

**State Allocation Board
Implementation Committee
June 6, 2003**

LEASE LEASE-BACK AGREEMENTS

This matter is being presented to the State Allocation Board for two purposes:

- Advise the SAB that projects constructed under lease Lease-back agreements are being recommended for reimbursement and to obtain SAB concurrence that that is a permissible use of state bond funds, and
- Propose amendments to current regulations necessary to clarify requirements for funding particular to lease lease-back arrangements.

Discussion

The Use of Education Code Section 17406 (Lease Lease-Back) as a contracting method.

Education Code Section 17406 provides a mechanism whereby a district may let district real property to a development entity without competitive bidding if the developer will construct a school facility and lease it back to the district. An increasing number of districts are using this approach to construct new facilities and modernize existing facilities. The districts then request State funding for the purpose of buying out the lease and acquiring the facility.

School districts which have used the Lease, Lease-back project delivery method cite the following as reasons for selecting it over the traditional design, bid, build approach:

- Avoid competitive bidding
Many districts consider the competitive bidding process as required under the Public Contracts Code to be problematic. The process leaves them with little control over the selection of the contractor for the project, and places them in financial jeopardy if the contractor selected is unwilling or unable to perform the construction as planned. The L, L-B process allows the district to select the contractor / developer based on criteria other than cost.
- 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 contractor / developer, not the school district.
- Team approach
Districts have expressed the opinion that L, L-B allows a team approach to the construction of school facilities. The district, developer and contractor all have an interest in a project completed on time and in budget.
- Known contractor
Contractors can be selected on the basis of their record of success, recommendations from previous clients and financial strength.
- No experienced staff at district
Many districts do not have experience with large construction projects. The responsibility for co-ordination of the project, obtaining required approvals, and

Discussion (cont.)

project scheduling become the contractor / developers, who have demonstrated experience in similar school construction projects.

- ❑ Value engineering opportunities
- ❑ Contractors and subcontractors come from other industries; not the same as usually bid on school projects

Although the law in EC 17406 is clear in allowing districts to proceed on lease lease-back arrangements without competitive bidding, there may be reasons to proceed cautiously when using lease lease-back arrangements. Primary among these is summarized in the Supreme Court majority opinion in *The City of Los Angeles v. Offner* where the following was stated:

"It has been held generally in the numerous cases that have come before this court involving leases and agreements containing options to purchase that if the lease or other agreement is entered into in good faith and creates no immediate indebtedness for the aggregate installments therein provided for but, on the contrary, confines liability to each installment as it falls due and each year's payment is for the consideration actually furnished that year, no violence is done to the constitutional provision. If, however, the instrument creates a full and complete liability upon its execution, or if its designation as a 'lease' is a subterfuge and is actually a sales contract in which the 'rentals' are installment payments on the purchase price for the aggregate of which and immediate and present indebtedness or liability exceeding the constitutional limitation arises against the public entity, the contract is void."(underlining added)

Thus, while the benefits anticipated by districts using lease lease-back may be many, the provisions of EC 17406 may only be used in specific circumstances. It appears to the Office of Public School Construction that some of these circumstances may not truly exist in all lease lease-back contracts.

- ❑ The lease lease-back must be entered into in 'good faith'. Presumably that means that both parties to the agreement intend that a lease arrangement will exist and will be implemented.
- ❑ The lease arrangement may not be a subterfuge. Many districts openly admit that they are using lease lease-back contracts for the perceived benefits listed earlier.
- ❑ The agreement may not create an immediate indebtedness beyond each yearly installment. Some agreements require 'pre-lease' or 'rental' in one form or another which amount to the full cost of the facility. It appears that an immediate indebtedness has been created by the agreement which is being satisfied.
- ❑ The District must own the site on which the project will be constructed. Under EC 17402, the district owns the site if it holds title, has an option to purchase, or is acquiring the site through eminent domain. An arrangement whereby the option to purchase the site is with the developing entity could be construed as a subterfuge to avoid EC 17407. That section allows lease lease-back on

Discussion (cont.)

property owned by others, but specifically requires competitive bidding of the agreement.

To date, the OPSC has not taken a position on these potential issues, believing that defense of the use of EC 17406 rests with the district using the process. However, if a lease lease-back agreement is found by the courts to be inappropriate or to have been a subterfuge as defined by the Supreme Court, the agreement is void. If the agreement is voided, then it would appear that funds were released in conflict with the SFP law and that a 'material inaccuracy' occurred. In that case, the SAB will not be able to avoid involvement even though it was not a party to the decision to use a lease lease-back arrangement.

