“True Lease” Required for Lease-Leaseback Exemption from Public Bidding

In a decision that may imperil many pending school construction transactions, the Fifth District Court of Appeal has held that, to qualify for exemption from public bidding, a lease-leaseback transaction must include "a financing component" and a "genuine lease" that provides for school district use of the facilities during the lease term. *Davis v. Fresno Unified School District*, No. F068477 (Fifth Dist., June 1, 2015). The court determined that the contract before it did not meet these criteria and hence was subject to competitive bid requirements under the Public Contract Code. Contracts for construction of school facilities exceeding $15,000 ordinarily must be competitively bid. An exception to public bidding exists under Public Contract Code § 17406, which provides that a district "without advertising for bids, may let . . . real property that belongs to the district if the [lease] requires the lessee . . . to construct . . . a building or buildings for the use of the school district." Under such a "lease-leaseback" arrangement, the district leases land to the contractor on which the contractor agrees to build school facilities to be leased back to the district for a specified time and rental amount. At the end of the lease term, title to the school facilities must vest in the school district. § 17406(a)(1). The Fresno Unified School District entered into such a lease-leaseback arrangement for construction of a $36 million middle school. Plaintiff challenged the arrangement, arguing that the contract did not create a true lease or satisfy other criteria under Section 17406, and hence was not exempt from public bidding. The appellate court agreed. Based on its review of the statute and its legislative history, the court concluded that the lease-leaseback transaction must satisfy two requirements to qualify for exemption from public bidding: *First*, the transaction must include a "true lease" that provides for the district's use and occupancy of the new buildings during its term, not simply a traditional construction contract designated by the parties as a lease. The court found that the "lease" document before it did not meet this requirement because, among other things, (i) the monthly lease payments to the contractor were not correlated to any specific period but were based on the progress of construction; (ii) the lease terminated immediately upon completion and acceptance of the construction; (iii) the contractor never acted in the capacity of a landlord holding rights to real property occupied by a tenant; and (iv) the district never occupied and used the new facilities as a tenant, but rather obtained full title to the buildings as they were completed. *Second*, the contracts must include a "financing component" for the project. The court determined that "obtaining a new source of school financing was the primary purpose of the lease-leaseback provisions" in the statute, and hence that a transaction must include such a component in order to qualify for the exemption. The court found that the terms in the lease before it did not provide any financing to the district, but simply required payment to the contractor for the construction as it occurred. Barring legislative action or review by the California Supreme Court, the *Davis* decision will require significant restructuring of the traditional lease-leaseback model commonly used by school districts. Provisions in the documents needing careful review in light of *Davis* include (1) the particular property rights held by each party and the timing of transfer of those rights between the parties; and (2) the amount and timing of the lease payments. The payment provisions -- particularly the source of payment funds and the length of time over which payments are made -- will be important in light of the court's conclusion that the primary purpose of the lease-leaseback legislation was to provide a source of financing for school construction.

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