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**LEASE-LEASEBACK
CONSTRUCTION DELIVERY METHOD
FOR
SCHOOL DISTRICTS**

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LEASE-LEASEBACK DESIGN BUILD PROJECTS

(Education Code Section 17406)

A. OVERVIEW OF LEASE-LEASEBACK DESIGN BUILD APPROACH

Lease-leaseback design/build projects are constructed pursuant to the provisions set forth in Education Code Section 17406, which authorizes school district governing boards, 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 lease 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 statutory language requires that school districts first lease its property to a chosen design/build contractor.

This delivery method to construction has been recognized by the State Legislature as a proven method 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. Education Code 17406 offers the Atraditional@ design/build method for school districts authorized by California Law. More recently, the Legislature has adopted Education Code Sections 17250.10-17250.50 which were codified January 1, 2002, but which have only recently become available for use by school districts (since State regulatory guidelines have been finalized and made available for school district review and adoption).

1. Design of a Lease-Leaseback Project.

Prior to entering into the Site and Facilities Leases, school districts must have plans for the Projects prepared and approved. School districts generally retain an architect or utilize a set of pre-approved plans. Often lease-leaseback projects include execution of a Preliminary Design Agreement which is entered into with the builder the school district desires to utilize for the construction project, in order to foster a Ateam-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 only for the chosen builder for the project to familiarize themselves with the plans and specifications, and modify them according to costs savings and feasibility issues. The plans and specifications must then be approved by DSA and the District=s governing board.

2. Construction of a Lease-Leaseback Project.

Essentially, the lease-leaseback approach is realized by having a school district enter into two leases with a chosen design/build contractor: a site lease and a facilities lease. The Site Lease is the document in which the school district will lease the real property to the builder for \$1 per year. The Facilities Lease is the document the school district will utilize to lease back the real property and completed facilities, and will also be the document that includes construction provisions which set the fixed price to be paid by the school district for the completion of the Project ("Guaranteed Maximum Price"). The construction provisions, which in turn will reference the plans and specifications to be completed by the architect and builder as a Ateam,@ will direct the contractor to construct the project pursuant to such plans and specifications. The construction provisions will also include legal requirements associated with public works projects, such as certain labor requirements, payment of prevailing wage, requirements regarding payment and performance bonds, as well as pertinent construction contract provisions such as indemnity and insurance language.

It is through the lease payments by the school district that the design/build contractor will be paid. The amount of the lease payments are based upon the Guaranteed Maximum Price, and are tied to construction progress on the project. Therefore, the contractor gets paid as construction progresses, and an incentive to complete the project continues. Finally, as lease payments are made, the rights to the building being constructed revert to the school district.

With respect to selecting a contractor for a lease-leaseback project, Education Code Section 17406 provides school districts great latitude. In fact, no selection or request for proposal process whatsoever is required for lease-leaseback projects. This fact makes the lease-leaseback delivery method particularly attractive to school districts which desire to work with a particular contractor, for example, when the school district has already worked with the particular contractor on a school facility project, or has targeted a developer/contractor based on a land use consideration.

Nevertheless, some school districts utilize an RFP process to select its contractor, which can be circulated to a handful of builders familiar with design/build projects, and are subject to strict enumerated criteria. This targeted RFP process can help identify a ballpark figure of what project costs would be had the school district bid the project under traditional design-bid-build construction. However, the school district is not bound to select the lowest RFP submittal for the project, or even any of the RFP submittals.

3. Restrictions and Limitations to Lease-Leaseback Projects.

There are several limitations with respect to the laws governing the design/build method of construction. First, the term of the Facilities Lease is limited to 40 years. (Education Code Section 17403). Second, as discussed above, 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 whichever State approvals may be required, as set forth in Education Code Sections 17280 to 17313. (Education Code Section 17421).

Finally, while State funding is not always a concern for school districts utilizing the lease-leaseback approach, school districts seeking State funding should be aware, that while there is some controversy regarding funding implications for design/build projects, it is this Firm=s opinion that no law governing funding and/or the design/build delivery approach to school facility construction prohibits State funding of design/build projects. The State Allocation Board Implementation Committee is currently discussing the lease-leaseback construction delivery method for state funded projects and envisions preparing an advisory or regulations on lease-leaseback projects in the near future, as discussed below in greater detail.

B. SUMMARY OF GENERAL PROJECT DOCUMENTS

1. Site Lease.

The purpose of the Site Lease is to effectuate the lease of the site to the chosen builder so that the school district can sublease the site back from the chosen builder pursuant to the Facilities Lease. The rental under the Site Lease is one dollar. The Site Lease terminates upon the District's payment of all of the lease payments, as defined in the Facilities Lease.

