



BB 4-30-10

MEMORANDUM

To: Dr. J. Brian Sarvis, Superintendent
From: David Hetynok, Director of Facilities and Operations
Carl Mayrose, Project Manager
Subject: Lease Lease-back Construction Delivery Method
Date: March 29, 2010

Background:

Education Code section 17406 authorizes a governing board of a school district, without advertising for bids, to lease property currently owned by a school district to any person, firm, or corporation for a minimum of \$1 per year as long as such document requires the other party to construct a building or buildings upon the subject property and that title to the subject property and the buildings vest in the school district at the expiration of the lease.

This construction delivery method has been used by school districts throughout the State to deliver school facilities on time, on budget, and with a reduced level of public agency risk associated with issues related to the low-bid method of construction delivery.

Issue:

The traditional construction delivery method used by school districts for public projects has been competitive bidding. With this method a contract is let to the lowest responsive, responsible bidder. The intent in this method is to award a contract at the lowest cost with the assumption that any "responsive, and responsible" bidder will ultimately perform the work within budget and to the satisfaction of the owner. In practice, and despite pre-qualification, licensing, and bonding requirements, school districts often find themselves in contracts with general contractors lacking sufficient experience in public school construction and which result in excessive and expensive change orders, claims, and litigation.

With the Lease Lease-back (LLB) construction delivery method a school district may select a general contractor at will and contract with that general contractor for project delivery. LLB has become a popular alternative to competitive bidding in school districts Statewide because it enables districts to select contractors who have performed well for them in the past. In a LLB contract the general

Adams Elementary School Cesar Chavez Charter School Cleveland Elementary School Franklin Elementary School Harding Elementary School	Home School Santa Barbara McKinley Elementary School Monroe Elementary School Open Alternative School	Peabody Charter School Roosevelt Elementary School Santa Barbara Charter School Santa Barbara Community Academy Washington Elementary School	Goleta Valley Junior High School La Colina Junior High School La Cumbre Junior High School Santa Barbara Junior High School	Alta Vista Alternative High School Dos Pueblos High School La Cuesta Continuation High School San Marcos High School Santa Barbara High School
--	--	--	--	--

contractor is a part of the “design-build” team and contributes their expertise regarding means, materials, and projected timelines prior to construction start. This results in fewer change orders, overall project savings, and realistic timelines. Contractors have an incentive to perform well in a LLB atmosphere because they have confidence that a successful project may result in the award of future work.

In a LLB a school district engages in two leases: a Site Lease and a Facilities Lease. The Site Lease is the document in which the school district leases the site or a portion thereof to the builder for \$1 per year. The Facilities Lease is the document the school district utilizes to lease back the property and that sets the fixed price to be paid by the school district for completion of the project (“Guaranteed Maximum Price”). Both leases terminate at the conclusion of construction and ownership of the real property and newly constructed facilities reverts to the public agency.

As LLB is becoming the preferred construction delivery method throughout the State, the State Allocation Board and the Office of Public School Construction have held fact-finding processes that would lead to regulations or guidelines for LLB projects. However, no regulations or guidelines have yet been enacted. While the method is under scrutiny and does have some opponents, LLB is being used in school construction projects throughout the State including projects using State matching funds and in districts operating under the California Uniform Public Construction Cost Accounting Act.

Plan:

The district and the Dos Pueblos Engineering Academy Foundation have been reviewing the LLB delivery method and would like to use this method for the construction of the new Elings Center for Engineering Education at Dos Pueblos High School. We will place an item on the May 11, 2010 agenda for a presentation and consideration by the board.

Attached is an outline from the 2009 Annual Coalition for Adequate School Housing Conference presentation by a legal firm experienced in the LLB construction delivery method, questions and answers during discussions with the Engineering Academy Foundation representatives and a list of districts utilizing this method.

