligation of contract under the Constitution. (*El Paso v. Simmons* (1965) 379 U.S. 497, 506-507.) Since the decision in *Home Bldg. & Loan Ass'n v. Blaisdell* (1934) 290 U.S. 398, the Supreme Court has employed a two-part test to determine this constitutional line. Under these cases, the initial issue is whether the state law has operated as a substantial impairment of a contract. Unless this showing is made, the Court will

uphold the statute and will not proceed to the second step – a review of the purpose and necessity of the state law.

In *Sveen*, the Court considered a Minnesota statute providing that the dissolution of a marriage automatically revokes a life-insurance beneficiary designation made by a person in favor of the person's former spouse. Mark Sveen married in 1997 and one year later purchased a life insurance policy, designating his then spouse as the primary beneficiary. In 2002, Minnesota enacted a statute that automatically revoked life insurance beneficiary designations of a spouse upon divorce. Five years later the Sveens were divorced. Mark Sveen took no action to revoke or modify his life insurance beneficiary designation and he died in 2011. Relying on the beneficiary revocation statute, his children argued that they were the lawful beneficiaries of the policy proceeds. Not surprisingly, his former spouse disagreed and argued that the statute retroactively impaired the obligations of Mark's life insurance contract and could not be constitutionally applied to revoke his beneficiary designation. Litigation ensued.

By a vote of 8 to 1, the Court reaffirmed its commitment to the *Blaisdell* test and upheld the statute as an unsubstantial impairment of the life insurance contract. In an opinion authored by Justice Kagan, the Court applied the long-standing two-step test. Initially noting that not all laws affecting pre-existing contracts violate the [Contracts] Clause[,] the Court explained the substantial impairment that must be shown. And [i]n answering that question, the Court has considered the extent to which the law undermines the contractual bargain, interferes with a party's reasonable expectations, and prevents the party from safeguarding or reinstating his rights. (*Sveen v. Melin, supra*, Slip Opinion at p. 7.) The majority of the Court agreed that three aspects of the Minnesota law, taken together, demonstrate that the law does not operate as a substantial impairment.

First, Justice Kagan explained, the statute was intended to further the typical policyholder's intent not to enrich their former partners. (*Id.* at p. 8.) The Legislature understood that an insured's failure to change the beneficiary designation after divorce is more likely the result of neglect than choice. (*Id.* at p. 9.) Thus, the statute often honors the intent of the contracting party who made the original beneficiary designation.

Second, the Minnesota law is unlikely to upset policyholders' expectations because an insured cannot reasonably rely on a beneficiary designation remaining in place after divorce. (*Id.* at p. 9.) Divorce courts have wide discretion to divide property between spouses and this power encompasses the beneficiary provisions of life insurance policies. Because the insured cannot possibly know the outcome of a property division at the time of contracting, Justice Kagan concluded, his reliance interests are next to nil. (*Id.* at p. 10.)

Finally, the statute allows the insured to reinstate his former spouse as beneficiary after divorce with the stroke of a pen – by filing a form. Thus, the burden on the contracting party is reduced to minimal paperwork and the statute thus safeguards the party's contractual expectations consistent with previous Contracts Clause cases. (*Id.* at pp. 10-12.)

The lone dissenter, Justice Gorsuch, challenged the majority decision on two primary grounds. Relying on the language and structure of the Constitution, he argued that the Contracts Clause imposes an absolute prohibition on state laws impairing the obligations of contracts, however minute For much of its history, he argued, the Court construed the Contracts Clause in this light. Invoking commentator and academic criticism of the *Blaisdell* test, Gorsuch argued for a return to an earlier era of Contracts Clause jurisprudence to invalidate the statute. But even under modern precedent, he argued, the Minnesota statute substantially impaired the policy because the whole point of the contract is designating a beneficiary for the proceeds.

The *Sveen* decision affirms the Court's commitment to modern Contracts Clause jurisprudence: the offending statute must substantially impair contract rights before the Court will consider an unconstitutionality claim. Brushing aside criticism of this rule, the Court looked at qualitative factors to evaluate substantial impairment: the contracting party's intent, the party's reasonable contractual expectations, and the safeguards provided to protect the contracting party's interest. In states without explicit pension protection clauses in their constitutions, this analysis may well inform their courts' evaluation of the substantial impairment question. In California, for example, several recent appellate court decisions have come to different conclusions over the application of the substantial impairment requirement in Contracts Clause challenges to statutes making changes to existing public pension rights under California law. Three of these decisions are now before the California Supreme Court. Focusing on the qualitative strength of the contracting parties' rights and expectations could provide the California court with strong guidance on the substantial impairment question in these cases.

To be sure, the *Sveen* case appeared to turn primarily on the right of the contracting party to override the operation of the statute by filing a new beneficiary designation – a form of notice similar to filing a deed. (See *id.* at pp. 10-14.) And the Court has long distinguished the test applied to purely private contracts like the one in *Sveen* from the stricter scrutiny given to statutes impairing public contracts like contractual pension rights. [See *U.S. Trust Co. of New York v. New Jersey* (1977) 431 U.S. 1, 25 (complete deference to the Legislature is not appropriate because the State's self-interest is at stake).] Nevertheless, the decision reflects the Court's continuing commitment to its longstanding Contracts Clause jurisprudence despite the criticism it has received.