2. Facilities Lease/Sublease Agreement.

The purpose of the Facilities Lease or Sublease Agreement (AFacilities Lease@) is to allow school districts to sublease the site back with the project as it is being completed. The lease payments under the Facilities Lease ("Lease Payments") are made as set forth in a Construction Provisions Document, which also sets forth the terms and conditions under which the chosen builder agrees to construct and complete the project. The aggregate of the Lease Payments are

subject to the Guaranteed Maximum Sum as set forth in the Construction Provisions. The schedule of payments for the Lease Payments is similar to the schedule of payments for a traditional construction project, and the Facilities Lease terminates upon the last payment made to the builder for the project.

It is essential that the Site Lease and Facilities Lease documents are drafted with appropriate abatement, appropriations and default language to ensure such arrangements do not violate the State Constitution with respect to public agency indebtedness. It is also necessary to address title ownership considerations which reflect that the school district continues to hold title to the site, and gains title to the project as it is constructed. Other important terms include appropriate termination and assignment language which clearly define the parties' rights and obligations.

Finally, the Site Lease and Facilities Lease for the project will incorporate title vesting clauses, lease payment schedules for both the land and the facility being constructed, and an early payoff clause for the lease on the facility, whereby title in the projects vests in the District as construction progresses and lease payments are made to the builder. Therefore, as authorized by Education Code Section 17406, the school district retains title to its real property and the project as it is being constructed.

3. Construction Provisions.

The Construction Provisions document sets forth the terms and conditions under which the chosen builder agrees to construct and complete the project. The following is a non-exclusive list of important terms set forth in the Construction Provisions.

Establishment of Guaranteed Maximum Sum and Contingency Fund.

The Construction Provisions establish a Guaranteed Maximum Sum which is the total sum to be paid to the builder for the project, including architectural fees and related design costs. This section of the Construction Provisions should include any major deal point line items not included in the guaranteed maximum sum, for example, site acquisition costs and tenant improvement allowances.

This Guaranteed Maximum Sum may also include or refer to a separate contingency fund, which we recommend establishing to cover true school district changes without the need for a formal Achange order@ process. Essentially, this contingency fund amount will be utilized for the payment of: (1) any unforeseen costs which are within the scope of the project; (2) any work modifications as defined in the construction provisions documents; or (3) any additional unforeseen costs associated with the financing of the Project. In addition, the Contingency Fund may be increased from any cost savings, as provided in the Construction Provisions. Any funds remaining in the Contingency Fund after completion of the project must be returned to the school district, as provided in the Construction Provisions.

The District may prescribe additional work, or modifications which differ from the plans and specifications (Amodifications@). Prior to the builder commencing any work with respect to such modifications, the school district and builder must agree upon the cost for such modifications which shall be added to the Guaranteed Maximum Sum or taken from the contingency fund.

Liquidated Damages.

A liquidated damages provision should be included which requires the builder to pay to the school district, as fixed and liquidated damages, a previously agreed upon sum for each calendar day of delay in completion of the project. This provision is particularly important to school districts that chose lease-leaseback as a construction delivery method to shorten project completion time lines. Furthermore, liquidated damages could prove important to bond

underwriting and financial institutions evaluating the project and its delivery method in conjunction with project financings (discussed below in greater detail).

Progress Payments for Construction Services.

This provision provides, generally, that the school district will make progress payments for construction services to the builder in a sum equal to 90% of the value of construction performed up to the last day of the previous month. Such payments must be made within a particular time frame after receipt of the approved periodic estimate for such payment. A progress schedule is to be created by the builder, with the design/build team and school district=s input.

District Inspector.

We recommend that school districts retain an inspector to observe the work associated with the construction of the project. This section should acknowledge that the work performed on the project shall be subject to standards set forth in the California Building Code, and if applicable, to Title 21 and 24 of the California Code of Regulations, depending on whether the project is to be built pursuant to the Field Act.

Payment and Performance Bonds.

This provision requires obtaining performance and payment bonds in an amount equal to the Guaranteed Maximum Sum. This amount should be paid by the builder and be included as a line item in the Guaranteed Maximum Sum. Many design build contractors are unfamiliar with the extent to which a project must be bonded, and attempt to have their contractors alone bear the burden of obtaining such bonds. It is important to ensure full project bonding, therefore different bond arrangements should be discussed prior to finalizing the Construction Provisions to ensure full, but affordable project bonding.

Insurance and Indemnification.

The Construction Provisions must include adequate insurance and indemnification language to protect the school district to the greatest extent possible.