Atkinson, Andelson, Loya, Ruud & Romo
A Professional Law Corporation

C.A.S.H. 30TH ANNUAL CONFERENCE ON SCHOOL FACILITIES
February 23-26, 2009 ♦ Sacramento Convention Center

**LEASE-LEASEBACK
CONSTRUCTION DELIVERY
METHOD:
*Past, Present, and Future***

Patrick A. Gunn, Esq., Partner
Atkinson, Andelson, Loya, Ruud & Romo

The Atrium, Suite 200
5776 Stoneridge Mall Road
Pleasanton, CA 94588
Phone: (925) 227-9200
Fax: (925) 227-9202
pgunn.aalrr.com

aalrr

Atkinson, Andelson
Loya, Ruud & Romo
A Professional Law Corporation

CERRITOS • FRESNO • IRVINE • PLEASANTON • RIVERSIDE • SACRAMENTO • SAN DIEGO

www.aalrr.com

SUMMARY OF LEASE-LEASEBACK PROCESS

Lease-leaseback projects are constructed pursuant to the provisions set forth in Education Code section 17400, *et seq.* (the "Lease Provisions"). Education Code section 17406 authorizes a governing board of a school district, without advertising for bids,¹ to lease property currently owned by a school district to any person, firm, or corporation for a minimum of \$1 per year as long as such document requires the other party to construct (or provide for the construction of) a building or buildings upon the subject property and that title to the subject property and the buildings vest in the school district at the expiration of the lease.

This delivery method of construction has been recognized by many as a way to deliver school facilities on time, on budget, and with a reduced level of public agency risk associated with design issues, delays and costs overruns.

A. DESIGN OF LEASE-LEASEBACK PROJECT

Prior to entering into lease-leaseback documents, school districts must have plans for the project prepared and approved. School districts may retain an architect, utilize a set of pre-approved plans, or contract with a lease-leaseback "team" to provide the necessary plans and specifications for a project. Often lease-leaseback projects include execution of a Preliminary Design Agreement or Preliminary Services Agreement which is entered into with the builder the school district desires to utilize for the construction project, in order to foster a "team-concept" and ensure that the builder contributes to the preparation of the plans and specifications, and is therefore familiar with the undertaking.

To this end, it is most beneficial to the school district to identify the builder the school district will utilize for the project early in the process. If the school district is already underway with its plans, it will be necessary for the chosen builder for the project to familiarize themselves with the plans and specifications, and coordinate with the architect to modify them according to costs savings and feasibility issues. The plans and specifications must then be approved by DSA and adopted by the school district's governing board.

B. CONSTRUCTION OF LEASE-LEASEBACK PROJECT

1. Overview of Education Code Section 17406.

The school district will enter into two leases with the builder for the project to create the lease-leaseback structure: a Site Lease and a Facilities Lease. The Site Lease is the document in which the school district will lease the underlying site, or portion thereof, to the builder for \$1 per year. The Facilities Lease is the document the school district will utilize to lease back the real property

¹ A California Attorney General's opinion concluded that the predecessor to Education Code section 17406 did not require competitive bidding (56 Ops.Cal.Atty.Gen. 572 (1973)). An Attorney General's opinion is not binding, and is merely persuasive. Therefore, a court may come to a different conclusion.

and the completed facility, and will also be the document that sets the fixed price to be paid by the school district for completion of the project ("Guaranteed Maximum Price").

The school district and builder will also enter into a Construction Provisions document for the project that will direct the builder to construct the project pursuant to the approved plans and specifications. Moreover, pursuant to Education Code section 17424, the Construction Provisions will provide that prevailing wages be paid with respect to any construction in accordance with Labor Code section 1720 *et seq.*, and, if applicable, labor compliance program requirements must be followed. The Construction Provisions will also include any other legal requirements with respect to public works projects such as other labor requirements, requirements regarding payment bonds, and assignment of antitrust claims, Field Act compliance, as well as necessary construction contract provisions related to indemnification, payment and performance bonds, and insurance.

2. Lease Payments.

It is through the lease payments that the builder will be paid. Thus, the amount of the payments is based upon the amount that the parties negotiate with respect to the price of completing the project. Once all of the payments are made for the project, all rights to the improvements and the real property will revert to the school district.

