Montana Legislative Services Division

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To: Cathy Duncan, Legislative Fiscal Division
From: Julie Johnson, Legislative Services Division
Re: Preliminary Research on Lease-to-Own Contracts and State Debt
Date: May 17, 2018

INTRODUCTION

You have asked me to provide some guidance on whether a lease-to-own contract that contains a nonappropriation clause is considered state debt. This memo reflects my preliminary research and conclusion; however, if the Legislative Finance Committee wishes to pursue or further investigate this potential funding strategy for the construction of state buildings, further research may be warranted.

QUESTION PRESENTED

Whether an obligation set forth in a lease-to-own contract between the state, as lessee, and a private party, as lessor, is considered "state debt" under Article VIII, section 8, of the Montana Constitution if it contains a nonappropriation clause[1]?

SHORT ANSWER

While it may be more legally sound to pursue a lease-to-own program with a 2/3 vote and bypass the question of whether such an obligation constitutes state debt, one can make a valid legal argument that as long as a lease-to-own contract contains a nonappropriation clause, the obligation is not considered state debt because the lease does not bind a future legislature to appropriate funds.[2] As long as the obligation is not state debt, legislation approving the construction of a state building through a lease-to-own contract could be approved by a majority vote.

LEGAL LANDSCAPE

I. Constitutional and Statutory Framework

Article VIII, section 8, of the Montana Constitution provides:

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[1] For purposes of this memo a nonappropriation clause is a contract term that provides that if funds are not appropriated or made available to support continued performance of a lease in subsequent fiscal periods, that lease must be canceled pursuant to 2-17-101(6), MCA.

[2] Section 18-3-101, MCA, would also have to be amended to allow for a lease with an option to purchase by a simple majority vote of the Legislature.

> **State debt.** No state debt shall be created unless authorized by a two-thirds vote of the members of each house of the legislature or a majority of the electors voting thereon. No state debt shall be created to cover deficits incurred because appropriations exceeded anticipated revenue.

Section 18-3-101, MCA, currently provides that the Department of Administration (DOA), through its long-range building program, may enter into a lease-to-own contract only when authorized by a two-thirds vote:

> **Authority to lease with option to purchase.** When authorized by a vote of two-thirds of the members of each house of the legislature, the department of administration may, as part of the long-range building program, enter into a lease contract that provides an option to purchase a building to be used by the state or any department of state government.

Also, section 2-17-101, MCA, places restrictions on leases for more than 40,000 square feet or for a term of more than 20 years and requires that all state leases contain a nonappropriation clause:

> (5) Any lease for more than 40,000 square feet or for a term of more than 20 years must be submitted as part of the long-range building program and approved by the legislature before the department of administration may proceed with the lease. Multiple leases in the same building entered into within any 60-day period are to be aggregated for purposes of this threshold calculation. When immediate relocation of agency employees is required due to a public exigency, the requirements of this subsection do not apply, but the new lease must be reported as required by subsection (1).
>
> (6) The department shall include language in every lease providing that if funds are not appropriated or otherwise made available to support continued performance of the lease in subsequent fiscal periods, the lease must be canceled.

The requirement that all leases contain a nonappropriation clause was inserted in 2009. (Ch. 375, Laws of 2009).

II. Attorney General Opinions

In 1973, shortly following the adoption of Montana's current constitution, Attorney General Woodahl authored an opinion in which he addressed whether a lease-purchase agreement for a new state office building was considered state debt under the 1972 Constitution. 35 A.G. Op. 41 (1973).

In 1973, the Legislature had passed Senate Bill No. 54. Section 12 of the bill authorized the Department of Administration, as part of the long-range building program, to enter into lease-

purchase agreement to provide a new office building for the Department of Social and Rehabilitation Services (now a part of the Department of Public Health and Human Services) as long as the total cost did not exceed $1,500,000.

The Attorney General focused on whether the Legislature had provided for "cash on hand" to finance the building or whether the Legislature would be obligated to make future lease and/or purchase payments. Because the Legislature did not provide cash on hand to finance the building, the Attorney General opined that the lease purchase payments were state debt within the purview of Article VIII, section 8, of the Montana Constitution.