Soils Investigational Report.

This provision should be included, whereby the builder acknowledges that it has made a visual examination of the site. This section further states that no claims for allowances or damages because of builder=s failure to adequately acquaint itself with the known conditions at the site will be recognized. In some situations, courts will not uphold provisions such as this if unforeseen site conditions are such that they substantially alter the agreement between the parties.

Arbitration, Mediation (Alternative Dispute Resolution).

With design build projects, we often recommend (especially those which proceed without a validation action) that any controversy or claim arising out of the Site Lease or Facilities Lease documents be submitted to arbitration. It is unclear how the courts or how juries may react to disputes under the lease-leaseback approach, as traditional concepts such as change order processes are somewhat modified.

Correction of Work Before Acceptance; Contract Close Out.

The Construction Provisions document provides all punch list and contract close out information as generally found in traditional design-bid-build project documents.

Workers; Wage Rates, Labor Code Compliance.

The Construction Provisions should set forth all public works labor code requirements, including payment of prevailing wages and worker, wage rates, work hours, and apprenticeship issues.

Warranties; Guarantees.

The Construction Provisions document should delineate the builder=s warranty and guarantee obligations.

Assignment or Termination for Convenience.

This clause should be included in the Construction Provisions to allow for the school district to terminate the design builder, if needed, and assign the project to another builder. This clause is also necessary to allow school districts to simply terminate, without cause, when termination is required, for example, when a funding shortfall occurs.

Continuance of Work.

In the event of a dispute between the parties as to performance of the work or the interpretation of the Construction Provisions, or payment or nonpayment for work performed or not performed, the parties shall attempt to resolve the dispute. However, pending resolution of such a dispute, the builder should agree to continue the work diligently to completion, and should agree to not stop progress of work on the Project.

C. CONTRACTOR PERFORMANCE SAFEGUARDS

In light of the fact that the contractor's leasehold interest lies in a for-profit corporation, many performance safeguards should be incorporated into lease-leaseback design/build projects to ensure completion, especially when financing institutions are involved.

1. Payment and Performance Bonds.

Payment and performance bonds are being obtained for the project in an amount "not less than one hundred percent of the total amount payable by the terms of the contract" pursuant to Civil Code Section 3248 and related statutes. The bonded amount will therefore cover all construction costs associated with the project, including soft costs associated with design and construction management.

These bonds can be called upon in a worst-case scenario where the contractor fails in some way to perform. For example, if construction is falling far behind, or the contractor refuses to work or becomes financially insolvent, the surety is notified of such failure to perform by school district=s issuance of a notice of termination to the contractor. If an amicable resolution to the existing problem is not forthcoming, the school district can call upon the surety to complete construction of the project and pay any subcontractor or supplier requiring payment. The surety is obligated under the issued payment and performance bonds to take over the completion of construction and pay subcontractors or suppliers. In return, the surety assumes the failed contractor's place and is able to collect lease payments made by the school district as the project is completed. Importantly, this assignment of rights drastically hampers the contractor's ability to claim such lease payments as an asset, for example, in a bankruptcy proceeding. Also, contractors do not take such failures to perform lightly, as their bonding capacity for future projects is affected by having a surety complete their work. Thus, the school district=s actions to ensure contractor performance is buttressed by the surety's desire to not have to pay out on the payment and performance bonds.

This level of bond protection is mandated on all public works pursuant to statutory law in order to provide public entities the comfort of knowing public projects will have a source of funds to complete construction. Thus, in the "worst-case scenario" described above, the school district will not have expended any financing-derived funds which have not been used towards completing the project, and the surety would be obligated to complete the project in exchange for the right to claim lease payments from the school district. In fact, only a failure of the bonding entity itself would jeopardize the ability to complete the project as envisioned. Accordingly, the Construction Provisions between the parties should provide that the bonds will be obtained from a California admitted surety as defined by Code of Civil Procedure Section 995.120, and that said bonds will be in effect for the necessary post-construction time periods.

2. Validation Actions.

School Districts can request a judgment from the Superior Court, thereby validating its board actions, lease-leaseback documents (Site Lease, Facilities Lease, and Construction Provisions), and any financing documents associated with the project. Validation actions are preemptive suits by which public entities ask the court to validate certain financial 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 to California Code of Civil Procedure Section 860.

By obtaining a validation action judgment, the school district can ensure that challenges to the design build project cannot be made after construction commences. Therefore, any would-be bidding contractor or disgruntled tax payer can be precluded, for example, from seeking an injunction to halt construction until such a challenge can be settled. Moreover, because obtaining a validation action declares the project to be legally valid, no claim can be made that the project is in any way unlawful, thereby ensuring that the school district may pay the contemplated lease payments to the builder.