OPSC Policy Positions

Over a period of several years, the OPSC has responded to individual school district questions on issues related to the use of the provisions of EC 17406. These responses have begun to form the office's informal policy on lease lease-back project delivery methods. The responses are summarized below by general topic:

- The District must have title to the site on which the project will be constructed at the time that the apportionment is approved by the SAB.
- The lease agreement must contain the following provisions or information:
 - The value of the lease.
 - A provision that the title to the improvements on the site shall vest with the District upon completion of the project.
 - A provision that the lease agreement shall terminate within 180 days of the filing of a notice of completion or occupancy of the project by the District, whichever occurs first.
- State bond funds may not be used to make lease or rental payments.

Staff believes that these policies need to be approved by the Board and formalized through the regulatory process.

Proposals

Clarify that lease lease-back agreements meeting the requirements of EC 17406 may be used as a means of constructing or modernizing school facilities otherwise eligible under the SFP. Add regulation section 1859.23 as follows:

1859.23 SFP Application for Funding of Property Leased Under the Provisions of Education Code Section 17406.

In addition to meeting the requirements of Sections 1859.20 and 1859.21 or

Proposals (cont.)

1859.120, a district may receive SFP funds for facilities that have been constructed or modernized, or will be constructed or modernized, under a lease agreement pursuant to Education Code 17406 provided the following are met:

- (a) At the time the funding application is approved by the State Allocation Board, the district has title to the site or meets one of the following:
 - (1) the site acquisition is in final escrow,*
 - (2) the district is leasing the site for a term specified in 1859.22 (b), (1), (2) or (3) and the property lease is not connected to or a part of the lease lease-back agreement created under EC 17406.*
 - (3) the district has filed an action in eminent domain and has received and order of immediate possession of the site.**
- (b) A lease provision that title to the improvements on the site shall vest with the district upon completion of the project.*
- (c) A lease provision that the lease agreement shall terminate within 180 days ~~from the filing of a notice of completion or occupancy of the project by the district, whichever occurs first.~~ Of a funding approval by the Board or occupancy of any portion of the project, whichever is later.*
- (d) The Application for Funding is filed with the Board not later than occupancy by the district of any part of the project.*
- (e) No funds from state bonds are used for lease or rental payments on the project.*

Strike Section 1859.30(i) (5) and substitute the following:

(5) Where the funding was not approved under this Chapter and the district has not taken occupancy of the classroom.

Legal References

17072.35. A grant for new construction may be used for any and all costs necessary to adequately house new pupils in any approved project, and those costs may only include the cost of design, engineering, testing, inspection, plan checking, construction management, site acquisition and development, evaluation and response action costs relating to hazardous substances at a new or existing schoolsite, demolition, construction, acquisition and installation of portable classrooms, landscaping, necessary utility costs, utility connections and other fees, equipment including telecommunication equipment to increase school security, furnishings, and the upgrading of electrical systems or the wiring or cabling of classrooms in order to accommodate educational technology. A grant for new construction may also 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.

17400. (a) Any school district may enter into leases and agreements relating to real property and buildings to be used by the district pursuant to this article.

(b) As used in this article, "building" includes each of the following:

- (1) One or more buildings located or to be located on one or more sites.
- (2) The remodeling of any building located on a site to be leased pursuant to this article.
- (3) Onsite and offsite facilities, utilities or improvements which the governing board determines are necessary for the proper operation or function of the school facilities to be leased.
- (4) The permanent improvement of school grounds.

(c) As used in this article, "site" includes one or more sites, and also may include any building or buildings located or to be located on a site.

17401. As used in this article "lease or agreement" shall include a lease-purchase agreement.

17402. Before the governing board of a school district enters into a lease or agreement pursuant to this article, it shall have available a site upon which a building to be used by the district may be constructed and shall have complied with the provisions of law relating to the selection and approval of sites, and it shall have prepared and shall have adopted plans and specifications for the building that have been approved pursuant to Sections 17280 to 17316, inclusive. A district has a site available for the purposes of this section under any of the following conditions:

(a) If it owns a site or if it has an option on a site that allows the school district or the designee of the district to purchase the site. Any school district may acquire and pay for an option containing such a provision.

