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COURT INVALIDATES LEASE-LEASEBACK ARRANGEMENT

By David J. Weiland and Darryl J. Horowitz

In order to streamline the bidding process and avoid problematic bidding rules in the Public Contracts Code, the California Legislature created an exception in the Education Code that allows school districts to get creative, and instead of requiring bidding on design bid projects, use a “lease-leaseback.” In doing so, the school district leases its property to the contractor and the contractor agrees to perform the construction work at an agreed-upon price. Once built, the completed project is intended to be leased back to the school district for its use with fixed payments overtime.

Harris Construction was selected to perform such a “lease-leaseback” contract to construct a middle school for the Fresno Unified School District under the applicable provisions of the California Education Code. As cited in the court’s published opinion, the term of the “lease” was only for the duration of the time needed to construct the project. The “lease” payments were the typical progress payments made to the contractor for work performed. Another contractor, Stephen Davis, as a taxpayer (who is also owner of Davis Moreno Construction), contested the award claiming that the exceptions that permitted a noncompetitive bid were not met by the process as set up by Fresno Unified, and thus a competitive bid was required. Harris and the school district demurred to the complaint,

which was granted by the trial court without leave to amend.

Davis appealed, arguing that sufficient facts were alleged in the complaint to support the claim that the lease-leaseback arrangement was not permitted as there was no true leaseback by the district upon completion, and that Harris was actually merely paid for the construction of the project, not for any lease of the property. In *Davis v. Harris Construction* (June 1, 2015) --- Cal.Rptr.3d ----, 2015 WL 3454720 (*Davis*) the appellate court reversed the judgment and ordered the trial court to enter a new order sustaining only as to the claims for breach of fiduciary duty, violation of the Political Reform Act of 1976, that a lease-leaseback arrangement is not permitted when funds are available from another source and to overrule all of the other claims. In doing so, the court agreed with *Davis* that none of the exceptions set forth in Education Code § 17417 existed in Fresno Unified’s process, thus requiring competitive bidding. In an exhaustive opinion, the court determined that the contract was one merely for construction of the project, rather than a true lease. The court also found that, by virtue of preconstruction consulting services provided to the school district by the contractor, Harris had a conflict of interest that rendered the contract void.

The matter will now go back to the trial court to determine if Davis can prove what he alleged. If so, Harris may be required to disgorge its profits on the project.

This case reminds all contractors that, even where a public entity wants the parties to move quickly into entering a contract that avoids the competitive bidding process, anyone can contest the contract; such that, even if the project is complete, the contractor remains at risk of litigation, potential voiding of the contract and perhaps disgorgement of profits. It is thus recommended that before entering into any such "lease-leaseback" contracts, you review them with counsel.



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