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## **LEGAL GUIDANCE- LEASE-LEASEBACK IN LIGHT OF DAVIS V. FRESNO UNIFIED SCHOOL DISTRICT & ASSEMBLY BILL NO. 566**

In 2007, CSBA formed a Construction Management Taskforce, which was comprised of board members, superintendents, other district administrators, and representatives from labor organizations to examine “the role the board plays in strategic planning, monitoring and oversight, and asking the right questions during the construction process.” The Taskforce then published a report that covered a multitude of areas: master planning, land and site acquisition, construction delivery methods, hiring a project manager, project stabilization agreement, cost containment, and apprenticeships.

This legal guidance is intended to build on the section of the Taskforce’s report on construction delivery methods, most notably lease-leaseback, in light of the recent ruling in *Davis v. Fresno USD* and the recent passage of Assembly Bill No. 566 (O’Donnell). CSBA’s policy unit will also be updating all the materials located at <https://www.csba.org/ProductsAndServices/AllServices/Gamut.aspx>. Additionally, CSBA’s Leadership Institute, scheduled for July 12-13, 2016, will address facilities construction and financing. For more information about the Leadership Institute, please contact Naomi Eason at [neason@csba.org](mailto:neason@csba.org).

Any school construction project involves three basic parts: the design of the project, the solicitation of who will construct the project, and the physical construction of the project. A project’s “delivery method” refers to the method chosen to achieve these three parts. Lease-leaseback (“LLB”) is one of the delivery methods described in CSBA’s 2007 Construction Management Taskforce Report. That Report also describes four other delivery methods: design-bid-build; design-build; construction manager at-risk; and multi-prime. This guidance focuses on the LLB delivery method in response to the recent decision in *Davis v. Fresno Unified School District* (2015) 237 Cal.App.4th 261 (“*Davis*”) and the passage of Assembly Bill No. 566 (“AB 566”), which went into effect on January 1, 2016. A brief review of other delivery methods is provided in the Appendix.

### **Background on Lease-Leaseback**

Under the typical LLB delivery method, the district leases property on which a project is located to the general contractor for a nominal annual fee, typically \$1 per year; this is often referred to as the Site Lease. The general contractor, in turn, subleases the property back to the district (often referred to as the “leaseback” component or the Facilities Lease). The district then makes lease payments to the general contractor in consideration for facility improvements – i.e., the construction of the project on the property – and for the ability of the district to use and occupy the property. This delivery method is explicitly permitted under Education Code section 17406.<sup>1</sup> Specifically, subdivision (a) states:

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<sup>1</sup> All further statutory references are to the Education Code unless otherwise stated.

the governing board of a school district, without advertising for bids, may let, for a minimum rental of one dollar (\$1) a year, to any person, firm, or corporation any real property that belongs to the district if the instrument by which this property is let requires the lessee therein to construct on the demised premises, or provide for the construction thereon of, a building or buildings for the use of the school district during the term of the lease, and provides that title to that building shall vest in the school district at the expiration of that term. The instrument may provide for the means or methods by which that title shall vest in the school district prior to the expiration of that term, and shall contain other terms and conditions as the governing board may deem to be in the best interest of the school district.

For decades, districts have legally used this statute to enter into LLB contracts that are in the “best interest” of the district. A comprehensive list of reasons for choosing a LLB contract over the traditional method is impossible to compile given the distinct facilities needs of the nearly 1,000 districts in California. However, two oft-cited reasons are the ability to place the risk of certain cost overruns on the general contractor and the ability to collaboratively plan and cost out the project to the satisfaction of the district before a final contract is signed. A LLB contract potentially reduces the level of financial risk of cost overruns incurred by the district because the cost of the project is fixed by a “guaranteed maximum price” (although limited change orders can still occur if there were design issues or unforeseen conditions); under other delivery methods, it is often the district that originally bears the financial risk of cost overruns by being subject to unlimited change orders while the project is being built. Additionally, other delivery methods do not ensure selection of a project manager or general contractor with the expertise necessary for the project given its size, type, or location. In contrast, a LLB contract allows the district to assemble a project team (i.e., the architect, project manager, and general contractor) that the district believes is best suited given the unique needs of the project.

Before *Davis*, LLB contracts had a long, successful track record in the courts. (See, e.g., *Los Alamitos USD v. Howard Contracting, Inc.* (2014) 229 Cal.App.4th 1222 [upholding a recent LLB contract].) As a result, LLB contracts were typically not contested. (See, e.g., *Alhambra USD v. All Interested* (2010) 2010 Cal.Super.LEXIS 1472 (Super. Ct., Case No. BC435175) [uncontested LLB validation action].) However, the appellate court in *Davis* disregarded this history and found that the allegations put forth by the plaintiff in that case were sufficient to find that the LLB contract could be improper. Additional changes are also in store for the use of LLB contract as a result of the recent passage of AB 566, which increased the prequalification and apprenticeship requirements if a LLB contract is to be used.

