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OAG 18-010

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Subject: Whether an early termination fee in a public services contract between the Commonwealth of Kentucky, Cabinet for Health and Family Services/Department for Community Based Services, and Red Buffalo Ventures, LLC, is valid and constitutional.

Requested by: Rep. Jim Wayne

Written by: Laura C. Tipton

Syllabus: The contract at issue is invalid, as it did not meet the requirements of a "sole source" contract, despite being approved as such. Accordingly, the early termination fee provision included in the contract is void. In general, a reasonable early termination fee or severance provision included in a valid contract may be in consideration of public services and constitutional.

Statutes construed: KRS 45A.095(1)(b) and (2)(a); 200 KAR 5:309 § 1(4); Ky. Const. § 3; KRS 45A.135; KRS 45A.695

OAGs cited: OAG 96-23; OAG 91-219; OAG 88-29; OAG 79-611; OAG 79-337

Opinion of the Attorney General

Rep. Jim Wayne has requested an opinion of this office on the validity of an early termination fee in a public services contract between the Commonwealth of Kentucky, Cabinet for Health and Family Services/Department for Community Based Services, and Red Buffalo Ventures, LLC. Pursuant to this

contract, Red Buffalo Ventures, LLC, having Daniel S. Dumas as its sole member, was to serve as a Special Advisor to the Commonwealth on child welfare issues. We advise that the contract at issue violated Kentucky's Model Procurement Code, as it was not a "sole source" contract, despite its approval as such. Accordingly, the early termination fee provision included in the contract was void. In an otherwise valid and legal contract, however, a reasonable early termination fee or severance provision may be in consideration of public services and constitutional.

Background

On May 1, 2017, the Commonwealth of Kentucky, Cabinet for Health and Family Services ("CHFS")/Department for Community Based Services ("DCBS") (hereinafter collectively "CHFS"), entered into a personal services contract for consulting services with Red Buffalo Ventures, LLC ("Red Buffalo"), and its sole member, Daniel S. Dumas. The contract price totaled \$250,000, including a base compensation of \$240,000. Its effective term ran from June 17, 2017 to June 30, 2018, with the option for two separate one-year renewals at the base compensation. The contract provided that "the Contractor shall serve as a special advisor . . . on child welfare issues affecting the Commonwealth and its citizens." Under the contract, the contractor was required to "perform an assessment of Kentucky's child welfare system" and coordinate with various state agencies "in determining current policies, practices, and procedures affecting the foster care system."

The contract provided that "in the event of termination without cause, the Contractor will be paid an early termination fee in an amount equal [sic] three (3) months regular base compensation subject to available funds. Based upon an annual compensation of \$240,000, the termination fee would total \$60,000." On January 16, 2018, the Cabinet for Health and Family services terminated the contract, and then paid the \$60,000 early termination fee. At issue is whether early termination fees such as the one in the contract are constitutional and permissible under Kentucky's Model Procurement Code.

At the request of this office, CHFS and the Finance and Administration Cabinet (the "Finance Cabinet") have provided their analyses. In addition, upon request the Finance Cabinet provided a copy of the Strategic Procurement Request ("SPR") associated with the contract, as well as the minutes from the June

13, 2017 meeting of the Legislative Research Commission Government Contract Review Committee where the contract was under review.

Analysis

A. The Contract Is Invalid.

As a threshold matter, we find that the state's contract with Red Buffalo was invalid. Although approved as a "sole source" contract – commonly called a "no bid" contract – it did not meet the legal requirements for such an agreement under the Kentucky Model Procurement Code ("KMPC"), which applies to CHFS. Accordingly, the contract violated the KMPC.

As stated in *Pendleton Bros. Vending, Inc. v. Commonwealth, Finance and Admin. Cab.*, 758 S.W.2d 24, 27 (Ky. 1988), "the purpose of the procurement code is to elevate state purchasing to a higher level of conduct." "Specifically, with the enactment of the KMPC, the General Assembly elevated the standard of conduct for the Commonwealth's procuring entities, *inter alia*, 'to provide safeguards for the maintenance of a procurement system of quality and integrity[.]'" *Commonwealth v. Yamaha Motor Mfg. Corp.*, 237 S.W.3d 203, 205 (Ky. 2007) (quoting KRS 45A.010(2)(g)). These safeguards include the imposition of "rules with objective criteria in purchasing," and the provision of "enforcement for these standards." *Pendleton Bros.*, 758 S.W.2d at 27.