Due to California constitutional debt limitations, if any of the lease payments will be made out of a future year's revenue, such lease payments can only commence once the constructed facility is occupied and such payments must not exceed the fair rental value of the facility. In order for the lease payments not to be considered debt under the California Constitution, the Facilities Lease includes appropriation of funds information and there are no provisions that would accelerate the lease payments beyond the current fiscal year.

It is important to note, however, that some argue that the lease arrangement authorized under Education Code section 17406 must constitute a "financing" because revisions to the Code were established as a mechanism to finance school facilities. Nevertheless, we are aware of lease-leaseback projects that have structured the timing of the lease payments similar to that of a normal progress payment schedule without borrowing from an outside source. Although these projects utilized a validation proceeding, discussed in greater detail below, none of them were challenged. Thus, it is unclear how a court would rule with respect to this issue if there was any opposition.

3. Other Restrictions and Limitations.

There are several limitations with respect to the laws governing the lease-leaseback method of construction. First, the term of the Facilities Lease is generally limited to 40 years. Second, prior to entering into the leases, a school district must have selected and approved a site and adopted the design development documents. (Education Code section 17402). Third, the building constructed is subject to whatever State approvals may be required, as set forth in Education Code sections 17280 through 17313. (Education Code section 17421).

There has been some controversy in the past regarding funding implications and the proper use of the lease-leaseback construction delivery method, a summary of which is set forth below.

C. IMPLICATIONS OF LEASE-LEASEBACK PROJECT CONTROVERSY

In light of school districts' increasing level of interest in the lease-leaseback construction delivery method, the State Allocation Board Implementation Committee began a fact-finding process which has failed to lead to SAB regulations or guidance for lease-leaseback projects, but led to a request for legislative amendment of Education Code section 17406 and a warning by the Office of Public School Construction (OPSC) regarding the use of the lease-leaseback construction delivery method.

Specifically, in 2003, at six (6) Implementation Committee Meetings the Committee discussed many issues concerning the lease-leaseback approach. Our office attended each of these discussions on behalf of school district clients interested in the method. These discussions culminated in the presentment of a report to the State Allocation Board in January of 2004, which in turn led to a request for legislative amendment of Education Code section 17406. However, new legislation was not adopted.

Based upon our extensive review of Committee meeting discussions, it is our opinion that lease-leaseback construction projects certainly remain a viable option for school districts. Of the Implementation Committee's issues and informal recommendations, the following items are of particular interest to most school districts interested in the lease-leaseback approach at this time:

1. The Committee has defined a prohibition of using State bond funds (or local match contribution funds) for lease payments to include any school district matching funds.

2. The Committee has acknowledged that any payment that constitutes "debt reduction" would likely be seen as a non-lease payment. To this end, lease-leaseback documents should be drafted to utilize terminology such as "debt reduction payment" or "construction progress payment" in lieu of a mere traditional "lease payment" (and hence the need for two separate payments to contractors when State funds are being utilized). This seemingly unimportant distinction should help facilitate OPSC's blessing of lease-leaseback projects, in audit, or otherwise. This "debt reduction" payment must co-exist with a relatively small true lease payment under the Facilities Lease document, which payment would need to be paid by the school district from other "non-local match" funds.

3. The OPSC and SAB repeatedly commented that lease-leasebacks that utilize no selection criteria or bid process could be deemed illegal contracts for failure to follow public bid requirements of the Public Contract Code. However, no such finding has been made over the past years.

Based on the issues presented above, we reiterate that the lease-leaseback method remains a desirable and suitable method for school facilities construction, but we provide a warning to all school districts that the method is under some scrutiny and has opponents. The State Allocation

Board has not provided a formal policy on that which constitutes a “legitimate” lease-leaseback arrangement, but has simply waited for new legislation on the statute(s) that provide for lease-leaseback construction (the most recent iterations of which were vetoed by Governor Schwarzenegger in the fall of 2005, and in the fall of 2004, respectively.)

Based upon this reasoning, school districts that utilize the lease-leaseback method should be free from detrimental State funding implications and most risk of project challenges by labor organizations and other lease-leaseback opponents. It is our opinion that school districts are free to utilize this method and can be insulated from most “challengeable” issues by having sufficient funds above local match to contribute to the projects, and by filing a validation action (discussed below in greater detail). Additionally, some school districts follow an informal selection or “RFP” process when selecting builders. This step is not required by law, however.

