
Coates' Canons Blog: New School Construction Lease Authority

By Norma Houston

Article: <https://canons.sog.unc.edu/new-school-construction-lease-authority/>

This entry was posted on July 09, 2018 and is filed under Construction Contracts, County Finance, Legislation, Purchasing, Construction, Property Transactions

The 2018 legislative session brought about several significant changes to public school funding, including school capital projects funded with lottery proceeds. Section 5.3(e2) of the 2018 Appropriations Act (S.L. 2018-5) authorizes counties (not local school boards) that receive Needs-Based Public School Building Grant funds from the Department of Public Instruction [DPI] to enter into a capital lease for construction of school facilities. Only counties designated by the NC Department of Commerce as development tier one or tier two areas are eligible to receive funds from the Needs-Based Public School Building Grant program (for more information about this program, see Kara Millonzi's blog post here). If your county is eligible for and receives one of these grants, how do you go about entering into a capital lease agreement under this new authorization?

Lease Agreement Requirements

The language of the budget provision requires four criteria be met when a county enters into a school capital lease under this new authorization:

1. The county must retain ownership of the real property on which the leased school is constructed.
2. The lease agreement must include a repairs and maintenance provision requiring the landlord (presumably, the developer who constructs and leases the school facility to the county) to bear the entire expense for all repairs, maintenance, alterations, or improvements to the structure, fixtures, appurtenances, and grounds of the property for the entire term of the lease (this requirement appears to prohibit the developer from passing these costs on to the county as part of the lease payments).
3. The term of the lease agreement must be for at least 15 years and no longer than 25 years (there is no authorization for extensions or renewal periods).
4. To receive reimbursement for lease payments, the county must provide a copy of the lease agreement to DPI and periodically document that the county is satisfying its local match requirement (the Needs-Based Public School Building Grant program is subject to a local match that varies depending on the county's tier designation).

Is Competitive Bidding Required When the County Enters Into the Lease?

When a local government is the lessee of real property, the unit is not subject to competitive bidding requirements under state law. For example, if a county needs more office space and chooses to lease private office space for its employees, it may negotiate directly with a landlord and enter into the lease without soliciting price quotes from other potential landlords. The county could even purchase the real property outright without bidding.

The new school capital lease authorized under the budget bill does not, however, fall into the typical category of leases involving developed real property, such as the office space example given above. Instead, the new authorization clearly contemplates a construction project to be undertaken on property owned by the county, as evidenced by the first criterion listed above requiring the county to retain ownership of the real property "on which the leased school is constructed." In addition, the law specifies that "ancillary agreements or predevelopment agreements entered into in anticipation of or in accordance with a lease" are considered part of the lease agreement. Predevelopment agreements typically relate to construction projects. Thus, while the language of the law does not explicitly define the scope of the new school capital lease arrangement, construction of school facilities is clearly contemplated.

Contracts under which construction or repair work is undertaken that involve the expenditure of public funds of \$30,000 or more are subject to either informal or formal competitive bidding requirements under state law (GS 143-131 for informal bidding, and GS 143-129 for formal bidding). A lease is a form of contract, and the new school capital lease is a contract

under which construction work would be undertaken and paid for in part, albeit over time through lease payments, with public funds. Since the law does not exempt the lease contract from competitive bidding requirements, school capital leases under which a public school facility would be constructed must be bid according to the statutory requirements in Article 8 of Chapter 143. If the school capital lease provides for construction work, a county does not have the legal authority to enter into the lease directly with a private developer without engaging in some form of competitive bidding authorized under state law.

Which Competitive Bidding Method Should Be Used?

The most frequently used method of bidding construction projects is single-prime bidding, although use of the construction manager at risk method is not uncommon, especially for school construction. While both of these methods work well for traditional construction contracts, they are not a good fit for the new school capital lease arrangement, primarily because the new lease involves a financing obligation subject to approval by the Local Government Commission.

The budget provision makes the new school capital leases subject to the requirements of Article 8 of Chapter 159. Under this Article, local government contracts that involve certain financing or debt obligations – including leases – are subject to approval by the Local Government Commission. The new school capital lease involves a long-term financial obligation by the county (at least 15 years up to 25 years). The only construction delivery method for which state law also authorizes financing arrangements between the parties as part of the contract is a public-private partnership contract (P3). GS 143-128.1C(b)(3) authorizes a development contract between a unit of local government and a private developer to specify, among other arrangements, the “responsibilities of the governmental entity and all other participants with respect to financing of the project.” Since a P3 contract may include financing arrangements (such as lease payments), it is the most logical – and probably the most legally valid – procurement method to follow when an eligible county enters into a school capital lease under the new law.

What are the Requirements for Entering into a P3 Contract?

Under the P3 statute, a local government has a great deal of flexibility in structuring the terms and conditions of its contractual relationship with its private developer partner. Details such as long-term property interests of the parties, responsibilities in development of the project, bidding the construction, and, as discussed above, financing arrangements, are largely left to negotiation between the local government and its private development partner.

Although flexible with respect to the details of the development contract, the P3 statute does impose some specific requirements on the local government and the private developer. Significantly, the private developer is required to provide at least 50% of the financing of the total costs of the project, and that 50% cannot include any payments by the local government or private financing where the source of repayment is the local government. Accordingly, a private developer wishing to enter into a school capital lease arrangement with a county under the new law must provide at-least 50% of the financing of the total cost of the project, and this at-least 50% cannot include any lease payments or other monies received from the county. While it is possible that the developer’s obligation to “to bear the entire expense for all repairs, maintenance, alterations, or improvements to the structure, fixtures, appurtenances, and grounds of the property for the entire term of the lease” (one of the lease requirements discussed above) might count toward the developer’s financing obligation (especially since the developer cannot pass these costs on to the county), the P3 statute is unclear on whether future, anticipated costs that are not firmly calculated or verifiable at the time the contract is entered into can count toward the at-least 50% financing requirement. What is clear is that if the developer attempted to recoup repair and maintenance costs through lease charges to the county, those costs could not count toward the developer’s at-least 50% financing requirement, and most likely would also violate the requirements of the lease under the new law itself.