In short, by obtaining a validation action judgment, school districts can help ensure that its project will be constructed without challenge from outside parties, can make relatively short construction schedules more likely since no external delays will affect construction, and can ensure that the school district can be able to make the lease payments necessary to pay for the completion of construction.

Finally, while validation actions are strongly recommended, school districts may wish to forgo filing a validation action when project costs do not warrant the legal cost expenditure and when school districts are not proceeding with a State funded project.

3. Contingency Amount.

Besides the Guaranteed Maximum Sum and any other project budget line items such as land acquisition costs or tenant improvements, a contingency fund amount can be set up and allocated by the school district for the project, as discussed above. This reserve fund may be used to pay for any increased interest to be paid through the project financing, for example, for issuance of certificates of participation in the "worst case scenario" event that the project is not completed on schedule and payment and performance bonds are called upon. This amount essentially adds another layer of financial projection to the project, ensuring that the school district will have the necessary funds budgeted to the project to repay the principal and interest amounts related to any financing, if applicable.

4. Liquidated Damages.

The Construction Provisions between the parties provides that liquidated damages will be assessed for each calendar day of delay in completion of the project. Therefore, assuming the

design-build contractor remains financial solvent but fails to perform in a timely manner, these additional funds will be theoretically available to the school district to pay project costs, including principal and interest associated with any financing, if applicable.

D. CURRENT STATE FUNDING IMPLICATIONS / PROPOSED REGULATIONS

In light of school districts= increasing level of interest in the lease-leaseback design/build construction delivery method, the State Allocation Board Implementation Committee has begun a fact-finding process which may lead to an SAB policy or SAB regulations for lease-leaseback projects. At the Implementation Committee=s May 2, 2003 meeting, the Committee discussed many issues concerning the lease-leaseback approach. The following is a reproduction of the Committee=s May 2, 2003 meeting agenda, with summary comments incorporated therein:

State Allocation Board
Implementation Committee
May 2, 2003

LEASE LEASE-BACK AGREEMENTS

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.

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:

- o The value of the lease.
- o A provision that the title to the improvements on the site shall vest with the District upon completion of the project.
- o 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.

Comment(s): School districts should be aware that controversy exists regarding funding implications for lease-leaseback projects. The OPSC has, through responses to school district inquiries, informally created the Apolicy@ set forth above, including a current prohibition of use of bond funds to make lease or rental payments. It may be argued, however, that no legislation or regulation restricts funding to school districts utilizing the design/build method.

For example, Education Code Section 17070.70 requires a school district to hold title to real property that are Acquired, constructed, or improved with [State] funds.@ However, this section does not require school districts to obtain title within a specified period of time. As discussed above, the Site and Facilities Leases to be utilized by school districts should incorporate title vesting clauses, lease payment schedules for both the land and the facilities being constructed, and early payoff clauses for the leases on the facility. The result of these provisions is that the facilities vest in the District upon completion of the project. Therefore, title to the underlying real property and the facility are completely held by the District, as required by State funding law and regulations.

Also, please note that Education Code Section 17070.71, which allows for funding for new construction or modernization on real property leased to school districts, is arguably inapplicable to the design/build method of construction because pursuant to Education Code Section 17406, the subject real property must be owned by the school district which is entering into the lease-leaseback with a proposed builder. Such a distinction is highlighted by the purpose behind Education Code Section 17070.71, which provides for Asafeguards@ to funding school projects leased to school districts. Such Asafeguards@ include authorizing funding to property leased to school districts by governmental agencies only, and funding only long-term leases (in excess of forty (40) years for state property and twenty-five (25) years on federal property). (Education Code Section 17071.71(a)(1)-(a)(2)). These restrictions are undoubtedly required by the State to ensure State funds will not be expended on projects which simply revert back to a lessor at the end of an underlying short-term lease agreement with a school district.

It is reasonable to argue that construction projects under Education Code Section 17406 do not need, and are therefore not subjected to, such safeguard requirements. The intention of the parties to design/build agreements is to allow this authorized method to provide financing and construction of a public projects. There is never an anticipation that a school district will default on any payment under the leaseback prong of the transaction. Again, it is the school district itself who owns the underlying real property in such a transaction. Thus, arguably, Education Code Section 17070.71 is inapplicable.

Outstanding Issues

Issues continue to surface regarding the use of EC 17406 and the subsequent reimbursement of the lease buy-out costs with State school building funds.

Exemption from the Public Contracts Code requirements.