### ***Davis v. Fresno Unified School District***

In *Davis*, the district had entered into a LLB contract with a general contractor for a middle school project. The LLB contract contained a site lease in which the district leased the project site to the general contractor for \$1 in annual rent; under the leaseback portion of the LLB contract, the general contractor agreed to build the project on the site and sublease the site and project back to the district in exchange for lease payments under a prescribed schedule. (*Davis*, 237 Cal.App.4th at pp. 271-73.) The lease payments included “monthly progress payments for construction services rendered each month, up to 95 percent of the total value for the work performed, with a 5 percent retention pending acceptance of the

project and recordation of a notice of completion. Final payment . . . was to be made within 35 days after recordation by [the district] of the notice of completion.” (*Id.*, p. 272.) The site lease and the leaseback portion of the contract both terminated upon completion of the project and the district took possession of the site immediately upon completion of the project. (*Ibid.*)

The plaintiff in *Davis* alleged that the leaseback portion of the LLB contract was not a true lease and that it did not satisfy the criteria set forth in section 17406. The district demurred and the trial court sustained the demurrer, dismissing the lawsuit on the grounds that the plaintiff failed to allege any viable legal theory on which the complaint could be based. On appeal, the court found that the plaintiff had alleged one or more viable legal theories. However, in order to determine whether the facts as alleged were actually true – i.e., did the district actually violate the law – the appellate court remanded the matter back to the trial court for further proceedings.

In upholding the plaintiff’s position, the appellate court considered the plain language of section 17406 as well as its legislative history. First, the court concluded that “the word ‘lease’ used in section 17406(a)(1)’s phrase ‘buildings for the use of the school district during the term of the lease’ means something more than a document designated by the parties as a lease. Rather, the Legislature chose the term to indicate the substance of the transactions that are eligible for the exception.” (*Davis*, 237 Cal.App.4th at p. 283.) In other words, the leaseback portion must – on a substantive level – be a genuine lease.

To determine the genuineness of a leaseback, the court considered “who holds what property rights and when those rights and interests are transferred between the parties.” (*Davis*, 237 Cal.App.4th at p. 285.) Based on the allegations in the complaint, the court found that the “[c]ontractor never acted in the capacity of a landlord holding rights to real property occupied by a tenant and [the district] never occupied and used the new facilities as a tenant.” (*Id.*, p. 287.) Indeed, it was uncontested that the district did not take possession of any portion of the site until after the project was completed and the final “lease” payment had been made.

Second, the court found that “[t]he Legislature adopted the lease-leaseback structure to create a way for school districts to pay for construction over time and avoid the constitutional limitation on debt.” (*Davis*, 237 Cal.App.4th at p. 278.) Thus, a LLB contract should “spread the school district’s liability for the construction and carrying costs over the term of the leaseback and limit [] the amount of debt attributed to the district for any one year.” (*Ibid.*) In other words, the court held that there must be a genuine financing component, although the reference to the constitutional debt limit, like other parts of the opinion, is not without controversy.

To determine the genuineness of the financing component in *Davis*, the court looked at “the amount and timing of the [leaseback] payments.” (*Davis*, 237 Cal.App.4th at p. 285.) More specifically, the court focused on “[t]he payment provisions, particularly the length of the period over which payments are made, are important . . . because [they] . . . will show

whether the project is being financed through the [general] contractor or whether the school district is paying for the project by using funds from other source.” (*Ibid.*) Here, the district’s payments to the general contractor did not extend past the project completion date. As a result, the court found that the general contractor did not carry any of the financial burden for the project – i.e., there was no genuine financing component. And without a genuine financing component, the project was simply a traditional construction project: “the true nature of the [LLB contract at issue] was that of a ‘traditional purchase type construction contract’” that should have been (but was not) subject to the competitive bidding process. (*Id.*, pp. 278-88.)

At its simplest, the practical effect of the court’s conclusion appears to be that the leaseback portion of a LLB contract *must* extend beyond the project completion date, despite the fact that the statute is silent on this issue. Extending the contract term has the potential to address the concerns raised in *Davis*. First, extending the term of the leaseback portion beyond the project completion date guarantees time for the district to occupy the site as a tenant during the term of the leaseback, forming a “genuine lease”.

Second, extending the leaseback period beyond the project completion date ensures that the district will continue to make leaseback payments to the general contractor for the remainder of the leaseback. This longer leaseback payment period functionally requires the general contractor to finance at least part of the project because it will have to pay its subcontractors for their work without having received full payment from the district for the work.