D. PREVAILING WAGE REQUIREMENTS

Lease-leaseback projects are certainly considered a public work under the prevailing wage statutes, Labor Code section 1720 *et seq.*, and require the payment of prevailing wages under current law. A school district’s involvement in a lease-leaseback project will trigger prevailing wage requirements.²

As long as there are some “public funds” used to pay any portion of the construction of the project, the project is a public work. Even if public funds are used only to pay for pre-construction work, such as planning, architectural design, project management and surveying, that work could be considered “construction” by the Department of Industrial Relations (“DIR”) and therefore would still constitute a public work.

E. VALIDATION PROCEEDING

When utilizing the lease-leaseback delivery method, we strongly encourage the filing of a validation action. State funding agencies have virtually “required” validation actions for this type of project. Validation actions can also minimize possible risks associated with a challenge by a taxpayer, labor organization or disgruntled contractor even on non-State funded projects.

A validation action is a preemptive suit in which the school district asks the court to validate the lease arrangements. Government Code section 53982 provides that an action to determine the validity of any resolution, ordinance, agreement, or method of financing may be made pursuant

² The requirement to pay prevailing wages is found in *Labor Code* section 1771 and is triggered on public works projects of one thousand dollars (\$1,000) or more. *Labor Code* section 1720 defines a “public work” as “Construction, alteration, demolition, installation, or repair work done under contract and paid for in whole or in part out of public funds....” Thus, the analysis then focuses on the three requirements of Section 1720, including: whether there is (1) construction, alteration, demolition, installation or repair work; (2) whether such work is done under contract; and (3) whether such work is paid for in whole or in part out of public funds.

to California Code of Civil Procedure (“C.C.P.”) section 860. A public agency may bring an action in the superior court of the county wherein the principal office of the agency is located, within sixty (60) days of enactment of an ordinance adopting the plan, to determine the validity of such a matter. (C.C.P. section 860).

If the school district decides not to file a validation action and a taxpayer or would-be bidder challenges the project after construction commences, the challenger could seek an injunction to halt construction until the legal issues are settled. Moreover, if the project was found to be legally invalid, the school district could be prohibited from paying the builder. We must warn that labor organizations indicate periodically that they may challenge lease-leaseback projects where they feel necessary, especially those that are State funded, given the fact that such projects do not utilize competitive bidding.

For further background information, please note that the procedure of a validation action includes first obtaining the jurisdiction of all parties by giving notice to all interested parties by publication of summons pursuant to section 6063 of the Government Code in a newspaper of general circulation designated by the Court. (C.C.P. section 861). In addition, the Court shall request to the extent reasonably practicable that the filing agency give notice of the pending proceeding by mail or other means ordered by the Court. (Id.). The summons must be directed to all persons interested in the specified matter in order that they may contest, if they so choose, the legality or validity of the matter by appearing in the action and filing a written answer to the filing agency’s complaint not later than ten (10) days after completion of publication of the summons. (C.C.P. section 861.1). The summons must also state in detail the matter sought to be validated and provide a statement that persons who seek to challenge the validity of the matter will not be subject to any punitive action. (Id.). Jurisdiction is deemed complete after the date to respond specified in the summons, and interested parties may not appear and contest the legality or validity of the matter after that date. (C.C.P. section 862).

Furthermore, C.C.P. section 867 provides that validation actions have preference over all other civil matters, highlighting the legislative objective of such actions to limit delay from litigation that could impair a public agency’s ability to operate financially. (*Friedland v. City of Long Beach* (1998) 73 Cal.Rptr. 2d 427, 62 Cal.App.4th 835).

Finally, the judgment in a validation action, if no appeal is taken or if any appeal is affirmed, shall become, without limitations, “forever binding and conclusive.” (C.C.P. section 870). Validation actions operate against the land itself, and bind the filing agency for its actions and all others. (Id.). Therefore, the school district, builder, and any applicable financing institution are protected after obtaining a validation action judgment, unless an appeal is both timely filed and successful.