EC section 17406 states in part that a district may enter into a lease lease-back arrangement without advertising for bids. This provision, the avoidance of competitive bid requirements, appears to be one of the major reasons that school districts are turning to the lease lease-back delivery system. (Education Code Section 17425 also states that the article containing EC 17406 prevails over any conflicting provision of law.)

Issue: What other public contract code requirements are avoided by the use of lease lease-back arrangements?

Comment(s): Likely, only the Public Contracts Code competitive bid requirements are inapplicable to lease-leaseback projects.

Compliance with field act and site approval requirements (EC 17402)

Article 2, Section 17402 requires that the district must have an available site which has met criteria pertaining to site selection and approval. It also provides that the plans for the project have been approved under the Field Act.

Issue: When is a site available? If a district leases a site with an option to purchase, or has an option to purchase a site, is it available? If so, can the district option a site from the lease lease-back developer?

Comment(s): While Education Code Sections 17402(a)-(c) discuss the available nature of a site, the OPSC has not yet determined any separate policy in this regard.

Issue: Does the requirement that the district shall have complied with the provisions of law relating to the selection and approval of sites mean that final CDE approval is required prior to entering into the lease lease-back contract?

Comment(s): It is not yet clear whether the OPSC will require that the site must be CDE-approved prior to the lease-leaseback contract. Ultimate state funding, however, would be contingent upon the site being CDE-compliant upon project completion.

Competitive selection of the design professional

Since the plans for the project must be done by the school district prior to entering into the lease lease-back arrangement, it appears that EC section 17070.50 continues to apply. Therefore, notwithstanding EC 17425, the district must be able to certify that the design professional was selected through a competitive process.

Comment(s): The OPSC may require that a selective process be followed in situations here school districts hire an architect to be a part of the lease-leaseback design/build team. Also, when hiring a team already coupled with a builder and architect, some selection criteria may be required.

Prevailing wage requirements.

EC section 17424 requires the payment of prevailing wage on lease lease-back projects.

Issue: Are projects done under lease lease-back arrangements subject to the requirements of AB 1506 and required to have a labor compliance program?

Comment(s): It is largely agreed that lease-leaseback projects must comply with the school district's labor compliance program.

Chargeable Facilities

Education Code Section 17071.75 (b) adds any building provided from any State or local funding source to the existing school building capacity of the district. In other words, the facility is chargeable.

Issue: When is the facility added to the existing school building capacity? Is the 180 day grace period specified in SAB regulation applicable?

Comment(s): The OPSC may determine that a school building is chargeable, for purposes of existing eligibility, upon completion and occupancy of the project and the passing of title. However, in situations where title does not pass for some time after project completion, the OPSC may provide for some time frame, after which, the facility becomes chargeable.

Eligible Expenditures

Issue: State bond funds may be used for specified expenditures and purposes.

Issue: How will the OPSC ensure that this occurs on a lease lease-back project?

In other words, will OPSC require expenditure reports and accounting from the lease lease-back developer?

Comment(s): Some lease-leaseback projects provide for developers/builders to submit invoices along with monthly payment applications. However in situations where developers are reluctant to provide such information, the OPSC may require some process by which the developer/builder must provide construction back-up documentation.

Modernization Projects

EC 17400 (b) defines a >building= for which a district may enter into a lease to include remodeling.

Issue: Is modernization a suitable project for lease lease-back arrangements?

Comment(s): Education Code Section 17400 provides for modernization under the lease-leaseback scenario. However, the OPSC may formalize some monetary or scope of work guidelines with respect to modernization projects utilizing the lease-leaseback method.

Use of EC 17406

The position of the OPSC has been that it is up to the district to determine that the use of the provisions of EC 17406 is >legal.=

Issue: What constitutes a legitimate lease lease-back arrangement? If the lessee does not finance the project, and the only funding for the construction comes from the district, is there a legitimate lease arrangement?

Comment(s): Arguably, a legitimate lease arrangement exists in lease-leaseback projects which do not use an outside source of financing. The lease-leaseback process is in fact a financing method and the school district pays consideration for its facilities lease in the form of increased risk to the developer. The OPSC has not yet formalized any opinion on what lease-leaseback arrangements are A legitimate.@

Issue: If a lease lease-back agreement is found by the courts to be inappropriate, is there a material inaccuracy which may subject the district to the repayment of the apportionment or restriction on future self-certification?

Comment(s): The OPSC has not formalized any opinion on this issue. Arguably, no material inaccuracy finding would be appropriate as no Afalse certification@ would have occurred. Also, by pursuing a validation action, this issue is likely rendered moot.

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