One of the many issues left unclear in *Davis* is the *length* that the leaseback portion must extend beyond the project completion date. The *Davis* court did supportively reference a LLB contract in which the lease to the contractor was for 50 years and the leaseback to the public agency was for 15 years (with options to purchase the property during the leaseback), which implies a 35-year occupancy and financing period. (*Davis*, 237 Cal.App.4th at p. 277 fn. 6 [citing to *City of Desert Hot Springs v. County of Riverside* (1979) 91 Cal.App.3d 441, 447–449].)<sup>2</sup> However, the court never indicated that a 35-year occupancy period was a minimum; indeed, there is not yet a consensus as to the minimum length of time to occupy and make lease payments following completion of the project. Many school law firms are recommending between 6 and 18 months. However, no one actually knows what the required minimum length of time that any occupancy and lease payments should extend past the completion date as the courts have yet to explicitly weigh in on this question. Thus, as always, CSBA highly recommends that districts consult extensively with legal counsel before entering into a LLB contract.

*Davis* was a case in the fifth appellate district, which covers many Central Valley counties. There are now two other current cases in other appellate districts that may reject the outcome in *Davis* or, at the very least, may establish the legal parameters for using a LLB contract in light of *Davis*. One case in the first appellate district is *California Taxpayers Action*

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<sup>2</sup> The current maximum lease term under section 17403 is 40 years.

*Network v. Taber Construction, Inc.*, which names the Mt. Diablo Unified School District as a defendant. The other case in the second appellate district is *McGee v. Balfour Beatty Construction, LLC*; the other named plaintiff in this case is California Taxpayers Action Network and Torrance Unified School District is also named as a defendant. CSBA's Education Legal Alliance has filed amicus briefs in support of the district in both cases.

These two cases were filed by the same attorney who brought the *Davis* case and the arguments are quite similar. Both cases involved a LLB contract, although the LLB contract in the second appellate district (involving Torrance USD) includes a leaseback that includes having the district occupy the site before the agreement terminates and the LLB contract in the first appellate district (involving Mt. Diablo USD) includes a six month financing component. It is possible that these two appellate courts will uphold *Davis* but find that these differences are sufficient to uphold the specific agreements; alternately, one or more of these appellate courts may reject the holding in *Davis* altogether and set up a conflict between the appellate courts that only the California Supreme Court can resolve.

### **Assembly Bill No. 566 (O'Donnell)**

Regardless of the outcome of these other two cases, districts looking to enter into LLB contracts will also have to contend with the additional requirements of AB 566, which went into effect on January 1, 2016.

Prior to AB 566, section 17406 required general contractors and, if used, any electrical, mechanical, and plumbing subcontractors to meet certain prequalification requirements for any project that (i) received state bond funding, (ii) had a projected expenditure of at least \$1 million, and (iii) utilized a LLB contract. These prequalification requirements included "the requirement for the completion and submission of a standardized prequalification questionnaire and financial statement that is verified under oath and is not a public record." AB 566 amended section 17406 to eliminate the first two conditions. Now, *any* public school construction by a school district with average daily attendance ("ADA") of 2,500 or more that utilizes a LLB contract must include the prequalification requirements, including the prequalification questionnaire and financial statement. (§ 17406; Pub. Contract Code, § 20111.6, 22002.)

Additionally, AB 566 adds section 17407.5 to the Education Code, which requires that a district can utilize a LLB contract only if the general contractor "provides to the . . . district an enforceable commitment that the [contractor] and its subcontractors at every tier will use [skilled journeypersons or apprentices] to perform all work on the project." Of the "skilled journeypersons" working on the project, AB 566 requires that at least 30 percent be graduates of a state- and federally-approved apprenticeship program in 2016. However, AB 566 quickly ratchets up this percentage: 40 percent starting on January 1, 2017; 50 percent starting on January 1, 2018; and 60 percent starting on January 1, 2019.

AB 566 provides two options to ensure that a general contractor will meet these new requirements. One option is for the general contractor to become a party to the district's

project labor agreement (“PLA”), but only if one exists that requires that all parties to the PLA meet the requirements of AB 566. The other option is for the LLB contract to require compliance with the requirements of AB 566 with the contractor presenting the district with a monthly report demonstrating such compliance. However, if the second option is chosen and the general contractor fails to provide the monthly report, the district *must* “immediately cease making payments” to the contractor. (§ 17407.5, subd. (c)(1)(B).)