The information contained in these materials is for informational purposes only and should not be relied upon as a legal opinion or in reaching a conclusion for a particular issue or matter. Atkinson, Andelson, Loya, Ruud & Romo is not responsible for inadvertent errors that may occur in the publishing process.

PATRICK A. GUNN

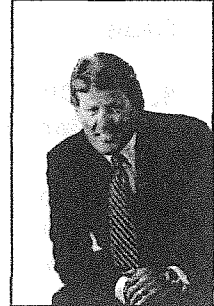
Pleasanton, California

Partner

phone(925) 227-9200

fax (925) 227-9202

email pgunn@aalrr.com



Construction - School/Facilities

Experience

Patrick Gunn is a partner in the Pleasanton office of Atkinson, Andelson, Loya, Ruud & Romo. Mr. Gunn's areas of experience encompass all aspects of civil trial and appellate practice. He focuses on business, construction, and real property transactions, dispute resolution, arbitration and litigation. He represents a variety of large and small public agencies throughout California, as well as private businesses, including land developers, contractors, technology and food service companies. Mr. Gunn has extensive experience in the negotiation of contracts and business disputes, public bid disputes, and litigation of construction claims ranging from defects, delays, and disruption to extras and differing site conditions to liens, stop notices and bond claims.

Education

Mr. Gunn received his Bachelor of Arts Degree with honors from California State University, Sacramento and received his Juris Doctor from Loyola Law School.

Admission

1988, California and U.S. District Court, Northern, Southern, Eastern and Central Districts; U.S. Court of Appeals, Ninth Circuit; U.S. Supreme Court

Membership

Alameda County, Contra Costa County and American Bar Associations; State Bar of California

Publication and Speaking Engagements

Mr. Gunn is a member of the Legal Advisory Committees of the Associated General Contractors of California and the Coalition for Adequate School Housing ("CASH"). He lectures extensively on all aspects of private and public works construction contracts and projects. Mr. Gunn is a contributor to various construction related publications. He has also taught courses with other members of the firm on "Legal Aspects of Construction" at California State Polytechnic University.

SBSD and DPEA Foundation Meeting: Questions Regarding Construction Delivery Methods

The following questions/comments have been submitted by Lars Bildsten and Sandy Seale:

- 1. Clarify the SBSB's choice for LLB (lease lease-back) and the path forward including a proposed new schedule for this management process.**

The LLB project delivery method is codified in the Education Code (17406) and is used successfully in school districts throughout the State for new construction, modernization, renovation, and infrastructure projects. This method allows the District complete freedom to select the general contractor and veto authority regarding selection of sub-contractors. Benefits to the District include a potentially lower project cost, fewer change orders, lower-cost change orders, significantly reduced incidence of claims and litigation, greater probability of timely project completion, and a general contractor with clear incentives to provide a cost-effective, quality, and on-time project.

The LLB method is compatible with State matching funded projects, including CTE granted projects, and with the Uniform Public Construction Cost Accounting Act.

Per counsel, a LLB for the Elings Center for Engineering Education (ECEE) could be developed without impacting the current construction schedule.

- 2. What is the fallback plan and schedule risk if LLB proves not to be a viable option?**

If the decision is made not to use the LLB delivery method the project will be first advertised for bid on May 9th with a start date of July 12th and a finish date of July 23, 2011. Should the DPEA Foundation require more time to consider a decision, the SBSB Planning Dept. has also created a schedule with a first advertising date of May 16th. This would move the start date to August 2nd and maintain the finish date of July 23, 2011.

- 3. What about payment of the additional legal fees?**

Approximately 20-30 hours would be required to set up the LLB. The advertised billing rate is \$230/hr for a range of \$4600 to \$6900. These legal fees would be part of the project cost.

In consideration of these legal fees two items should be noted: first, the advertised hourly rate would be subject to negotiation, and, second, choosing the LLB delivery method would result in a savings in bid costs including printing of construction documents of approximately \$3000+.

