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LONDON MARKET IMPACT OF U.S. COVID-19 BI LAW CHALLENGE

HOW MIGHT THE PROPOSED U.S. STATE COVID-19 BI LEGISLATION BE CHALLENGED? HOW MIGHT IT AFFECT INSURERS AND REINSURERS, PARTICULARLY IN THE LONDON MARKET?

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Reinsurers are generally bound to follow the fortunes of their reinsureds, but will these be the same fortunes that were priced, sold, and reserved at inception or post-contractual coverages that are mandated by state action? We look at recent actions by states in the U.S. to expand coverage under business interruption and other policies to cover losses arising from the COVID-19 pandemic, and discuss potential defenses to these state-mandated coverages.

U.S. Mandates for Pandemic-Related Coverage

*So*me states have already proposed legislation requiring insurers to cover pandemic-related claims under certain insurance policies, including business interruption cover. These mandates would apply even if the policies themselves have virus or other potentially applicable exclusions or limiting conditions.

Insurers have indicated that business interruption losses from the COVID-19 pandemic are not generally covered under their standard property policies because the virus would not constitute "physical damage to property" and/or the policy contains a standard virus exclusion. New Jersey was the first to propose a bill that would nevertheless mandate such coverage, and require that policies covering property loss or damage to small businesses (i.e., those with under 100 employees) be construed as including pandemics and global viruses as covered perils, regardless of virus and bacterial exclusions. *See* N.J. Assembly Bill 3844, introduced on March 16, 2020. Coverage would be retroactive to the date New Jersey declared a state of emergency.

Ohio, Massachusetts and now New York, have proposed similar, and even broader bills. For example, the Massachusetts Bill (Senate Docket No. 2888) applies to businesses with less than 150 employees and precludes insurers in the Commonwealth from denying COVID-19 related business interruption claims by invoking a virus exclusion or by asserting that there was no physical damage to insured's or other relevant property. Bills proposed in New York (Assembly Bill No. A10226), Ohio (House Bill 589), Pennsylvania (House Bill 2372) and Louisiana (House Bill 858 and Senate Bill

477) also appear to override any virus exclusions or requirements of physical damage to property to mandate coverage for COVID-19 related business interruption losses.

Each of the proposed bills limits an insurer's exposure to policy limits and, with the exception of the Louisiana bills, provides a way for insurers to be reimbursed for paying claims in accordance with the mandates. Such reimbursement would be accomplished by a state collecting funds from other insurers transacting insurance in the state and making such funds available for COVID-19 related claims. Similar legislation from other jurisdictions is expected. Beyond state legislation and initiatives, it's possible that coverage obligations could also be affected by local and municipal laws. For example, the Office of the Mayor of New York has reworded its Executive Orders to state that the "virus physically is causing property loss and damage" and that the "actions taken to prevent [the spread of the virus] have led to property loss and damage." This wording is likely an attempt to affect policy requirements that there be a physical loss or damage to property for coverage to incept. Again, similar wording of Executive Orders in other jurisdictions is possible, if not expected.

Challenging the Mandates

In a statement issued on March 25, 2020, the National Association of Insurance Commissioners (NAIC) noted:

"…[W]e would caution against and oppose [legislative] proposals that would require insurers to retroactively pay unfunded COVID-19 business interruption claims that insurance policies do not currently cover ... While the U.S. insurance sector remains strong, if insurance companies are required to cover such claims, such an action would create substantial solvency risks for the sector, significantly undermine the ability of insurers to pay other types of claims, and potentially exacerbate the negative financial and economic impacts the country is currently experiencing."

Given this strong sentiment expressed by the NAIC and echoed by leading Insurance Industry groups, we no doubt will see court challenges to these bills if any of them are enacted into law, at least in their current form. These challenges will likely allege that states violated the U.S. Constitution, and parallel provisions in state constitutions on these or other grounds:

- State action interfering with private parties' contractual obligations is unlawful under the U.S. Constitution's Contracts Clause.
- Mandating coverage, especially on a retroactive basis, would violate the Due Process and Equal Protection Clauses of the U.S. Constitution.
- Mandating coverage constitutes an unlawful regulatory taking requiring just compensation under the Fifth Amendment of the U.S. Constitution.

Enforceability of Mandates

Practitioners and commentators are in general agreement that the most likely basis on which these laws could be overturned will be the Contracts Clause.

In determining whether a state has so interfered with, or impaired, the contractual rights of private parties to the point that it has violated the Contracts Clause, federal courts in the U.S. have focused on whether:

- The state's action or law has substantially impaired a contractual relationship;
- There is a significant and legitimate public purpose for the law; and
- The adjustment of the rights and obligations under the contract is reasonable and appropriate given the public purpose justifying the law.

See, Energy Reserves Group, Inc. v. Kansas Power & Light Co., 459 US 400, 410-413 (1983).

Even with the well-being of the public in mind in the wake of this global emergency, the proposed state legislation could very possibly fail these tests and be held to exceed what is permissible under the Contract Clause. Undoubtedly, the legislation substantially impairs a contractual relationship, but the "adjustment of the rights & obligations under the contract" is not some minor adjustment. Rather, it is the imposition of an entirely new and substantial coverage obligation that was never priced, sold, or reserved. And while there is a "significant...public purpose for the law," arguably taking private money - the reserves of insurers established for coverage that was actually sold - is not a legitimate public purpose to solve a public problem. A federal court, based on these considerations, could very well view the coverage mandated by these state bills to be extreme, and beyond what is permissible under the Contracts Clause.

