

The “Lease Lease-Back”

Exciting New Method for School Delivery

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Introduction

For over the past hundred years, public schools have been classified as part of a community’s infrastructure – paid for and built in a process little different than the same used to construct roads, bridges and other public works projects. As we move into the 21st century, we are finding ourselves in a highly competitive global market where outsourcing of labor and technology has put more importance on quality education for this nation’s youths than ever before. Unfortunately, the manner in which public schools are funded typically means the delivery of a much needed school lags significantly behind voters approving local or state general obligation bonds and/or a time when local developer fees from home sales have amassed enough to fund the school. Whenever you see schools forced into double sessions, high student-to-teacher ratios and leased portable classrooms scattered about athletic fields and parking lots, you are witnessing a result of this antiquated process.

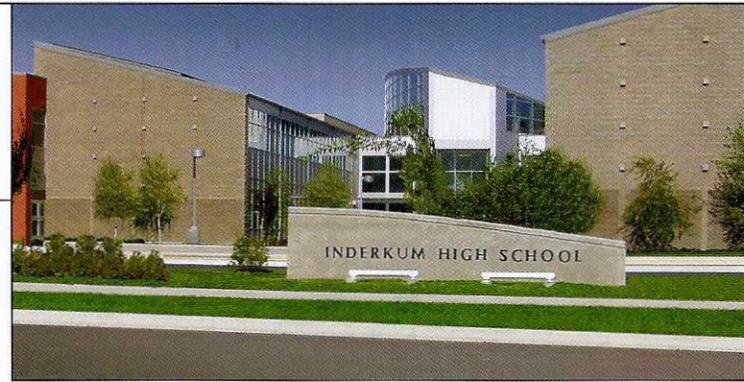
But a methodology for alternative funding and construction of schools is emerging across the country. It allows school districts to obtain funding from outside sources while concurrently having the private sector take on all construction risks and potential cost overruns. It is called the “lease lease-back” delivery method, and is the focus of this article.

This article examines California Public School Districts and the enabling legislation that provides this option for school construction. However, the advantages and challenges in using this delivery method are also found in other public sectors, including, among others, the construction of higher level education facilities, adjudicated youth housing, detention centers and administrative offices.

California Education Code 17406 (“Lease Lease-Back”)

Two sections within the California Education Code provide a conceptual departure from other delivery methods in that they allow a developer to finance, build, own and lease completed facilities to public school districts. Although previous versions of these delivery methods have been in the Education Code since the 1970s, they have recently gained a lot of attention for various benefits they provide school districts.

The first of these methods, Section 17406 of Article 2, is more commonly referred to as a lease lease-back development. In this scenario, the school district leases real property it owns to a developer through a site lease for a minimum rent of one dollar per year. The developer subsequently finances and constructs the facility, then leases the facility back to the school district through a facility lease (hence the term “lease lease-back”).



A second but more obscure delivery method is found in Education Code Section 17407 of Article 2. This delivery method is very similar to Section 17406 but with two significant differences. First, unlike Section 17406, Section 17407 requires the developer to own the designated site upon which the building will be constructed; therefore, both the site and completed facilities are leased to the district under a single lease. Technically this process is not a “lease lease-back”; however, it is often included in the context of lease lease-back discussions. The second difference found in EC 17407 is the requirement that the school district must advertise for bids prior to awarding the contract. Both delivery methods provide that title to the facilities must vest with the district upon lease expiration or in the event the lease is terminated early through the exercise of a purchase option. The Education Code limits the terms of all leases for both methods to 40 years.

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These construction financing options are often misconstrued as forms of “design-build” as the district is less involved in the construction contracting. But in its simplest terms, design-build contracting, which is addressed in a separate section of the Code, involves the consolidation of the architect’s contract with the construction contract. The assumption that lease lease-back developments are a form of design-build is not only incorrect, but in California, if the district seeks to enter into a lease to build a “school building” the Code requires that the district must first have the school designed and then approved

by the Division of State Architect (DSA). This precludes the ability to structure the lease lease-back contract as a form of design-build. However, if the district desires to build administrative offices or other facilities not falling within the definition of a “school building”, there appears to be no prohibition for entering into a lease lease-back arrangement prior to DSA approval.

