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The Honorable Jae Spears
Senator, State of West Virginia
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Dear Senator Spears:

As Chairman of the Senate Committee on Government Organization, you have requested our opinion as to, among other things, whether the inclusion of a nonsubstitution agreement or clause in a lease-purchase agreement violates the public policy of the State of West Virginia. You have also asked whether the State may cancel the lease, and if so how that may be accomplished and what redress the State may have regarding the same.

Your inquiries flow from a specific real estate transaction in which the State of West Virginia was a participant. On August 3, 1988, several events took place. Morris Square, which currently houses the Division of Workers' Compensation of the Bureau of Employment Programs, West Virginia Department of Health and Human Resources, was sold by a limited partnership to the newly-formed Charleston Building Corporation. The State of West Virginia signed a twenty-year agreement whereby it contracted to lease-purchase the Morris Square property. Charleston Building Corporation immediately assigned the lease to One Valley Bank, N.A., which, as trustee, financed the purchase through the issuance of certificates of participation (COPS) to both individual and institutional investors.[1]

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[1] The issuance of COPS created fractional interests or shares in the lease-purchase agreement when the COPS were marketed to investors. A Guide to Municipal Leasing, Second Printing 1985. The certificate holders will proportionately share in the income or loss which results from their investments in an amount determined by the ratio of their individual investment to the total investment.

Within the lease-purchase agreement is numbered Paragraph 14, entitled "Statement of Intent and Nonsubstitution Agreement." It reads in its entirety:

> (14) STATEMENT OF INTENT AND NONSUBSTITUTION AGREEMENT
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> Lessee represents and warrants that it has no present intention and does not foresee having any intention to cancel this Lease pursuant to the provisions of Paragraphs 11 and 13 herein. Without in any way compromising its rights under West Virginia Code § 12-3-17, Lessee further represents and warrants that except for compelling reasons of public policy as determined solely by the Commissioner of Finance and Administration of the State of West Virginia, it will not, during the first three months following the date on which any said necessary cancellation takes effect, lease, purchase or otherwise acquire any property intended for the replacement of or substitution for the leased premises.

On August 18, 1988, Assistant Attorney General Ellen Gay Jarrell issued an opinion letter addressed to Charleston Building Corporation; Baskin, Flaherty, Elliott & Mannino, P.C.; One Valley Bank, National Association; Merrill Lynch, Pierce, Fenner & Smith, Incorporated; and Putnam Mutual Funds. The letter concluded that "[t]he execution . . . of the Lease and compliance with the provisions thereof . . . do not in any material respect conflict with or constitute a breach of . . . any existing law . . . to which the State is subject."

At the time the lease was executed and the opinion letter of August 18, 1988 issued, West Virginia Code § 12-3-17 established the only method by which long-term leasing of buildings, land or space could be accomplished. Then Code § 12-3-17 was substantially reenacted in 1990 as current Code §§ 5A-3-40, and remains the law in this State today. These Code provisions conditionally authorize the State to enter into long-term real estate leases, subject to the following limitations:

(1) The period of the lease cannot exceed forty years. Code § 12-3-17 (1983); Code § 5A-3-40 (1990). The term of the Morris Square lease is twenty years.

(2) The Department of [Finance and] Administration, as lessee for the State of West Virginia, must have the right to cancel the lease without further obligation upon giving thirty days' written

notice to the lessor. Code § 12-3-17(1) (1983); Code § 5A-3-40(1) (1990). Paragraph 13 of the Morris Square lease reserves this right for the lessee with the following language:

> (13) CANCELLATION OF LEASE
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> It is further agreed by and between the parties hereto that the Department of Finance and Administration, as Lessee, shall have the right to cancel this lease, without further obligation on the part of the Lessee, upon giving thirty (30) days' written notice to the Lessor, such notice being given at least thirty (30) days prior to the last day of the succeeding month (12-3-17(1) West Virginia Code).

Paragraph 14 of the lease, the "Statement of Intent and Nonsubstitution Agreement," purports to preclude the lessee from housing the Division of Workers' Compensation anywhere else for three months following the date on which any unanticipated but necessary cancellation takes effect.[2] This wording does not, however, appear to prevent the State from acquiring other property to replace the Morris Square property at any time prior to the effective date of any such cancellation.

The insertion of this clause into the lease presents yet another problem because it contradicts Paragraph 13, the lease cancellation provision. While warranting that the State of West Virginia will not, for three months, seek alternative housing for the Division of Workers' Compensation if cancellation becomes necessary, Paragraph 14 also provides that the State does not in any way compromise its rights under W. Va. Code § 12-3-17. The nonsubstitution language is non sequitur to Paragraph 13 of the lease, which recites the lessee's statutorily-required right of cancellation without penalty upon proper notice to the lessor.