The new state requirements established in AB 566 are likely to impact the use of LLB contracts in two ways. First, the cost of the project under a LLB contract is likely to increase due to the need for prequalification and the rise in the minimum percentage of highly paid skilled journeypersons required to build the project. Additionally, there may be fewer general contractors able to enter into a LLB contract due to the current supply of skilled journeypersons.

## **Conclusion**

The *Davis* decision and AB 566 have added obstacles to the use of the LLB delivery method to construct a project. However, these obstacles are not necessarily insurmountable. The LLB delivery method is still legal and may still be considered as an option by districts. Indeed, there are general contractors that are well-prepared to develop and manage a construction project using a LLB contract that meets the requirements of *Davis* and AB 566. As always, CSBA recommends that districts determine whether the LLB delivery method is best suited to meet their individual needs and to consult with legal counsel prior to determining what delivery method is best to use on a particular project. Consultation with legal counsel is particularly important if a school district wishes to use the LLB delivery method because of the still evolving legal issues raised by *Davis*.

## **Additional CSBA Resources**

CSBA’s Construction Management Taskforce: *Delivery Methods Fact Sheet* (2007)

- [www.csba.org/~media/CA9BEE186D424DCEB442EF5AF595F5E6.ashx](http://www.csba.org/~media/CA9BEE186D424DCEB442EF5AF595F5E6.ashx)

## **Additional Non-CSBA Resources (not endorsed by CSBA)**

Design-Build Institute of America: *A Design-Build Done Right Primer* (2015)

- [www.dbia.org/about/Documents/db\\_primer\\_choosing\\_delivery\\_method.pdf](http://www.dbia.org/about/Documents/db_primer_choosing_delivery_method.pdf)

Construction Management Association of America: *An Owner’s Guide to Project Delivery Methods* (2012)

- <https://cmaanet.org/files/Owners%20Guide%20to%20Project%20Delivery%20Methods%20Final.pdf>

## APPENDIX

### Summary of other delivery methods

<p><b>Design-Bid-Build (DBB)</b></p> <p>DBB involves three distinct steps. First, the district hires an architect to design the project; this does not have to be through a formal competitive bid process, though for state funded projects, some degree of competitive process may be required (e.g., Request for Proposal). Second, the district puts the project out to bid; while not required, a statement of qualifications is a good way to determine which general contractors may be capable of working on the project. Prequalification is also required for school districts of 2,500 ADA or more on projects of over \$1 million. Third, the project is given to the general contractor with the lowest responsive and responsible bid, who then contracts with subcontractors to perform the work in accordance with the design. (Be aware that change orders could significantly alter the design and/or cost of the project.) Under DBB – which is the traditional method of construction delivery – the district assumes the risk of cost overruns but also retains control over the project as the general contractor reports directly to the district.</p>	<p><b>Design-Build (DB)</b></p> <p>DB combines the design and construction together and the district then works with a single entity to design the project and then construct it. While districts may choose to award a DB project to the lowest responsible bidder, they may also develop an objective set of criteria to determine which bidder provides “the best value to the school district.” To utilize DB, the project must be worth at least \$2.5 million, decreasing to \$1 million on July 1, 2016. Prior to July 1, 2016, the board must first make specific written findings regarding the benefits of using DB. After July 1, 2016, such written findings are no longer required. Under DB, the financial risk is still born by the district but the district retains more control over the selection and basis for selecting the DB entity. Beginning on July 1, 2016, DB projects must also meet requirements for a “skilled and trained workforce” similar to what is now required for LLB.</p>
<p><b>Multi-Prime (MP)</b></p> <p>MP involves the district assuming the role of the general contractor by contracting directly with <i>each</i> trade contractor (who would be referred to as a subcontractor when there is a general contractor). Each contract with a trade contractor must be competitively bid using the Public Contracts Code. The district may hire a construction manager to assist the district in working with the trade contractors, but the construction manager is not a party to the district’s contracts with the trade contractors. As with DBB, the district separately hires an architect to design the project. This delivery method gives the district the greatest control over all aspects of the project but the district then shoulders all the responsibility for coordination and scheduling of the trade contractors, which is otherwise handled by the general contractor under the other construction delivery methods.</p>	<p><b>Construction Manager at Risk (CMR)</b></p> <p>CMR entails the district hiring the construction manager, via a competitive bidding process, with the lowest responsive and responsible bid to deliver the project at a guaranteed maximum price. The construction manager then contracts directly with subcontractors to perform the work in accordance with the design. While the district separately hires an architect to design the project, the construction manager is often involved in the design process as well. This delivery method reduces the district’s risk with respect to cost but also gives the least control over the project as it is the construction manager that ensures adherence to the project’s design. Please note: there is no consensus over whether and how CMR may be used by school districts. Districts are encouraged to contact legal counsel prior to utilizing CMR.</p>