
SENATE COMMITTEE ON EDUCATION

Senator Carol Liu, Chair
2015 - 2016 Regular

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Consultant: Kathleen Chavira
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Subject: School facilities: leasing property

SUMMARY

This bill, until July 1, 2022, modifies lease-leaseback provisions to remove the authority to let such a contract without advertising for bids, requires that such a contract be awarded through a competitive process, as specified, and entitles a contractor to be paid reasonable costs, as specified, if a court invalidates a lease-leaseback instrument entered into prior to July 1, 2015 for a school construction project, if specified conditions are met. The bill permanently deletes the authority to enter into a lease-leaseback instrument without advertising for bids beginning July 1, 2022.

BACKGROUND

Existing law authorizes the governing board of a school district to enter into a lease-leaseback contract without advertising for bids. Current law prescribes that real property may be let by the district for a minimum rental of \$1 per year if the lessee is required to construct, or provide for the construction of a building/buildings for the use of the school district during the term of the lease, and requires that title of the building vests in the school district at the expiration of that term. Existing law, until January 1, 2019, also requires that school districts entering into lease-leaseback comply with specified pre-qualification requirements, if the project is funded with state bond funds, the expenditure of the project is \$1 million or more, and the average daily attendance (ADA) of the school district is greater than 2,500. (Education Code § 17406)

Existing law establishes a pilot program to authorize the Los Angeles Unified School District (LAUSD) to utilize a best value procurement process, as specified, for construction projects over \$1 million until January 1, 2021. (Public Contract Code § 20119-20119.7)

Existing law provides that when a construction project is competitively bid and any intended or actual award of the contract is challenged, the contract may be entered into pending final decision of the challenge. Existing law provides that if the contract is determined to be invalid due to a defect or defects in the competitive bidding process caused solely by the public entity, the contractor who entered into the contract with the public entity is entitled to be paid the reasonable cost, (excluding profit) of the labor, equipment, materials, and services furnished by the contractor prior to the date of the determination that the contract is invalid if specified conditions are met including that:

- 1) The contractor proceeded with the project based upon a good faith belief that the contract was valid.
- 2) The public entity has determined that the work performed is satisfactory.
- 3) Contractor fraud did not occur in the obtaining or performance of the contract.
- 4) The contract does not otherwise violate statutory or constitutional limitations. (Public Contract Code § 5110)

ANALYSIS

This bill:

- 1) Modifies lease-leaseback provisions applicable to school construction projects. It:
 - a) Deletes the authority to let such a contract without advertising for bids.
 - b) Requires that such a contract be awarded through a competitive process generally based upon existing design build and best value processes with certain exceptions. It:
 - i) Authorizes a school district request for proposal to include “pre-construction services” defined as advice during the design phase including, but not limited to, scheduling, pricing, and phasing to assist the school district to design a more constructible project.
 - ii) Authorizes a school district to enter into a lease-leaseback agreement prior to written approval by the Division of the State Architect (DSA) if the instrument provides that no work that requires that a contractor be licensed will be initiated before receipt of statutorily required DSA approvals.
 - c) Establishes provisions to be retroactively applied to lease-leaseback school construction projects. It:
 - i) Entitles a contractor to be paid reasonable costs, as specified, if a court invalidates a lease-leaseback instrument entered into prior to July 1, 2015 for a school construction project, if specified conditions (mirroring those outlined in Public Contract Code § 5110) are met.
 - ii) Prohibits these provisions from affecting any protesting and legal proceedings, whether contractual, administrative, or judicial, to challenge the award of the public works contract, nor affecting any rights to bring a civil action regarding a deficiency or injury related to deficiency in the development or improvement of real property, per specified provisions of the Code of Civil Procedure.

- d) Extends prequalification requirements applicable to lease-leaseback under current law from 2019 to 2022.
 - e) Sunsets all of these provisions on July 1, 2022.
- 2) Permanently deletes the authority to enter into a lease-leaseback instrument without advertising for bids, beginning on July 1, 2022.

STAFF COMMENTS

- 1) ***Need for the bill.*** According to the author this bill responds to lawsuits which have been filed charging that lease-leaseback provisions have been used to bypass the competitive bid process. Courts have had varied interpretations of the appropriate use of lease-leaseback contracts. In a lawsuit against the Fresno Unified School District, an appellate court found that a 2014 contract for construction of a middle school awarded under these provisions was not a true leaseback, while the plaintiff argued that the contract should have been competitively bid. In a lawsuit against the Torrance Unified School District a different appellate court found that the law does not require competitive bidding nor did it specify that there had to be a true leaseback in order to use this contracting method.

