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United States: Contract Clause of the United States Constitution

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UNITED STATES

CONTRACT CLAUSE OF THE UNITED STATES CONSTITUTION

Executive Summary

The United States Supreme Court interprets the Contract Clause of the United States Constitution in a manner that restricts the power of state governments to modify existing contracts, but preserves the states' power to regulate private affairs to protect the well-being of its citizens. The Court employs a three-factor test to determine whether a state law or regulation that impairs a contract violates the Contract Clause.

I. Introduction

The United States Constitution provides that "[n]o State shall ... pass any ... Law impairing the Obligation of Contracts."[1] This clause is commonly referred to as the "Contract Clause." While this clause historically has been the subject of varying interpretations by the United States Supreme Court, this report will focus on the current interpretation of this clause.

The Contract Clause restricts the power of state governments to enact legislation or adopt regulations that modify contracts. However, while the Contract Clause provides that a state may not pass "any" law impairing contracts, the prohibition is not absolute. The federal government recognizes the power of state governments to regulate private affairs when necessary to protect the well-being of their citizens.[2] An absolute reading precluding states from ever impairing any contracts would allow private parties to avoid regulation simply by structuring private contracts in a manner to effectuate that result.[3]

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[1] U.S. CONST. art. I, § 10, cl. 1, *available at* http://www.gpo.gov/fdsys/pkg/CDOC-110hdoc50/pdf/CDOC-110hdoc50.pdf.

[2] Energy Reserves Group, Inc. v. Kansas Power & Light Co., 459 U.S. 400, 410 (1983), *available at* http://supreme.justia.com/us/459/400/case.html. ("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.")

[3] United States Trust Co. v. New Jersey, 431 U.S. 1, 22 (1977), *available at* http://www.law.cornell.edu/supct/html/historics/USSC_CR_0431_0001_ZO.html ("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. Otherwise, one would be able to obtain immunity from state regulation by making private contractual arrangements.")

II. The Supreme Court's Three-Factor Test

The Supreme Court has established a three-factor test to determine whether a state law or regulation that impairs a contract violates the Contract Clause.

First, a court must determine as a threshold matter whether the state law has *substantially* impaired a contractual relationship. An impairment that is not substantial, such as a state regulation that restricts a party to the gains it reasonably would have expected from a contract, will not give rise to Contract Clause concerns.[4]

Second, if the state regulation constitutes a substantial impairment, the court must consider whether the state has a significant and legitimate public purpose for the regulation. For a regulation to have a significant and legitimate public purpose, it must have been enacted to remedy a general social or economic problem and not to benefit special interests.[5]

Third, if the purpose for the regulation is legitimate, the court must evaluate whether the law or regulation is a reasonable and appropriate means to achieve the government's purpose. In conducting this third prong of the Contract Clause test, courts treat government contracts differently from private contracts.[6] With respect to general economic and social regulation, courts defer to legislative judgment as to the necessity and reasonableness of a particular measure. Such deference is not appropriate when the state government is a party to the contract in question, because the state's self-interest is at stake.[7]

III. Illustrative Cases

Three contemporary Supreme Court decisions illustrate the current application of this test.

Allied Structural Steel Co. v. Spannaus[8] involved a Minnesota law that retroactively increased the monetary obligations of companies which had an employee pension plan and either terminated the plan or closed their facility in Minnesota. Allied Structural Steel, a company whose employee pension plan was affected by this law, filed suit, claiming the law violated the Contract Clause.[9] In evaluating this claim, the Supreme Court, on the first prong of the test, ruled that the state law substantially impaired the company's contractual relations, because the company had based its annual contributions to its employees' pension fund on the contractual

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[4] Energy Reserves Group, 459 U.S. at 411.

[5] *Id*. at 411-12.

[6] *Id*. at 412-13.

[7] United States Trust, 431 U.S. at 22-23.