(3) The lease must be considered canceled without further obligation on the part of the lessee if the State Legislature or the Federal Government should subsequently fail to appropriate sufficient funds therefor or should otherwise act to impair the lease or cause it to be canceled. Code § 12-3-17(2) (1983); Code § 5A-3-40(2) (1990). Paragraph 11 of the Morris Square lease bestows a substantial portion of this right upon the lessee:

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[2] The insertion of such a clause is an apparent attempt to present a lease agreement to the investing public as an installment debt of the State.

> It is further agreed by and between the parties hereto that this lease shall be considered canceled, without further obligation on the part of the Lessee, if the State Legislature should subsequently fail to appropriate sufficient funds therefor, or should otherwise act to impair this lease or cause it to be canceled . . . .
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> . . . .
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> In the event that no funds or insufficient funds are appropriated in any fiscal year enabling the payment of any rent or additional payments due during the term of this Lease, then Lessee will immediately notify Lessor of such occurrence in addition to the notice required by Paragraph 13 of this Lease. On the first day of the month following the payment date on which the last lease payment can be made in full from lawfully appropriated funds, this Lease shall terminate without penalty or expense to Lessee of any kind whatsoever . . . .

However, neither this paragraph nor any other provision of the lease contains the statutorily-required right of the lessee to terminate the lease in the event that the Federal government should ever fail to appropriate sufficient funds necessary for payment of the rent, or act in any other way to impair the lease or cause it to be canceled. Because many State agencies must receive funding from both State and Federal sources in order to administer their programs, this right of the lessee should be set forth in all leasing contracts. If the Division of Workers' Compensation or any other state agency tenant occupying the Morris Square building relies in part upon the Federal government for financial support, then Paragraph 11 of this lease lacks a pertinent requirement of the Code.

(4) The lease must automatically renew each year during the term of the lease unless canceled by the Department of Finance and Administration before the end of the then current fiscal year. Code § 12-3-17(3) (1983); Code § 5A-3-40(3) (1990). Paragraph 1 of the Morris Square lease contains this provision.

Under the foregoing analysis, it is clear that the opinion letter dated August 18, 1988, incorrectly stated the law by failing to recognize that a nonsubstitution clause in the lease agreement violated West Virginia Code § 12-3-17. Then Code § 12-3-17, and current Code § 5A-3-40, declare any leasing arrangement which does not conform to each of these requirements to be "unlawful."

Accordingly, in answer to your first question, we are of the opinion that the nonsubstitution clause in the Morris Square lease is illegal and is therefore against the public policy of the State of West Virginia. This clause also violates public policy by allowing the Commissioner of Finance and Administration to contract away the statutory duty of the Division of Workers' Compensation to provide a public service. Code §§ 23-1-1, et seq., clearly establish certain duties of the Commissioner of Employment Programs. If the Division of Workers' Compensation were required at some time in the future to discontinue operations for three months in order to comply with a strict application of the nonsubstitution clause in the lease, the agency could not discharge its statutorily-mandated duties.

The next question to ask, then, is whether or not the clause is enforceable as against the State. A promise or other term of an agreement is unenforceable on grounds of public policy if legislation provides that it is unenforceable or the interest in its enforcement is clearly outweighed in the circumstances by a public policy against the enforcement. Restatement (Second) of Contracts § 178 (1981). Then Code § 12-3-17, and current Code § 5A-3-40, constructively declare the nonsubstitution clause in this agreement to be unlawful because its sole purpose is to emasculate the statutory requirement that any lease be cancellable on thirty days' notice. Public statutes are a determinative source of public policy. Cordle v. General Hugh Mercer Corp., _____ W. Va. _____, 325 S.E.2d 111 (1984). The public policy of the State of West Virginia, as evidenced by the above statutes, is obviously against such a provision.

It is therefore clear to us that the nonsubstitution clause itself is unenforceable. See Boatland, Inc. v. Brunswick Corporation, 558 F.2d 818 (6th Cir. 1977). The question then presented is whether the contract of lease-purchase itself is generally enforceable, without this provision.[3] Divisibility and severability are flexible concepts and decided on a case-by-case basis. Restatement (Second) of Contracts § 183, comment a (1981). That there is no established formula to apply in West Virginia in a determination of contract severability was recognized by our Supreme Court of Appeals in Quinn v. Beverages of West Virginia, Inc., 159 W. Va. 571, 224 S.E.2d 894 (1976).