In *Pendleton Bros.*, the Kentucky Supreme Court found that, for agencies falling under the KMPC, procurement is "a regulated administrative procedure subject to a court challenge if the decision was contrary to law, or arbitrary and capricious." See *Pendleton Bros.*, 758 S.W.2d at 25. This includes challenges on grounds that statutory procedures were disregarded.¹ See *Yamaha Motor Mfg. Corp.*, 237 S.W.3d at 206 ("Additionally, our decision in *Pendleton Brothers* recognized that an award or decision must not be arbitrary and capricious or contrary to law, and this includes a decision or award made in violation of the KMPC."). Indeed, "[t]he availability of legal recourse is essential if the KMPC is to constitute more than a precatory body of law." *Pendleton Bros.*, 758 S.W.2d at 30.

¹ Notably, the Court indicated that standing for such a challenge could reside in a losing or disappointed bidder or a taxpayer. See *Pendleton Bros.*, 758 S.W.2d at 25.

Where it applies, failure to follow particular mandates of the KMPC "render[s] the resulting contract void." *See id.* at 29.

Here, in the SPR submitted to the Finance Cabinet, CHFS categorized the contract with Red Buffalo as a "sole source" personal services contract. Under KRS 45A.095(1)(b), the term "'[s]ole source' means a situation in which there is only one (1) known capable supplier of a commodity or service, occasioned by the unique nature of the requirement, the supplier, or market conditions." The sole source designation is significant as, unlike most contracts awarded by the state, sole source contracts are exempt from competitive bidding, *i.e.*, they are "no bid" contracts. *See* KRS 45A.095(2)(a); 200 KAR 5:309 § 1(4); FAP 111-10-00; FAP 111-43-00. Before a sole source contract may be approved, the state contracting agency must submit a "sole source justification" to the Finance Cabinet. *See* FAP 111-43-00(3)(b).

As noted, the contract between CHFS and Red Buffalo provided that Red Buffalo, the Contractor, would serve as a special advisor to the Commonwealth on child welfare issues. The Contractor was specifically tasked with: (1) performing "an assessment of Kentucky's child welfare system, with particular focus on Kentucky's current statutes, laws, regulations, rules and policies pertaining to or otherwise affecting Kentucky's foster care system, the permanent placement and adoption of child[ren] within the foster care system, and the current supports provided to prospective and current foster and adoptive parents"; (2) coordinating with CHFS and other applicable state agencies and appropriate third parties in order to determine "current policies, practices and procedures affecting the foster care system, the permanent placement and adoption of children within the foster care system, the supports provided to prospective and future foster and adoptive parents, and other child welfare issues that affect or otherwise pertain to the foregoing"; (3) making recommendations to the Governor, CHFS, and other state agencies regarding "statutory, regulatory and policy changes that will better serve current and future children within the Kentucky foster care system, including how best to expedite the permanent placement and adoption of children within the foster care system and how best to support prospective and current foster and adoptive parents"; (4) supervising the implementation of any recommendations approved by the Governor, CHFS, and other applicable state agencies; (5) providing periodic reports to the Governor, the Secretary of CHFS, and the Commissioner of DCBS regarding the pro-

gress being made in the performance of contract obligations; and (6) maintaining “positive relationships with all stakeholders, including the Office of the Governor, CHFS, DCBS, other applicable state agencies, advocates for foster children and foster and adoptive parents, individual foster and adoptive parents, and the public.”