To enter into a P3 with a qualifying private developer, the local government must follow the procedural requirements of the P3 statute which include making written findings of the need for the project, determining its programming needs, and conducting a qualifications-based selection process through which interested private developers respond to a request for qualifications (RFQ) submitting information required by statute and requested by the local government. The local government then selects the developer it determines to be the best qualified and negotiates the development contract (or, in the case of a school capital lease project, the lease). The development contract (or lease) must be approved by the county board of commissioners after 30 days public notice. For more information on these procedural requirements, see the summary available here and this blog post.

Could a Developer Simply Build the School and then Lease it to a County without Triggering Bidding Requirements?

In my opinion, the answer to this question is “no.” Someone who wished to avoid bidding requirements might propose that the developer construct the school on his own accord and without any agreement with the county, and then, in a separate formal agreement, lease the completed school facility to the county. Under this scenario, one might argue that the lease is now a simple lease of fully developed real property that is not subject to competitive bidding requirements (as in the office space example given above). The county doesn’t have to bid the lease, the developer doesn’t have to compete for the lease, and the county gets lottery funds to pay for it. While it may sound good, this arrangement violates state law.

Our state’s appellate courts have held that a private construction project undertaken for intended future conveyance to a local government for compensation must comply with competitive bidding requirements. *Styers v. City of Gastonia*, 252 N.C. 572, 114 S.E.2d 348 (1960). If a developer constructs a school building and receives compensation from a county for the construction costs either up front or over time through lease payments, that contract is subject to competitive bidding requirements. Absent this rule, any local government could avoid competitive bidding requirements by negotiating an informal “gentlemen’s agreement” with a developer to construct a project for the local government which, once completed, is leased back to the local government, thus evading competitive bidding requirements.

The requirements of the law itself involve the county in the construction project, thus making the project, in essence, one undertaken on the county’s behalf. One of the requirements of the lease is that the county retain ownership of the real property on which the school building is constructed. This requirement necessarily includes the county in the construction project, at a minimum requiring a formal agreement between the county and the contractor authorizing the contractor to undertake construction work on county-owned property. To be eligible to receive Needs-Based Public School Building Grant funds, the agreement must be a lease of the school facility. Since the project must be constructed on county-owned property and would be paid for, in part, with public funds, it is essentially a public construction project, thus making it subject to competitive bidding requirements. Any attempt to divide the projects into separate components (privately-conducted construction and the lease itself) runs afoul of state law and could render the lease agreement void. *Hawkins v. Town of Dallas*, 229 N.C. 561, 50 S.E.2d 561 (1948).

Can the Existing Operational Lease Authority for Public Schools be used for the New Lottery Grant Program?

No. Since 1997, GS 115C-530 has authorized local boards of education to enter into operational leases for school facilities. This authority does not apply to the newly authorized school capital leases for which counties are eligible to apply for Needs-Based Public School Building Grant funds. First, the authority under GS 115C-530 is granted only to local boards of education, while the new school capital lease law applies only to counties. Counties are not authorized to enter into school operational leases under GS 115C-530, and local boards of education are not authorized to enter into school capital leases under the new law. In addition, GS 115C-530 only authorizes *operational* leases, not *capital* leases. An operational lease is one where the school board uses the property for a specified period of time but does not obtain actual or effective ownership of the property at the end of the lease term. A capital lease, such as that authorized under the new law, can result in actual or effective ownership of the property at the end of the lease term. Thus, the two types of leases are fundamentally different – schools may only enter into operational leases, while the authority to enter into school capital leases is granted only to counties.

Conclusion

Here are the main points articulated in this somewhat lengthy discussion:

1. Newly authorized school capital leases may be entered into only by tier one or tier two counties, not local school boards.
2. The new school capital leases are subject to specific requirements under the new law, including county ownership of the property on which the school facility is built, a lease term of between 15 and 25 years, and landlord obligation to bear all expenses for ongoing repair and maintenance.
3. Because it involves the expenditure of public funds for construction work, a school capital lease is subject to state competitive bidding requirements.
4. The P3 statute is the most logical – and likely the most legally valid – competitive procurement method for this type



of project.

In a future post, my colleague Kara Millonzi will discuss the finance aspects of the new school capital lease authority.

Links

- www.ncleg.net/Sessions/2017/Bills/Senate/PDF/S99v6.pdf
- www.nccommerce.com/research-publications/incentive-reports/county-tier-designations
- www.ncleg.net/gascripts/statutes/statutelookup.pl?statute=143-131
- www.ncleg.net/gascripts/statutes/statutelookup.pl?statute=143-129
- www.ncleg.net/gascripts/statutes/statutelookup.pl?statute=143-128
- www.ncleg.net/gascripts/statutes/statutelookup.pl?statute=143-128.1
- www.ncleg.net/EnactedLegislation/Statutes/PDF/ByArticle/Chapter_159/Article_8.pdf
- www.ncleg.net/gascripts/statutes/statutelookup.pl?statute=143-128.1C
- www.sog.unc.edu/sites/www.sog.unc.edu/files/additional_files/HOUSTON%20-%20New%20Design-Build%20Contracting%20Requirements.pdf
- www.ncleg.net/gascripts/statutes/statutelookup.pl?statute=115C-530