If the total cost of the project exceeds the budgeted amount of \$5,990,372 as referenced in the MOU the district would fund these costs out of developer fees pending board approval

<p style="text-align: center;">SBSD and DPEA Foundation Meeting: Questions Regarding Construction Delivery Methods</p>

4. Changes to the MOU.

An amendment to the MOU would address language in the section, "FACILITY CONSTRUCTION." The language would recognize LLB as a legitimate alternative to competitive bidding and make provision for its use.

5. Description of the School Board Approval process.

School districts have statutory authority to award contracts on a lease lease-back basis. As a LLB involves the lease of real property owned by the District, the Board of Education would need to approve the lease. The Board would be given a Brief describing the LLB and it would be an agenda item at a Board meeting. Board members would have an opportunity to question staff and counsel and could then vote to approve or disapprove the LLB or they could table it for further discussion.

Additionally, the Board may make specific findings regarding the use of LLB and may adopt a policy regarding the use of LLB to ensure that its use will result in the best value to the District.

6. We would like a clear description of the two different leases and the time period they cover.

The SBSD would enter into a Site Lease and a Facilities Lease with the contractor.

The Site Lease is the document in which the District leases the relevant portion of the site to the contractor at the rate of \$1 per year.

The Facilities Lease is the document the District utilizes to lease back the real property and the completed facility. It is also the document that sets the fixed price to be paid by the District for completion of the project ("Guaranteed Maximum Price"). The District makes payments on this lease that are similar to construction progress payments and result in the entire GMP being paid on completion of construction.

Both leases terminate at completion of construction.

7. "The Committee has defined a prohibition of using State bond funds (or local match contribution funds) for lease payments to include any school district matching funds." Does this apply to this project?

SBSD and DPEA Foundation Meeting: Questions Regarding Construction Delivery Methods

The SAB Implementation Committee has acknowledged that any payment that constitutes "debt reduction" would likely be seen as a non-lease payment. Counsel has advised the District that LLB is a suitable construction delivery method for this project.

- 8. Is a validation action something we need to do? What are the implications and cost of filing one versus not filing one? If we do file one, how long does it take and does it slow down the schedule?**

Per counsel, "A validation action is the most conservative and prudent course, but would likely not be filed in your case because it would impact your desired start of construction."

- 9. There is some reference to an RFQ—how does that work?**

A Request for Qualifications can be issued to develop a list of general contractors as a step in a selection process. The RFQ could be publicly advertised or sent to an existing list of contractors. Typically a group of stakeholders would review the submitted RFQ's and select a small number of candidates to interview. The finalists could be considered for LLB contracts.

There is no requirement for a school district to use an RFQ process in the selection of a suitable contractor.

The following submitted questions address the competitive bidding process:

- 1. What is the qualification process for contractors?**

For this project, a formal pre-qualification submission to an independent construction qualification company would be required. The pre-qualification document requires data on the contractor's business, applicable experience, finances, legal history, licensing, bonding history, and other relevant details. The independent analyst issues a statement for each contractor indicating whether or not they appear to meet the pre-qualification criteria.

- 2. What are our options if we like NONE of the bids? Do we need to make substantial changes before rebidding?**

The District has the right to reject all bids. Bids are most commonly rejected because they exceed the budget, the bid documents are incomplete, or the contractor is not considered responsive. If the low bid is too high the project is usually changed in some way before rebidding.

**SBSD and DPEA Foundation Meeting: Questions Regarding
Construction Delivery Methods**

3. What's the frequency of DSA inspectors during a job like this?

DSA requires the project be continuously inspected. This project will require a full-time inspector plus specialty inspection services at various times in the construction. Examples of these specialty inspections include soil compaction, structural welding, and water testing.

4. Can you give us an example of a recent advertisement so we can see what these look like?

Yes.

<p>Partial List of School Districts Using the Lease Lease-back Construction Delivery Model</p>

Vacaville USD

Poway USD

LA USD

Yuba City USD

Yuba City Community College District

Marysville Joint USD

Fall River Joint USD

Piedmont USD

Pasadena USD

Sacramento City USD

Alvord USD

Folsom Cordova USD

Palo Verde USD

Santee USD

Sierra Sands USD