

# Update: Financing Essential for Lease-Leaseback Contracts to be Eligible for Validation, Otherwise Disgorgement May be Available After Project Completion

Vol. 2020, No. 10 | December 03, 2020

California's Fifth Appellate District issued a new opinion in a long-running court battle over the legality of school district lease-leaseback construction contracts. (*Davis v. Fresno Unified School District* (Cal. Ct. App., Nov. 24, 2020, No. F079811) 2020 WL 6882737 ("*Davis II*").) The case alleged that a contractor and school district violated competitive bidding and conflict of interest laws by entering a lease-leaseback contract for the construction of a school facility. The trial court held that the legality of the contracts was moot because the plaintiff is not entitled to disgorgement under the validation statutes. In this latest opinion, the appellate court held that, in this specific set of circumstances, the entire legal action was not moot and the taxpayer may seek the disgorgement (i.e., the return) of payment made to the contractor for construction of the facility.

In reaching this holding, the Court of Appeal concluded that the contract could not be immunized from legal attack through a court validation proceeding because the lease-leaseback contract at issue does not include financing. Therefore, a taxpayer can challenge the contract for alleged violations of competitive bidding laws and conflicts of interest. Without court validation, a taxpayer can seek disgorgement notwithstanding the completion of the project, because the money could still be returned.

As explained below, this decision reinforces the importance of including financing obligations in lease-leaseback contracts.

## **Background**

The lease-leaseback project delivery method, authorized under Education Code section 17406, permits a school district to lease land to a contractor who constructs or improves a facility on the leased land. After the construction is complete, the contractor leases the facility back to the school district until the district's lease payments are fully paid. Under the prior version of section 17406, the contractor may be selected without bidding. The proper procurement of a lease-leaseback contract has been the subject of numerous lawsuits for several years.



DANNIS WOLIVER KELLEY

Attorneys at Law

In 2015, in an earlier appeal in this litigation, the Court of Appeal reversed the trial court's dismissal of the plaintiff's complaint, finding the plaintiff had properly alleged the lease-leaseback contract at issue was not a proper lease and therefore must comply with competitive bidding requirements and was made in violation of conflict of interest statutes. (*Davis v. Fresno Unified School Dist.* (2015) 237 Cal.App.4th 261, 271 ("*Davis I*").)

The competitive bidding claim was supported by allegations that the bidding exception under Education Code section 17406 did not apply because, among other issues, the lease-leaseback contract did not have a financing component. Because the lease-leaseback contract contained only progress payments, the lease-leaseback contract was no different from regular construction contracts and should be subject to competitive bidding requirements.

The conflict of interest claim was supported by allegations that the contractor and district had entered a separate preconstruction services agreement before entering into the lease-leaseback contract for the project. Based on its influence on the district during preconstruction services, the contractor could have an impermissible conflict of interest because they have a financial interest in the subsequent lease-leaseback contract. (Note that the Legislature later amended Education Code section 17406 to permit districts and contractors to include preconstruction services in the lease-leaseback contract, which may eliminate this type of conflict altogether.)

Because the allegations in the complaint were sufficient to state a claim against the contractor and district, the Court of Appeal remanded the case to the trial court. At trial court, the district moved for judgment on the pleadings on the ground that the complaint was moot (i.e., no longer an actual controversy) because the contractor had completed the project and contract. The trial court granted the motion and entered a judgment dismissing the complaint, leading to this appeal.

## **Decision**

Now, in *Davis II*, the Court of Appeal has reversed the judgment and revived the taxpayer's complaint. The opinion explains that the complaint functioned as both (i) a reverse validation action under Code of Civil Procedure section 863 and (ii) a taxpayer action under Code of Civil Procedure section 526a.

The reverse validation action sought a judgment that the lease-leaseback contract was invalid. The Court of Appeal determined that this portion of the case was moot, because reverse validation only provides a declaration of whether a contract is valid, and receiving such a declaration after the construction project was complete and the contract had been fully performed would not be effective relief.



DANNIS WOLIVER KELLEY

Attorneys at Law

The Court of Appeal also analyzed the taxpayer action, which sought the contractor's return of payment on the allegedly invalid lease-leaseback contract. The Court of Appeal found that the taxpayer action is not moot and could proceed at the trial court level. The Court of Appeal reasoned that, although the construction project was complete, relief could be obtained by requiring the contractor to return the money received for its work (i.e. disgorgement)—assuming that the taxpayer can prove his case at trial.

Notably, the Court of Appeal also discussed the lease-leaseback contract's lack of financing and how that precluded application of validation statutes, which could have otherwise insulated the lease-leaseback contract from the taxpayer action under section 526a. Per the Court of Appeal, validation applies only to certain contracts that relate to indebtedness. In the present case, the lease-leaseback contract did not have a financing component so validation statutes do not apply. Meaning, the lease-leaseback contract was not capable of being validated and legally insulated from attack, and the taxpayer action could still proceed. Accordingly, the appellate court again remanded the case to the trial court for further proceedings.

## Impact

*Davis II* decided a narrow issue of mootness for a specific case under a specific set of circumstances. The appellate court did not decide that the lease-leaseback contract was unlawful or that the contractor must disgorge payment. These determinations are reserved for the trial court.

Still, the decision is an important reminder that at least one California appellate district has interpreted Education Code section 17406 as mandating a financing component for lease-leaseback contracts, and that failing to include a finance component may preclude a lease-leaseback contract from the legal protection of validation. Two other appellate districts have taken a more permissive interpretation and disagreed that financing is required by the statute without examining the validation issue in the same detail as *Davis II*. (See *California Taxpayers Action Network v. Taber Construction, Inc.* (2017) 12 Cal.App.5th 115; *McGee v. Balfour Beatty Construction, LLC* (2016) 247 Cal.App.4th 235.) This leaves an unresolved split of authority with regard to the proper structure of a lease-leaseback construction contract that will only be resolved with a Supreme Court decision. If lease-leaseback contracts do not include financing obligations consistent with the *Davis I* and *Davis II* interpretation of the lease-leaseback and validation statutes, then there may be the risk of judicial invalidation of the contract and a disgorgement order — a risk, as shown in *Davis II*, that will not necessarily be reduced by the passage of time and successful completion of the project.

For further information regarding the impact of this decision on your district's lease-leaseback contracts or assistance with your district's construction program, please contact a member of our Construction Practice Group.



DANNIS WOLIVER KELLEY

Attorneys at Law

## **PRACTICE AREAS**

- Business and Property
- Construction