However, in 2001 Attorney General Mike McGrath issued an opinion that directly addressed the use of a nonappropriation clause in a long-term lease with an option to purchase and whether the lease was considered debt if the lease contained a provision that allowed a government to terminate the agreement without penalty if it, in its sole discretion, failed to appropriate funds to make payment due under the lease in any fiscal year constituted indebtedness. 49 A.G. Op. 3 (2001).

In that case, the City of Great Falls was considering entering into a contract with a private party for the development and operation of a water park whereby the City would lease real property to the private party who would then construct a water park (considered the private party's personal property) that the private party would then lease to the City. The lease agreement for the personal property would include an option for the City to purchase it at the close of the lease term. The agreement would also contain a nonappropriation clause, under which the lease would terminate without penalty to the City if the City did not appropriate funds for the lease payments in any fiscal year.

First, Attorney General McGrath observed that the test to determine whether a particular government expenditure constitutes a debt is the same whether the debt is city, county, or state debt and that it appeared "that the authorities with respect to the definition of 'indebtedness' are interchangeable without regard to the level of government involved." Id.

The Attorney General then noted that Montana case law has been "fairly consistent in holding that an expenditure payable from funds currently available is not a 'debt'", while one "that would require appropriation by a future government legislative body would create a 'debt'." Id.

Ultimately, the Attorney General concluded that the lease purchase agreement would not create a debt because the payment under the lease purchase contract would be made from currently available revenue and nothing in the contract would obligate the City to make a payment in any future budget year. The Attorney General also emphasized that the agreement would clearly disclose that the City is not pledging to make any particular payment in any particular year and that the lessor would have not legal remedy to compel the City to pay if it chose not to do so in any given year.

OTHER RELEVANT INFORMATION

A lease containing a nonappropriation clause was at the heart of litigation when SBC Archway LLC (SBC) sued the State in 2009 over a lease and proposed construction of a building on Nob Hill in Helena. In that case, three state agencies had signed an agreement with SBC to lease over 65,000 square fee of office space in a building to be constructed by SBC. The lease provided that the agencies were dependent on state and federal funding for their funding.[3] However, after almost 2 years of postponing the construction of the building for a variety of reasons, the 2009 Legislature did not appropriate funds for the lease.

SBC sued for breach of contract and sought $3.9 million in costs for the aborted project and $9.9 million in lost profits and additional damages. After months of litigation and just prior to a 5-day trial, the State settled with SBC for $3 million. According to a newspaper article at the time, Governor Schweitzer stated "the state's lawyers told him the developer had no legal case. The odds were 75 percent to 25 percent the state's favor, he said, but there was some uncertainty because the case was going to a jury." Others in the construction industry, however, noted at the time that the settlement of $3 million "at least sends a message that contracts work both ways," and that "[c]ontractors are held liable to their terms in their dealings with state agencies, and the state is similarly held accountable."

Even more recently, prior to the 2015 Session, the DNRC entered into a long-term lease with a private party. The lease complied with the limitations of square footage and length of lease term outlined in section 2-17-101(5), MCA, and therefore the lease itself did not require legislative approval. The lease also contained a nonappropriation clause. Nevertheless, when the 2015 Legislature considered not appropriating funds to DNRC for lease payments due under the lease, the lessor advised legislators that if lease funds not appropriated, the lessor would pursue legal action. After much debate, the Legislature approved appropriations sufficient to make the lease payments.

ANALYSIS AND CONCLUSION

Given the 2001 Attorney General opinion, there is a valid legal argument to be made that a lease-to-own contract that contains a nonappropriation clause is not considered state debt given that a future legislature is not required to make payments under the contract. However, even if such a lease agreement is not considered state debt, this does not mean that the State faces no financial liability should a future legislature choose to not appropriate funds for lease payments. Were the State to enter into a lease-to-own contract with a private party, there is a possibility that if a future legislature did not appropriate funds for lease payments, the lessor could file a lawsuit

[3] I have not obtained the contract between SBC and the State; however, it is believed that the contract had some form of a nonappropriation clause in it given the newspaper articles I located.

against the state seeking damages as SBC Archway did.