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Lease-Leaseback Arrangements Must Be Genuine; Otherwise, a Contractor May Face Disgorgement of Monies Even After Project Completion

A common method of California public school districts to award contracts for new construction and improvements to existing facilities is the lease-leaseback method. Authorized under Education Code section 17406, the lease-leaseback method permits builder-financed construction. A school district leases 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. This method of contracting allows districts to pay contractors over the term of the lease, which is generally for a significant period and exempts the construction from the competitive bidding process.

In February 2012, Fresno Unified School District's ("District") governing board adopted a resolution authorizing the execution of lease-leaseback construction contracts with Harris Construction, Co. ("Contractor") for the construction of a new middle school campus. The District characterized the construction project as a "lease-leaseback project." The construction contracts allowed the District to make progress payments to the Contractor for services performed during construction. Once the project was complete, the Contractor's lease terminated and titled reverted to the District. The lease was in effect only during the construction of the facilities, and the funds the District paid to the Contractor were only for services performed by the Contractor.

In November 2012, Stephen Davis ("Davis") sued the District and the Contractor challenging the propriety of the lease-leaseback project because the entirety of the District's lease payments occurred while the Contractor built the project and thus, there was no true lease of a facility since it was under construction. Thus, Davis argued the District and the Contract violated competitive bidding laws and requested disgorgement of the monies received by the Contractor back to the District.

The District and the Contractor challenged Davis's complaint arguing there were no legal grounds for Davis's claims. The trial court sustained the challenge and entered judgment in favor of the District and the Contractor. Davis appealed. In *Davis v. Fresno Unified School District* (2015) 237 Cal.App.4th 261 ("*Davis I*"), the Court of Appeal held that the District's lease-leaseback arrangement was more akin to a traditional construction contract, and not a lease. The payment schedule aligned with progress for construction services; whereas, under a lease,

payments are for a set time. Because the contract was for “construction services” and not a genuine lease-leaseback as a method of financing, the *Davis I* court declared the construction contracts invalid and remanded the case back to the trial court.

On remand, back in the trial court, the District again challenged the lawsuit, arguing that Davis’s complaint was moot because the Contractor had completed the project and contracts. The trial court agreed and reasoned that because Davis was seeking to have the entire transaction declared invalid, (rather than on the rights of the parties), disgorgement of monies paid to the Contractor was no longer available relief because the contract was fully performed. Davis appealed.

The Fifth Appellate District reversed the trial court’s decision. The Appellate Court acknowledged that Davis’s suit sought to invalidate the transaction, but also included a taxpayer action challenging illegal expenditure of public funds. Because disgorgement of funds is available relief in a taxpayer action, despite completion of the school. The Appellate Court held the suit was not moot and again remanded the case to the trial court for further proceedings.

Davis v. Fresno Unified School District. (2020) 57 Cal.App.5th 911.

NOTE:

If a district contemplates a lease-leaseback arrangement, the transaction must be a genuine lease that includes a contractor-financing component and allows the district to use the premises as a tenant during the term of the lease. Otherwise, there is risk that a court will invalidate the arrangement and order disgorgement of the proceeds.

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