This bill deletes the authority to issue a lease-leaseback contract without advertising for bids and establishes a competitive selection process for these contracts modeled after design-build and best value provisions. The bill also entitles a contractor who entered into a lease-leaseback school construction contract prior to July 1, 2015 to compensation for any reasonable costs (excluding any profit) if the contract is subsequently found to be invalid by a court.

- 2) ***Lease-leaseback.*** Current law requires the governing board of a school district to competitively bid, and award to the lowest responsible bidder, any contract for a public project involving an expenditure of \$15,000 or more. Lease-leaseback is a process whereby a governing board of a school district may, without advertising for a bid, rent district property for a minimum of \$1 a year, to any person, firm or corporation. The person, firm or corporation constructs the school building and rents the facility back to the school district. At the end of the lease, the district resumes title to the building and site. The lease is terminated when the building is constructed.
- 3) ***Historical concerns with lease-leaseback.*** In January 2004, the State Allocation Board was presented with a report to discuss the use of lease-leaseback agreements for project delivery of facilities funded through the School Facility Program. According to that report, the use of this project delivery method was growing. Increasingly, districts were interpreting existing law to allow the use of these provisions to award a public works project without a competitive bid. The report noted that some districts do institute a competitive selection process voluntarily, but many do not, and expressed concern that an interpretation that would potentially allow billions of state bond dollars to be contracted through a "sole-source" mechanism should be closely examined.

The report concluded that the State Allocation Board (SAB) might wish to consider whether new construction and modernization projects interpreting the authority as an exemption from competitive bidding requirements should continue to be presented for state funding, and whether legislation clarifying the appropriate use of this authority was necessary. The SAB did not accept the report, some members expressed interest in pursuing proposed legislation to address this issue, and staff were directed to provide written notification to school districts to proceed with caution when using lease-leaseback and interpreting the law.

- 4) ***New competitive process.*** Over time, alternative methods to traditional design-bid-build for awarding construction contracts have emerged and been approved by the Legislature. These include design-build (which enables a school district to issue a request for proposal for both design and construction of projects) and best value (which authorizes school districts to consider the best combination of factors, and not just cost, in selecting a bidder). AB 1358 (Dababneh, Chapter 752, Statutes of 2015) generally aligned the design build process for school districts with the process authorized for state and local governmental agencies and sunsets this authority in January 2025. AB 1185 (Ridley-Thomas, Chapter 786, Statutes of 2015) authorized the Los Angeles Unified School District to use a best value procurement method until January 2021.

According to the author, the traditional “lowest responsible bidder” method doesn't work well in a lease model because the lease structure can vary depending on the length, interest, and monthly payments, making it difficult to compare costs. This bill establishes a competitive selection process that is modeled after a combination of design build and best value. The author states that similar to design build, this bill allows a contractor to work with an architect early to avoid costly change orders later, and similar to best value, this bill allows evaluation of proposals based on price and other factors, including the proposed lease structure.

According to the author, these provisions will ensure that districts will no longer be able to issue these contracts without soliciting bids. Establishing a process that utilizes existing contracting models will ensure that there is a competitive process while allowing districts to determine the elements that are important for the project.

- 5) ***With modifications.*** As noted in the analysis of this bill, the competitive process created by this bill goes beyond current design build and best value provisions by authorizing the inclusion of preconstruction services in a request for proposal and authorizing districts to sign contracts prior to receiving Division of the State Architect approval.
- a) ***Pre-construction Services.*** According to the author, the pre-construction services provisions are based upon a similar authority granted under Public Contract Code § 6702 applicable to California Department of Transportation projects in which a construction manager is procured to provide preconstruction services during the design phase of the project

and construction services during the construction phase of the project. It is the intent to authorize a process that can provide continuity and collaboration between the design and construction phases of the project as part of the competitive bidding process.

This bill authorizes pre-construction services to be included in a request for proposal under the competitive process it establishes. While a district could continue to contract for pre-construction services separate from the construction contract, the competitive process required by the bill would apply to all bidders for the construction contract, including any provider of pre-construction services.