According to the “Sole Source Justification” CHFS attached to the SPR, Red Buffalo’s CEO, Daniel S. Dumas, was “uniquely qualified” to perform these duties and responsibilities due to his personal and professional experiences. In particular, the Justification indicated that Dumas is himself the parent of two adopted children. He served for ten (10) years as Senior Vice President to Institutional Administration at The Southern Baptist Theological Seminary, significant, according to the Justification, in light of the Governor’s Office of Faith-Based and Community Initiatives, an Office focused on “actively and robustly engag[ing] Kentucky’s faith-based and other non-profit organizations to assist the Executive Branch in implementing many reforms initiated by Governor Bevin, including reforms to Kentucky’s . . . child welfare system.” Dumas also served in the United States Navy for five (5) years in the 1980s, after which he acted “as a consultant to many organizations in helping them to identify and hire talented individuals, build sustainable cultures based upon collaboration and positive achievement, and create and implement strategic visions that fulfill the core mission of the institution.” Additionally, Dumas has authored books and articles on leadership and service, and he serves on boards that “focus on servant leadership and how to make positive contributions to the community.”

A review of the contract requirements and the CHFS Justification reveals that the Justification is woefully insufficient. Although Dumas may be capable of performing the assessment contemplated by the contract, he undeniably is not *uniquely* or *solely* qualified to do so. Indeed, Dumas’ only experiences with Kentucky’s child welfare system relate to the adoption of his own children. But last year, nearly 1,000 children in CHFS foster care were adopted and more than 80% were adopted by their foster families. See <https://adopt.ky.gov/learnMore/Pages/fostering.aspx> (last visited Aug. 6, 2018). Thus, if Dumas’s experience comes from the adoption of children, he cannot be the only or “sole” individual with such experience.

Further, although Dumas's professional and military experiences may very well have provided leadership and other skills that would be useful, there are numerous other individuals with such military service, and there are certainly other professions and jobs that similarly would qualify an individual to assess and make recommendations concerning the Commonwealth's child welfare system. A leader of foster care systems for other states, or for private foster care services, for example, would certainly have experience in leadership of the exact type of personnel at issue here. Indeed, one can envision that there are individuals more qualified than Dumas to perform the duties and responsibilities outlined in the contract.

Speaking before the Government Contract Review Committee, Scott Brinkman, Secretary of the Governor's Executive Cabinet, emphasized the urgent need for the special advisor position and the Governor's determination that Dumas would be the "ideal individual" for the job. That might make him a competitive bidder, but hardly the "sole" qualified individual. Missing from Secretary Brinkman's comments and the Sole Source Justification is any evidence that Dumas was the only known capable supplier of the services required. Although the Committee asked questions regarding Dumas's qualifications, puzzlingly the Committee did not expressly question or challenge the designation of the contract as "sole source."

The Committee should have questioned the sole source designation. Simply stating that Dumas was uniquely qualified to provide the services contemplated by the contract did not make him so. Dumas' personal experiences with the child welfare system are shared by other adoptive parents, and his professional leadership and consulting experiences, while unique to him, do not make him uniquely qualified to serve as special advisor to Kentucky's child welfare system. Accordingly, it is the opinion of this office that CHFS's contract with Red Buffalo violated the Model Procurement Code and is void. The contract could not meet the sole source requirements, and thus should have been subject to competitive bidding.

B. In General, A Contract Early Termination Fee Or Severance Provision May Be Constitutional.

Because the contract at issue here was invalid, the early termination fee provision included in the contract also was invalid. We find that generally, however, in an otherwise legal contract, an early termination fee or severance provision may be in consideration of public services and constitutional.

The KMPC does not expressly address any kind of early termination fee or severance provision. Under KY. CONST. § 3, however, “no grant of exclusive, separate public emoluments or privileges shall be made to any man or set of men, except in consideration of public services.” The issue, then, is whether an early termination fee or severance provision included in a contract is “in consideration of public services.”

Although there do not appear to be any Kentucky authorities directly on point, KY. CONST. § 3 has been interpreted in other contexts. In *Miller v. Robertson*, 208 S.W.2d 977 (Ky. 1948), a Commonwealth’s Attorney was absent for several years during active duty in the U.S. Navy. *Id.* at 978. The former KRS 69.065 provided for Commonwealth’s Attorneys who had served in the armed forces to receive the salary of their position minus the salary paid to officers serving *pro tempore* in their place. *Id.* at 979. The statute was challenged as violating KY. CONST. § 3. The Court found that the statute was constitutional, reasoning that KY. CONST. § 3 should not be too strictly interpreted, otherwise many public goods would be unduly restricted. *Id.* at 980. The Court explained that a rigid construction of Section 3 would mean that “a public officer or employe[e] would be denied his pay if he should be absent from his work on account of illness or vacation even for one day, or part of a day.” *Id.* The Court did not think that could be the intent of the provision. *Id.*

