

Financing Now Required for Lease-Leaseback Agreements

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***Davis v. Fresno Unified School District, et al.* (2015) ___ Cal.Rptr.3d ___ [2015 WL 3454720]**

On June 1, 2015, a California Court of Appeal held for the first time that in order for a lease-leaseback transaction to be valid, allowing the competitive bidding exemption to apply, the leases must be “genuine”, containing both a financing component and a lease term, during which the District occupies and uses the improvement. (*Davis v. Fresno Unified School District, et al.* (2015) ___ Cal.Rptr.3d ___ [2015 WL 3454720].) Under the *Davis* Court’s holding, financing will now be required on school district lease-leaseback projects.

Background

In 2012, the Fresno Unified School District (District) entered into an agreement, utilizing the lease-leaseback construction delivery method for the construction of improvements at one of the District’s middle schools. Under this arrangement, the District leased the project site to the contractor through a Site Lease. The contractor then constructed the project on the site and leased the improvements and site back to the District through a Facilities Lease (the leaseback). Plaintiff Stephen Davis, a taxpayer, filed a lawsuit against the District and the contractor, challenging this arrangement and contending, in relevant part, that this was an invalid arrangement because it did not satisfy the statutory criteria for lease-leaseback.

The District and the contractor demurred on the grounds that the complaint failed to state facts sufficient to constitute a cause of action. The trial court agreed, sustained the demurrers, and judgment was entered in favor of the District and contractor. Davis appealed.

Decision

The Court of Appeal disagreed with the trial court, holding that the exception to the competitive bidding requirement in Education Code section 17406(a) (section 17406(a)) only applies if the leases are “genuine”, meaning, that they include both a lease term during which the District uses the improvement and a financing component.^[1] This, the court reasoned, accomplishes the primary legislative intent of lease-leaseback – to provide a source of financing for the construction of schools, enabling districts to avoid the constitutional debt limit while making payments over time.

With regard to the lease term, the court found that, contrary to the requirements of section

17406(a), the Facilities Lease did not provide for the District's use of the newly constructed buildings during the term of the lease. Instead, the leases terminated upon final payment at project completion and acceptance of construction. Based upon this finding, the court concluded that the Facilities Lease was not a true financing lease in that it did not include a financing component and was instead, more like a traditional construction contract.

Finally, in addition to the financing requirement, the court expressed reservations about the propriety of a lease-leaseback developer also serving as a consultant under a preliminary services agreement, holding that the plaintiff had stated a cause of action for a violation of section 1090 of the Government Code.

Impact

For many years, Dannis Woliver Kelley has been advising its clients to ensure their lease-leasebacks include provisions which would avoid the result in the *Davis* case; specifically, by including a financing component with a schedule of lease payments made over time, commencing when the school district occupies the newly constructed premises. Also, districts should strongly consider filing validation actions following approval of the lease-leaseback agreements in order to resolve any outstanding issues prior to the commencement of construction.

Please note, on June 11, 2015, Dannis Woliver Kelley will be hosting a webinar on the *Davis* decision and its impact on the lease-leaseback delivery method, pending lease-leaseback legislation, and recommended best practices.

^[1] Notably, the court did affirm the holding in *Los Alamitos Unified School District v. Howard Contracting, Inc.* (2014) 229 Cal.App.4th 1222, that, assuming the leases are genuine, section 17406 exempts lease-leaseback from competitive bidding, and this exception applies to both the Site and Facilities Lease. Further, the appellate court confirmed that the use of lease-leaseback is not limited to situations in which school district funds are not otherwise available.

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