(b) If it is acquiring a site by eminent domain proceedings and pursuant to Chapter 6 (commencing with Section 1255.010) of Title 7 of Part 3 of the **Code** of Civil Procedure, the district has obtained an order for possession of the site, and the entire amount deposited with the court as the probable amount of compensation for the taking has been withdrawn.

(c) In the case of a district qualifying under Section 17410, if it is leasing a site from a governmental agency pursuant to a lease having an original term of 35 years or more or having an option to renew that, if exercised, would extend the term to at least 35 years.

17403. The term of any lease or agreement entered into by a school district pursuant to this article shall not exceed 40 years.

17404. Sections 17455 to 17480, inclusive, shall not apply to leases made pursuant to this article.

17405. Any lease or agreement shall be subject to the following requirements:

(a) A building or structure that is to be used for school purposes shall be subject to the provisions of Article 3 (commencing with Section 17280) and Article 6 (commencing with Section 17365). A building or facility used by a school district under a lease or lease-purchase agreement into which neither pupils nor teachers are required to enter or that would be excluded from the definition of "school building," as contained in Section 17368, shall not be considered to be a "school building" within the meaning of Section 17283.

(b) Subdivision (a) shall not apply to trailer coaches used for classrooms or laboratories if the trailer coaches conform to the requirements of Part 2 (commencing with Section 18000) of Division 13 of the Health and Safety **Code**, and the rules and regulations promulgated thereunder concerning mobilehomes, are not expanded or fitted together with other sections to form one unit greater than 24 feet in width, are used for special educational purposes, and are used by not more than 12 pupils at a time, except that the trailer coaches may be used by not more than 20 pupils at a time for driver training purposes.

(c) The site on which a leased relocatable structure is located shall be owned by the school district, or shall be under the control of the school district pursuant to a lease or a permit. "Relocatable structure" is any structure that is designed to be relocated.

(d) For purposes of interconnection of fire alarms, buildings leased for 24 months or less shall be subject to Section 809 of the Uniform Building **Code** until applicable regulations proposed by the State Fire Marshal are adopted as part of Title 24 of the California **Code** of Regulations.

(e) Notwithstanding any other provision of law, this section shall become operative on September 30, 1997.

17406. (a) Notwithstanding Section 17417, 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 such 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 thereof, 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 such other terms and conditions as the governing board may deem to be in the best interest of the school district.

(b) Any rental of property that complies with subdivision (a) shall be deemed to have thereby required the payment of adequate consideration for purposes of Section 6 of Article XVI of the California Constitution.

17407. The governing board of any school district may enter into an agreement with any person, firm, or corporation under which that person, firm, or corporation shall construct, or provide for the construction of, a building to be used by the district upon a designated site and lease the building and site to the district. The instrument shall provide that the title to the building and site shall vest in the district at the expiration of the lease, and may provide the means or method by which the title to the building and site shall vest in the district prior to the expiration of the lease, and shall contain such other terms and conditions as the governing board of the district deems to be in the best interest of the district.

The agreement entered into shall be with the lowest responsible bidder who shall give the security that any board requires. The board may reject all bids. For the purpose of securing bids the board shall publish at least once a week for two weeks in some newspaper of general circulation published in the district, or if there is no paper, then in some paper of general circulation circulated in the county, a notice calling for bids, stating the proposed terms of the agreement and the time and place where bids will be opened.

17424. The governing board of the school district shall obtain the general prevailing rate of per diem wages from the Director of the Department of Industrial Relations for each craft, classification or type of workman needed for the construction of the building and shall specify in the resolution and in the notice, required by Section 17417, or in the resolution required by Section 17418 and in the lease or agreement made pursuant to this article, what the general prevailing rate of per diem wages and the general prevailing rate for holiday and overtime work in the locality is for each craft, classification or type of workmen needed for the construction of the building. The holidays upon which such rate shall be paid need not be specified by the governing board, but shall be all holidays recognized in the collective bargaining agreement applicable to the particular craft, classification or type of workmen employed on the project.

Any agreement or lease entered into pursuant to this article shall require that such general prevailing rates will be paid. It shall also require that work performed by any workman employed upon the project

in excess of eight hours during any one calendar day shall be permitted only upon compensation for all hours worked in excess of eight hours per day at not less than 1 1/2 times the basic rate of pay. There may also be included in leases or agreements entered into pursuant to this article any other requirements with respect to matters related to the subject of this section which the governing board deems necessary or desirable.

17425. The provisions of this article prevail over any provisions of law which conflict therewith.