Another misconception is that since the developer is technically the owner of the building and is a private entity, the developer is exempt from labor requirements found in the other delivery methods used by school districts. Section 17424 clearly establishes that when developing under a lease lease-back arrangement, the developer must comply with general prevailing wage rates as established by the Department of Industrial Relations. Hence, labor compliance programs should be established when using the lease lease-back method.

Eligibility for State Funding

State funding for the acquisition of school facilities that are privately owned and financed is granted under Education Code Section 17072.35. This Code establishes that State grant funding for new construction may be used to acquire an existing government or privately owned building, or a privately financed school building, and for the necessary costs of converting the government or privately owned building for public school use.

Historically, the Office of Public School Construction (OPSC) has made determinations as to the eligibility of State funding for any given lease lease-back development on a case-by-case basis. To date, neither the State Allocation Board (SAB) nor the OPSC have taken a position on when the use of lease arrangements under Sections 17406 and 17407 is appropriate or when exemption from competitive bidding generally required by the Public Contracts Code is valid. It has been the position of the OPSC that the obligation to determine the appropriate and legitimate use of any contract delivery method permitted in law rests with the school district and its governing board, not the OPSC. They have also made it clear that the granting of State funds in any given project does not constitute a validation of the legality of the contractual arrangements used for that project. Thus, the onus for assuring legal compliance to the Education Code falls solely upon the school district.

However, the consistent misuse of lease lease-backs by some districts solely to avoid the competitive bidding process has increased the level of scrutiny by the SAB. The following is an excerpt of a report issued by the OPSC regarding lease lease-backs that underscores their concerns:

"In broad terms there are currently two types of lease, lease-back arrangements being used to construct state funded projects:

- 1. The project is financed by the developer/contractor team and the district pays a yearly lease to use the facility. The district makes no other payments to the developer, who carries the outstanding cost of the project. The lease, by law, may be up to 40 years in length. It may include an agreement to terminate the lease at any time.*
- 2. The project is paid in full by the district with state or local funds, or a combination of both. In this case a 'lease agreement' may exist, but it is designed to be terminated at the end of the construction. The lease payments, if any, are made during the course of construction and at the completion of the project. They are essentially progress payments as would be found on a traditional construction contract in that they constitute the entire cost of the construction project.*

Staff [OPSC] believes that agreements structured in situation #1 when competitively bid, constitute the intended use of Article 2 and of EC 17406 in particular."

The report also addresses the concern that projects developed under the second scenario were contracted in a manner solely to avoid competitive bid requirements. It states:

" It has been the position of the OPSC that the obligation to determine the appropriate and legitimate use of any contract delivery method permitted in law rests with the school district and its governing board, not the OPSC."



"...Although EC Section 17406 is clear in allowing districts to use lease lease-back agreements without competitive bidding, a lease lease-back agreement may be subject to challenge in court if the agreement is really a contract for construction and is not created for the purpose of financing the project. Ultimately, the courts could find such agreements to be illegal and the contracts or agreements void."

Because of the concern by the SAB and OPSC of misapplication of this delivery method, some districts are seeking validation actions to justify the manner in which their lease lease-back projects were developed. A validation action basically requests the court to make a ruling on the validity of the contracts and is ultimately used to support the district's future application for State funding.