- b) *DSA Approval.* Current law requires architectural plans to be approved by the Division of the State Architect (DSA) before a construction contract can be signed. In 2012, the State Architect convened a task force to review the DSA approval process applicable to alternative delivery methods such as best value and lease-leaseback in response to concerns that the process hampered districts' ability to guarantee contract prices or plan for summer construction activity. The task force submitted recommendations to the State Architect on legislative, regulatory and administrative policy changes to clarify and better guide approvals using these alternative delivery methods. Among other things, the task force recommended authorizing districts to sign contracts prior to receiving DSA approval as long as construction does not begin prior to DSA approval. This bill incorporates that recommendation.
- 6) ***Sunset of authority.*** This bill sunsets the authority to use the alternative competitive process in 2022, at which point statutes authorizing lease-leaseback will require the traditional design-bid-build process. According to the author, requiring a competitive process for lease-leaseback contracts is intended to be permanent. The sunset is added to conform with sunsets incorporated in design build and best value legislation, and will allow the Legislature to determine whether the competitive process established by this bill needs to be modified when considering whether to extend or remove the sunset.
- 7) ***Related court cases.*** As previously noted, two recent court cases came to different conclusions as to whether competitive bidding was required under the specific lease-leaseback contracts in question. In *Davis v. Fresno Unified School District*, the Fifth Appellate Court ruled (June, 2015), based upon a complex analysis of the Legislature's intent and the structure of the specific contract in question, that competitive bidding was required. In *McGee v. Balfour Beatty Construction*, the Second Appellate Court specifically rejected the Fifth Appellate Court finding and ruled (April 2016) that the contract in question was legally entered into by the school district and that competitive bidding was not required. This bill deletes the authority to enter into a lease-leaseback contract without advertising for bids and establishes an alternate competitive procurement process for this purpose.

In addition, both lawsuits alleged conflict of interest on the part of contractors based upon Government Code § 1090 which prohibits public officials from having

personal financial interest in contracts formed in their official capacities. At issue is whether the contractor had acted as a public official when it provided pre-consulting services under one contract and then received another contract for construction services. The Fifth Appellate Court determined that a "corporate consultant" could be considered a public employee, the Second Appellate Court agreed, and the respective trial courts will now determine whether there is sufficient evidence to prove that a conflict of interest had occurred.

- 8) **Disgorgement.** The lawsuits discussed in staff comment #7 seek to invalidate the lease-leaseback contracts in question and "disgorge" or require repayment of the funds received by the contractor. Current law (Public Contract Code Section 5110) entitles a contractor to be paid reasonable costs, including labor, equipment, materials and services, but excluding profit, if a contract for the construction, alteration, repair, or improvement of any structure, building, or road, is found to be invalid by a court *due to a defect or defects in the competitive bidding process*. Current law does not apply in lease-leaseback cases because lease-leaseback contracting does not involve a competitive bid process.

This bill contains provisions modeled after Public Contract Code provisions that protect against disgorgement if the contract is invalidated because of a defect in the bidding process. However, as drafted, this bill appears to extend these protections to lease-leaseback contracts that are invalidated for any reason.

The Committee may wish to consider the following:

- a) How broad an insulation from action against improper activity should be allowed?
- b) How would these provisions affect current litigation regarding the violation of conflict-of-interest provisions? Is it the desire of this Committee to insulate contractors from disgorgement if the courts find that there was a conflict-of-interest?
- c) How many lease leaseback contracts were entered into prior to 2015 that are affected by the disgorgement provisions?
- d) Should statute eliminate the discretion of a court to determine the appropriate remedy if a contract emerges that is particularly egregious?

Staff recommends the disgorgement provisions be amended to:

- Delete "retroactively" as it appears to be unnecessarily duplicative
- Clarify that the specific reason for being determined "invalid" is in relation to the competitive bidding provisions of the lease-leaseback statute.
- Preserve the discretion of the court to determine the appropriate remedy based upon the specific circumstances surrounding the contract that is being challenged by "authorizing" rather than entitling payment of reasonable costs.

- Clarify that it is the court that determines whether the specified conditions have been met.

These changes should be reflected as follows:

(d) (1) This subdivision shall apply ~~retroactively~~ to a project for the construction, alteration, repair, or improvement of any structure, building, or other improvement of any kind that was leased through an instrument pursuant to this section before July 1, 2015. If at any time the instrument is determined to be invalid by a court of competent jurisdiction, **because it fails to fall within the competitive bidding exception pursuant to paragraph (1) subdivision (a) of this section, as it read on December 31, 2016**, the contractor who entered into the instrument with the school district ~~shall~~ **may** be ~~entitled to be~~ paid the reasonable cost of the labor, equipment, materials, and services furnished by the contractor before the date of the determination that the instrument is invalid if all of the following conditions, **as determined by the court**, are met:

- (A) The contractor proceeded with construction, alteration, repair, or improvement based upon a good faith belief that the instrument was valid.
- (B) The school district has reasonably determined that the work performed is satisfactory.
- (C) Contractor fraud did not occur in the obtaining or performance of the instrument.
- (D) The instrument does not otherwise violate state law related to the construction or leasing of public works of improvement.

SUPPORT

Associated General Contractors
 Association of California School Administrators
 California Association of Suburban School Districts
 California Chapters of the National Electrical Contractors Association
 California Legislative Conference of the Plumbing, Heating, and Piping Industry
 California School Boards Association
 Coalition for Adequate School Housing
 Construction Employers Association
 School Employers Association of California
 Small School Districts' Association
 United Contractors

OPPOSITION

California Taxpayers Association
 Howard Jarvis Taxpayers Association
 KernTax

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