[8] 438 U.S. 234 (1978), *available at* http://www.law.cornell.edu/supct/html/historics/USSC_CR_0438_0234_ZO.html.

[9] *Id.* at 236-40.

terms, and the law retroactively modified the funding needed, rendering the company's past contributions inadequate.[10] On the second prong, the Court found there was no showing "that this severe disruption of contractual expectations was necessary to meet an important general social problem."[11] The Court found that the law was not enacted to protect a broad societal interest, but rather had a very narrow focus, applying only to a small number of employers.[12] The Court thus concluded that the law violated the Contract Clause.

United States Trust Co. v. New Jersey involved a New Jersey law passed during the energy crisis in 1974 that repealed a 1962 law that limited the extent to which the New York Port Authority subsidized rail passenger transportation. Bondholders of the Port Authority sued, arguing that the 1974 repeal violated the Contract Clause.[13] Because this case involved a municipal bond contract, in applying the third prong of the test – whether the law is a reasonable and appropriate means to achieve a valid state purpose – the Court declined to defer to the state legislature's judgment of necessity and reasonableness.[14] It found that the state had other alternatives available to meet its objectives, such as modifying (rather than repealing) the 1962 law or adopting alternative means of improving mass transit.[15] It also noted that the repeal of the 1962 law could not be considered reasonable due to changed circumstances, because the state legislature in 1962 could have anticipated the likely future need for mass transit.[16] The Court thus found the 1974 New Jersey law violated the Contract Clause.

Energy Reserves Group, Inc. v. Kansas Power & Light Co. involved long-term contracts entered into in 1975 for the sale by Energy Reserves Group (ERG) of natural gas to Kansas Power & Light. The contracts included clauses that permitted the prices to rise under certain circumstances. In 1979, the State of Kansas enacted price controls that prevented ERG from charging the higher prices that otherwise would have been allowed under the contract. ERG filed suit, arguing that the law violated the Contract Clause.[17] The Supreme Court first considered whether the Kansas law substantially impaired the contractual relationship. The Court found that in light of the regulatory background of substantial and extensive regulation that existed when the contracts were entered into in 1975, ERG had no reasonable expectation that the price escalator clauses would not be affected by government regulation, and therefore there was no substantial impairment of ERG's contractual rights.[18] While that holding by itself was sufficient to resolve the issue,[19] the Court went on to consider the second and third prongs of the

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[10] *Id.* at 246-47.

[11] *Id*. at 247.

[12] *Id*. at 248-50.

[13] 431 U.S. at 4-14.

[14] *Id.* at 24-25.

[15] *Id*. at 30.

[16] *Id.* at 31-32.

[17] 459 U.S. at 403-09.

[18] *Id*. at 413-16.

[19] *See id*. at 421 (Powell, J., concurring).

test. On the second prong, it ruled that Kansas's price controls rested on significant and legitimate state interests in protecting consumers from price increases.[20] On the third prong, it ruled that the means used by the state to achieve these goals were reasonable.[21] The Court thus rejected ERG's claim that the Kansas law violated the Contract Clause.

IV. Conclusion

The Supreme Court's contemporary Contract Clause jurisprudence limits states' power to enact legislation or regulations that modify existing contracts, but preserves states' traditional power to regulate private affairs to protect the public interest. The *Allied Structural Steel* case shows that where private contracts are affected, the Court will find a violation of the Contract Clause if a state law affects a narrow rather than a broad societal interest and retroactively diminishes a private party's reasonable expectations. The *Energy Reserves Group* case indicates the Court will not find a Contract Clause violation in the context of a highly regulated industry where a party has no reasonable expectation not to be subject to regulation. The *United States Trust Co.* case illustrates that the Court will closely scrutinize a state law that affects the state's own public contracts and in such cases will decline to defer to the state legislature's judgment of the necessity and reasonableness of a regulatory measure.

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[20] *Id.* at 416-17.

[21] *Id.* at 418-19.