That said, there is somewhat similar precedent for defending state insurance initiatives against constitutional challenges under trying times. For example, in 1993, legislators in Florida adopted a law to address insurance coverage for devastating losses suffered in Hurricane Andrew. The law restricted an insurer's ability to cancel or non-renew more than 5% of its residential policies in Florida, or more than 10% of its residential policies in a single Florida county during a 12-month period. The insurance industry challenged the legislation based on the Contracts Clause, but the Eleventh Circuit Court of Appeals upheld the statute, stating that "the protection and stabilization of the Florida economy, particularly the real estate market," was a significant and legitimate public purpose for the law. *Vesta Fire Ins. Corp. v. State of Fla.*, 141 F. 3d 1427 (11th Cir. 1998).

Another hurricane-related law survived state and federal constitutional challenges in a state court in 2006. *See State v. All Property & Casualty Insurance Carriers Authorized & Licensed To Do Business In State*, 937 So. 2d 313 (La. 2006). The Louisiana Supreme Court in that case upheld against such challenges a Louisiana law that extended the limitations period for insureds to sue their insurers for hurricane-related damages. The court reasoned that although the law substantially impaired contract rights, it was a "reasonably proportionate measure" by the state to advance a “significant and legitimate purpose” – the protection of citizens following one of the worst natural disasters in U.S. history. As support for its decision, the court noted, “…[S]tate law has traditionally regulated insurance as a matter of public policy, even including the precise procedural mechanism for filing claims at issue herein.”

This legislation will also be defended by citation to “liberalization” and other similar clauses in the standard property policy form. These provisions typically provide that if “any filed rules or regulations affecting this Policy are revised by statute so as to broaden the insurance provided without additional premium charge, such broadened insurance will inure to your benefit only within such jurisdiction.” Such clauses would lend credence to an argument that the legislation amends the policy language and institutes coverage.

Implications for Reinsurers

In the event these state legislative proposals in the US were to pass and take effect, coverage under business interruption policies would be significantly expanded and the new laws would have the potential to significantly impact the reinsurance market. In particular, a number of US carriers look to the Lloyd’s/London reinsurance market to reinsure their own inwards exposures. As US insurers’ exposures increase by state-sanctioned coverage expansion, this could mean that reinsurers’ exposures increase with them. Many of the reinsurance contracts to be impacted will be governed by English law, notwithstanding that the underlying insureds may be US businesses who have insurance cover with US insurers and whose policies are governed by US law.

In principle, it is settled English law that a cedant (e.g. a US insurer) can establish its liability for reinsurance recovery purposes by settlement of their insureds’ claim or by a judgment or arbitration award that determines that they are liable. In a previous article, we considered what is required of cedants, such as US insurers, to ascertain COVID-19 related liabilities by way of settlement (you can find that article here). We now consider some of the potential issues arising for the reinsurance market where liability is ascertained by new legislation at the state level, or through a US Court judgment implementing the proposed legislation discussed earlier in this article. Another potential issue here is where US insurers settle claims in the future, as obliged by a state law that is subsequently overturned at federal level.

Under English law (which may apply to the reinsurance contracts on which US reinsureds seek to make a recovery) the general principle is that, if a reinsurance contract and the underlying insurance contract are governed by different laws, the terms incorporated from the insurance contract into the reinsurance contract shall have the same meaning and effect as in the insurance contract (see *Vesta v Butcher* [1989] AC 852 and *Groupama v Catatumbo* [2000] 2 Lloyd’s Rep 350). So far, so good.

However, at the time the reinsurance contracts at issue in *Vesta v Butcher* and *Groupama v Catatumbo* were entered into, the national law by which each insurance contract was governed was readily ascertainable and would have been in the contemplation of the parties. But compare that to the potential position here, where reinsurance contracts entered into on, say, January 1, 2020 may be asked to pick up losses on the basis of US state legislation passed many months later, which could not reasonably have been foreseen when the reinsurance was placed. Whilst running such an argument may have its difficulties, one can see how reinsurers may seek to question claims presented to them by US cedants in the future.

In the more recent decision of *Wasa v Lexington* [2009] UKHL 40, which considered the position where the underlying policy was governed by US law whilst English law applied to the reinsurance contract, the English Court considered it of utmost relevance that the parties, at the time the relevant reinsurance contract was entered into, could not have ascertained the law under which coverage on the underlying policy was finally determined. The reinsurers could therefore not consult what was referred to in *Vesta v Butcher* as a notional "foreign legal dictionary" to interpret the scope of cover under the reinsurance contract. Reinsurers were subsequently held not liable for the claims presented to them by their US cedant. Whilst *Wasa* concerned issues entirely removed from the COVID-19 pandemic, nevertheless one can see the potential for reinsurers to question their liability when presented with claims arising from a change in US law (at state level) after the reinsurance contract (governed by English law) was agreed, notwithstanding that a legal liability has been ascertained. It would be wise for cedants exposed to increased coverage in the US to maintain an open dialogue with their broker and reinsurers as to how back-to-back their reinsurance cover is in the light of COVID-19 related claims.

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Jonathan Sacher

London

jonathan.sacher@bclplaw.com
+44 (0) 20 3400 2307