In contrast, in *Littleton v. Reed*, 456 S.W.2d 695 (Ky. 1970), the Court considered a statutory amendment that had the effect of “bring[ing] into the judicial retirement system certain judges whose public service had been completed prior to its creation.” *Id.* In reviewing whether the statute violated KY. CONST. § 3, the Court held that:

no . . . [public] purpose could be served by the payment of a pension to one who was not induced to enter or remain in public service, or who was not induced to retire by reason of such plan. Such compensation could not be declared 'in consideration of public service' because no public service was performed therefor. To appropriate public funds in recognition of some past public service for which compensation has already been paid is to grant a gratuity.

Id. at 696. In short, the *Littleton* Court held that to pay someone after the fact for services already rendered would be a gratuity in violation of KY. CONST. § 3, as it could not have been an inducement to provide public services.

Accordingly, the primary Kentucky case law interpreting KY. CONST. § 3 indicates that it should not be read too strictly in terms of what may constitute a public service. It also establishes as a bright line rule, however, that no additional payment may be made for any past public service already rendered, as the payment necessarily would not be made in consideration of any future public service.

Several opinions of this office have addressed whether various other forms of compensation violated KY. CONST. § 3. These opinions follow the precedent set by *Miller* and *Littleton*. Thus, in OAG 88-29, we advised that a statute allowing a school board to grant sabbatical leave to a public school teacher or superintendent who agrees in writing to return to employment with the board for at least two (2) years is constitutional, as such sabbatical leave payments are intended to be for and in consideration of services rendered and for the benefit of the common schools. In OAG 96-23, we found a proposal by a school district to offer all teachers with a minimum of thirty (30) years of service a one-time payment of \$10,000 for their election to retire constitutional, as "a public employee voluntarily retiring to assist the state (or school board) in fiscal savings is a 'public service.'" And in OAG 79-337, we advised that a school district could **not** compensate employees for snow days where the employees' contracts did not include such payment as part of the negotiated compensation.

Additionally, cases from other jurisdictions have upheld various termination fees or severance provisions included in contracts against constitutional challenges grounded in the theory that the provisions did not represent payment

in consideration of public services. See *Vill. of Oak Lawn v. Faber*, 880 N.E.2d 659 (Ill. Ct. App. 2007) (upholding a village manager's contractual severance package of nine months' pay and benefits); *City of Omaha v. City of Elkhorn*, 752 N.W.2d 137 (Neb. 2008) (upholding a severance provision in the contracts of police and city management personnel which provided for severance benefits - compensation equal to 52 weeks - in the event the city was annexed); *Elliott v. Enka-Candler Fire & Rescue Dep't, Inc.*, 713 S.E.2d 132 (N.C. Ct. App. 2011) (upholding a provision in a contract between a fire department and a fire chief stating that if the fire department terminated the fire chief's contract, the department would pay the chief the balance of his salary and all benefits through the end of the contract).

Accordingly, based on Kentucky law and guidance from other jurisdictions, we arrive at two general conclusions. First, any compensation or buyout of a contract paid after services have already been rendered which is not included in the contract is necessarily unconstitutional, as it cannot have been made in consideration of any public service. Second, a reasonable early termination fee or severance pay provision included in a contract is generally permissible as an inducement for the rendering of public services.

We caution, however, that the fact that an early termination fee or severance provision is included in a contract is not a guarantee that it complies with KY. CONST. § 3. A termination fee or severance provision may be so excessive that it could not reasonably be in consideration of public services, but rather amounts to a gift.

Conclusion

In sum, the contract at issue here was in violation of the KMPC and therefore void. Consequently, the early termination fee provision included in the contract was invalid. In an otherwise lawful contract, however, a reasonable early termination fee or severance provision included in a contract may be in consideration of public services and therefore constitutional under KY. CONST. § 3.

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