The good news is that the lease lease-back continues to receive backing at the highest levels in government. To date, two assembly bills designed to restrict usage of the lease lease-back have failed. AB 1486 (Dutra) introduced to the Assembly last year would have required school districts to engage in a detailed competitive proposal process to award lease lease-back contracts. After it failed, it was resurrected as AB 1097 (Mullin), with an added condition that would have exempted districts with project labor agreements from many of the procedural requirements of its competitive proposal process. Both bills were vetoed by Governor

Schwarzenegger, the most recent being in October, 2005, with the following veto comments issued by the Governor:

"I am generally supportive of using a competitive process for public works projects, however, this bill imposes restrictions on lease-leaseback contracts that could limit competition, inadvertently limit flexibility for schools, and drive higher administrative costs, thereby potentially increasing the overall cost of building school facilities."
- Governor Arnold Schwarzenegger

The OPSC has recognized the lease lease-back as a valuable delivery option for school districts and continues to apportion State funds for its use. However, given the dynamics of the political environment surrounding this delivery alternative, it is well advised that school districts retain developers and legal counsel experienced in successful funding and developing schools wherein full State grant monies were received subsequent to completion.

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Lease Lease-back Advantages and Disadvantages

There are numerous benefits of these delivery approaches:

- **Immediate funds for school projects:** When a district does not have funding for a needed school, this approach allows the district to immediately begin school construction as the developer funds the project. The lease lease-back arrangement can be either a bridge or a longer term financing mechanism.
- **Guaranteed price:** The district is able to negotiate a fixed price for the lease and, if necessary, the purchase price of the project. Unanticipated costs are the responsibility of the developer, not the school district.
- **Risk reduction for the school district:** Because the developer guarantees performance and completion of the project, the district is relieved of much of the financial and legal risks of construction.
- **Increased motivation for performance:** Because the developer takes on most of the completion risks, there is a high level of motivation to manage costs and meet deadlines.
- **Single point of contact:** The developer/contractor acts as a single point of responsibility making the process more efficient for the district.
- **Cost savings:** Districts are often of the opinion that when a reputable and qualified developer is used, privatization of the development process creates efficiencies and cost savings not within the reach of many governmental agencies. This may include value engineering or the ability of the developer to negotiate with subcontractors in a manner whereby a public agency cannot. Further, the process can reduce the number of consultants and resources required by the district as the developer takes on the roles of both project funding and delivery.
- **Optimization of staff resources:** It can also unburden and/or augment over-worked district staff as the developer takes on an expanded role of project oversight.
- **Professional expertise:** Many school districts do not have experience with large construction projects. The responsibility for coordination of the project, obtaining required approvals, and project scheduling become the developers, who have demonstrated experience in similar projects.
- **Team approach:** Districts that have used this approach are generally of the opinion that the lease lease-back allows a team approach with the district playing an integral part. This is because the district, developer and contractor all have an interest in project completion on time and within budget.
- **Known Contractor:** The lease lease-back allows selection of a contractor based upon record of success, references from previous clients and financial strength as opposed to a “lowest bid”.



- **Larger list of interested contractors:** The increasing use of lease lease-back projects is drawing contractors and subcontractors from other industries that are normally not interested in participating in the low bid process, but are interested in the negotiated contracts as permitted by the lease lease-back process. This brings new and highly qualified contractors into the school construction arena.

Although there are many benefits to delivery using these methodologies, there are potential challenges in their use, which include:

- **Added costs:** Added costs are incurred due to the developer's fee and costs associated with any financing the developer needs for the project. This includes carried (capitalized) interest during construction.
- **Additional contract documentation:** The introduction of leases into the process also creates more documents; however, this is mitigated through the district not being a party to the construction contract, which is held between the developer and the contractor.
- **Future rent payments must be budgeted:** In addition, the district must plan for payment of rent if the facilities lease does not terminate shortly after construction.

Conclusion

California is but one of many states that have begun to use the lease lease-back delivery method at an increasing rate. As addressed herein, there are numerous benefits to this process including access to immediate school construction funds, guaranteed price and delivery date, professional oversight, cost savings and better selection of contractors. Its growing popularity, however, has outpaced the regulatory environment wherein policies are formulated. The good news is that the OPSC continues to apportion State funds for these projects, provided compliance to existing regulations are met and the process is not used as a subterfuge to get around competitive bid requirements found in other Codes of California law.

Mr. Baize is CEO of Brookhurst Development, a development firm specializing in development of public facilities. He is considered a foremost authority on lease lease-back construction for California public schools. For more information on Brookhurst Development, visit www.brookhurstcorp.com