One party may be allowed to enforce one part of an agreement even though another part of the same agreement is unenforceable on grounds of public policy, for the reason that the first part does

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[3] It is noted that the lease-purchase agreement does not contain a severability clause.

not materially advance the improper purpose. Restatement, supra; Mazda Motors of America v. S. W. Motors, Inc., 36 N.C.App. 1, 243 S.E.2d 793 (1978). See also, Keene v. Harling, 61 Cal. 318, 392 P.2d 273 (1964); Mailand v. Burckle, 20 Cal.3d 367, 572 P.2d 1142 (1978). This general rule would permit the State of West Virginia to enforce all other parts of the lease-purchase contract, while ignoring the nonsubstitution clause.

If the performance as to which the agreement is unenforceable is an essential part of the agreed exchange, the inequality will be so great as to make the entire agreement unenforceable. Restatement (Second) of Contracts § 184 (1981). Frederick v. Frederick, 44 Ill.App.3d 578, 358 N.E.2d 398 (1976). However, considering the inclusion of Paragraph 13 in the lease, in our opinion it would be difficult for the lessee to argue effectively that the nonsubstitution clause in the Morris Square lease is an essential part of the agreed exchange.

Turning to your second question regarding the State's remedies, it is therefore our opinion that the Executive Branch may choose either: (1) to continue abiding by the lawful provisions of the lease, or (2) to terminate the lease with 30 days' written notice to the lessor. Of course, the lease would also be considered canceled should the Legislature fail to appropriate funds to make the rental payments, or otherwise act to impair the lease or cause it to be canceled.

Although your letter also asked what redress the State may have, including recoupment of costs, this opinion does not fully address other potential issues that might arise, depending upon the option chosen.[4] Nor do we render any opinion regarding remedies for the COP investors, should the State choose to terminate the lease,[5] or any potential adverse consequences to the

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[4] For example, W. Va. Code § 12-3-17 (1983) and § 5A-3-40 (1990) provide: "Any member of a state board or commission or any officer or employee violating any provision of this section shall be personally liable for any debt unlawfully incurred or for any payment unlawfully made."

[5] Theoretically, those remedies are: (1) to repossess the property; (2) in order to mitigate losses, to sell the property or lease it to another tenant for less, more or the same rent; and/or (3) to sue the State for any resultant reduction in rent. COPS and Lease-Backed Bonds in Major Leasing States, John W. Illyes, Nuveen Research, January 1990.

State's credit rating.[6] It is incumbent upon the Executive and/or the Legislature to first determine whether the lease should be continued. Then, depending upon the course chosen, we may provide additional information or advice regarding possible remedies available to the State. It should be noted, however, that specific remedies have neither been agreed upon by the parties to the lease-purchase agreement, nor set forth in the trust agreement in this instance.[7]

In conclusion, the lease-purchase agreement with its nonsubstitution clause clearly violates West Virginia law as well as public policy. Without legislative authority, such clauses should never be used by officers contracting on behalf of the State of West Virginia.[8]

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[6] Certain investment brokers and financial analysts have raised the possibility of adverse consequences to the credit standing of the State, particularly to its ability to issue debt subject to nonappropriation, which could result if the State should decide to cancel the lease. Although it is our preliminary view that the likelihood of such consequences is questionable, we do not have all the facts necessary to render such an opinion. It should be noted, however, that these COPs were not issued by the State, so they are not the State's debt. To the extent it could be argued they are the State's obligations, the failure of the State to abide by an illegal contract provision should not have any appreciable impact on the State's credit rating. This situation must be contrasted with the State defaulting on its <u>own</u> bonds issued under a <u>valid</u> contract.

[7] "For the protection of all concerned . . . the contract should specify what steps can be taken should a default occur." A. Fleming Bell, II, <u>Lease-Purchase Agreements and North Carolina Local Governments</u>, Popular Government, Vol. 49, No. 4 (Spring, 1984).

[8] It would appear that any executive decision to cancel the lease, or any legislative decision to refuse to appropriate sufficient monies to meet the monthly lease payments, should be made after a careful weighing of, among other things, such a decision's impact upon the general financial planning of the State, the future real estate requirements of the State of West Virginia, and the potential resultant financial losses which could be suffered by investors.

SUMMARY

A nonsubstitution clause, if included in a lease to which the State of West Virginia becomes a party, violates public policy, is violative of W. Va. Code §§ 5A-3-38 and -40, as well as their statutory predecessor, W. Va. Code § 12-3-17, and is therefore illegal and unenforceable. The opinion letter dated August 18, 1988, to the extent that it finds that a nonsubstitution clause in such a lease does not violate West Virginia law, is overruled.

Very truly yours,

Mario J. Palumbo

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