MAY 2023 NO. 23-03

Supreme Court's Decision Does Not Disturb Commonly Held Understandings Surrounding The Use of Lease-Leaseback

On April 27, 2023, the California Supreme Court issued a decision in *Davis v. Fresno Unified (Davis III)*[1] regarding lease-leaseback contracts ("leaseback"). Lease-Leaseback is a method of school construction contracting that is often used as an alternative to competitive bidding. Lease-leaseback procurement allows Districts to consider factors in addition to price, such as a contractor's experience, strength of personnel and technical expertise. The case is important for what it didn't say, as much as what it did say.

The Court addressed the narrow question of whether a specific lease-leaseback arrangement, wherein construction is financed through bonds, rather than the builder, was subject to validation. The Court concluded the specific lease-leaseback arrangement at issue in *Davis III*, (which contained no contractual financing through the builder) was not a "contract" within the meaning of Government Code section 53511, and thus, was not subject to validation. The decision in *Davis III* does not disturb commonly held understandings surrounding the use of lease-leaseback.

What The Applicability of Validation Means

If a contract is subject to validation, it is also subject to a short, 60-day statute of limitations. Contracts that are *not* subject to validation may be subject to challenge for longer periods of time. For example, there is a three-year statute of limitations on actions based on a violation of a statute, under C.C.P. § 338.

The Question Decided Was Narrow

Due to a complex procedural history, and to resolve a split of appellate authority, *Davis III*, came before the Supreme Court on the narrow issue of whether the validation statutes applied to the leaseback contract in that case. In 2020, *McGee III* [2] held that a leaseback contract was subject to validation because it was funded with general obligation bonds, and thus it was "inextricably bound up in the District's bond financing." In 2022, *Davis II* [3] reached a different conclusion and held that because the leaseback in that case did not include a financing component, it was not the type of "contract" that is subject to validation.

The Supreme Court Found A Leaseback Contract Containing No Financing By or Through the Builder Was Not Subject to Validation, Even If It Is Funded With School Bond Dollars.

The Supreme Court rejected the argument that *all* local agency contracts funded by local agency bonds are subject to validation. The Court reasoned that in such a case, minor contracts could be made and finished before they even come to the public's attention during the 60-day statute of limitations period applicable to validation actions. Instead, the Supreme Court held that a contract is subject to validation if it is "inextricably bound up" with government indebtedness or debt financing guaranteed by the agency. To satisfy this standard, the Court stated, "the contract must be one on which the debt financing of the project directly depends."

What the Court Did Not Say

The Court acknowledged but did not address the existing 4-1 split among court of appeal decisions regarding how leaseback contracts must be structured. One appellate Court, *Davis I* [4] has held that to satisfy the leaseback statute, a leaseback transaction (1) must include a "true" lease; (2) must include a financing component; and (3) the district must use the leaseback building during the term of the lease. The Supreme Court did not address or opine on that issue.

In short, while *Davis III* held that a leaseback contract without financing is not subject to validation, as a practical matter, it is a common practice for schools to structure their leasebacks to contain a financing component. Further, *Davis III* did not address the issue of whether a leaseback must contain financing in order to be a valid contract, and thus the state of the law on that issue remains as it was. Thus, *Davis III* has limited impact on the way schools may use lease-leaseback.

[1] *Davis v. Fresno Unified School District* (Cal., Apr. 27, 2023, No. S266344) 2023 WL 3107288, at *4 (*Davis III*).
[2] *McGee v. Torrance Unified School District* (2020) 49 Cal.App.5th 814, 824 [263 Cal.Rptr.3d 331, 339, 49 Cal.App.5th 814, 824] disapproved of by Davis v. Fresno Unified School District (Cal., Apr. 27, 2023, No. S266344) 2023 WL 3107288.
[3] *Davis v. Fresno Unified School District* (2020) 57 Cal.App.5th 911, 941 [271 Cal.Rptr.3d 818, 843, 57 Cal.App.5th 911, 941], as modified on denial of reh'g (Dec. 16, 2020), aff'd (Cal., Apr. 27, 2023, No. S266344) 2023 WL 3107288 (*Davis II*).
[4] *Davis v. Fresno Unified School Dist.* (2015) 237 Cal.App.4th 261 [187 Cal.Rptr.3d 798], as modified (June 19, 2015).

If you have any questions regarding this decision and how it affects your agency, please call one of our six offices.

F3 NewsFlash® Written by:
James Traber, partner

FRESNO | INLAND EMPIRE | LOS ANGELES | OAKLAND | SACRAMENTO | SAN DIEGO
www.f3law.com