

# Leasing and Buying Commercial Properties for Charter School Use

*Unparalleled School Legal Services*

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## INTRODUCTION

Every year interest and enrollment in California’s public charter schools continues to grow. Just as no two communities are the same, each charter school finds its own unique approach to preparing students for success in life. Whether a charter school operates in multiple locations or is just starting out, finding the right space to house its program is a top priority.

This Guide was prepared by California attorneys who specialize in real estate matters and regularly advise charter schools on all aspects of their facilities. Intended to provide practical advice, this Guide covers the basic real estate transactions that charter schools use to address their immediate and long-term needs.

Once the school settles on a particular location, the process to acquire the site, whether through a lease or purchase, typically commences with a letter of intent directed to the current owner. The most important aspects of the letter of intent are discussed in Chapter 2. Lease and purchase agreements are covered in Chapters 3 and 4, respectively. In Chapter 5, special consideration is given to purchases of raw land and sites where the school intends to demolish and replace an existing building. Finally, Chapter 6 addresses some of the principal means by which charter schools pay for the leasing, purchasing and development of new facilities.

This Guide assumes that the property is an office, church or commercial property has not previously been operated as a public school site, but will be converted to a charter school. All aspects of local government compliance are covered in *Planning and Permitting the Construction of New Facilities for Charter Schools in California*, which is a companion to this Guide.



## **THE PROCESS: LOCATION CONSIDERATIONS, LETTER OF INTENT, DUE DILIGENCE, CONTRACT, AND CONTINGENCIES**

### **Location**

Although this Guide will primarily focus on the various transactional aspects of charter school facilities projects, as a preliminary step, charter school operators should be prepared to consider how the location of various potential school sites will impact the acquisition process. The location of a potential property often involves the interplay of factors such as zoning regulations, possible use permits, environmental impacts, and potential community support or opposition to the proposed charter school project. Charter school leaders that have worked with their attorneys and project consultants

to gain a thorough understanding of these potential factors will be well-positioned to ensure that these factors are addressed in the lease or purchase and sale negotiations and contract.

As discussed in *Planning and Permitting the Construction of New Facilities for Charter Schools in California*, property in California is subject to various zoning, land use, permitting, and environmental regulations. Many charter school projects will require a conditional use permit. This type of permit will very frequently take 9 months or more to obtain, and charter leaders should be prepared to include this and other permitting related provisions in purchase or leasing contractual documents. Charter leaders are encouraged to visit the city or county planning department and learn as much as possible about the location specific regulations that will apply to a particular property before entering negotiations for acquisition.

Charter school leaders should also consider the impact the school site location will have on the school's ability to obtain funding or financing for the project. Several of the facilities funding programs available to charter schools, most notably the Charter School Facility Grant Program ("SB 740") and the federal New Markets Tax Credit program, have eligibility requirements that are impacted by economic demographics that vary from community to community. Having an early understanding of school site locations, availability of funding sources, and the impact of those sources on the affordability of certain sites will allow school operators to better address potential impacts within the context of the leasing or purchase negotiation.

Finally, any discussion of the location of charter school facilities would be incomplete without at least referencing the legal issues that have arisen for many charter schools that have established school facilities outside the boundaries of their authorizing district pursuant to California Education Code Section 47605. Due to the aggressive legal posture adopted by several California school districts to prevent charter schools from operating outside of their authorizing district, many of these California charter schools have become embroiled in what has become known as "location litigation". This facil-



ities guide is focused on the transactional aspects of charter school facilities projects, and a discussion of the legal issues raised by locating outside the boundaries of an authorizing district is beyond the scope of this document. However, to the extent that charter leaders have heard that it is possible do so and are interested in considering this option, they should be sure to consult with experienced legal counsel to gain a better understanding of the legal challenges they are likely to encounter before they choose to explore out-of-district locations

### **Due Diligence**

In addition to potential challenges associated with obtaining the various government approvals discussed in greater detail in *Planning and Permitting the Construction of New Facilities for Charter Schools in California*, charter school operators should be sure take other steps to investigate the suitability of the property for school uses beyond what might be required to obtain necessary permits. Early identification of potential concerns will provide more time to address these issues during the contract negotiation. Charter school operators should at a minimum work with their consultants to:

- Visually inspect the property and buildings
- Determine whether adequate parking exists for staff, parents and visitors
- Consider whether space exists for safe pick up and drop off of students
- Determine whether the site has adequate outdoor play space on site or nearby
- Observe how adjacent properties are used and consider potential impacts on students
- Analyze sufficiency of space for current and projected enrollment

### **Draft Letter of Intent**

After a property is identified and preliminary due diligence is completed, but before a lease or purchase and sale contract is prepared, one or both parties to a real estate transaction will often convey their “deal points” in a letter of intent. The purpose of the letter of intent is to summarize the key provisions for the parties, which will be reflected in a formal contract if an agreement in concept is reached. With a good letter of intent, the task of documenting the transaction in a full contract can be more efficient.

To properly serve as a platform for negotiations, a letter of intent must always indicate that it is non-binding on the parties. As its name suggests, the letter conveys the parties’ intentions to transfer certain property interests, but does not itself serve as a contract. Timing is always critical in real estate matters. Typically, the letter of intent will specify an expiration date or require that a formal offer be provided within a certain number of days.

The most important terms to a real estate transaction are set forth in the letter of intent. To be effective, the letter must convey the basic deal points as clearly as possible. A price will usually be specified, although the letter may call for the purchase price to be set by an appraisal. For a lease, the rent, term of the lease, and any extensions or options, must be specified.

The letter must also accurately define the premises or property. In urban settings, parties often refer to properties simply by the address. Parties should be careful that their description of the property or premises cannot be confused. If something less than the entire property is intended to be covered, this must be expressed in the letter clearly.

Whether the property is being offered for lease or sale, the owner must provide an opportunity for thorough inspection by professional building inspectors and contractors. The letter of intent should specify the length of time which will be provided for additional due diligence, typically called a contingency period. Where a purchase or



long term (5+ year) lease is contemplated, the letter should specify a period of at least a month in which to conduct due diligence, which will also include any necessary exploration of and application for all required government permits, approvals, and other requirements.

The charter school operator should assume that some alterations to the property will be needed to make the space suitable for its use as a charter school. The letter should therefore discuss the scope of alternations, improvements or repairs, and indicate which party is responsible for these. Each party's responsibility for repairs and maintenance should be stated clearly in the letter of intent.



## LEASES

Every year new leases are executed for many charter school properties in California. Research by the California Charter Schools Association indicates the more than 40% of California charter schools lease their facility.

A charter school operator must therefore understand the contractual nature of a lease. The lease serves dual purposes; it guarantees that the school will have a facility in which to operate, but it also guarantees income to the building owner. Should the school decide that it cannot remain in the space or vacates the premises before the lease terminates, all of the prospective rent payments due under the lease would likely be converted to a claim for damages. Charter schools should plan accordingly when determining the length of a lease. If a sponsoring or parent organization will be named

as a guarantor of the lease, that party will be responsible for all lease payments in the event of default.

While some landlords ask for personal guarantees from charter school employees, we never recommend that you agree to such a demand. If landlords insist on some sort of security for future lease payments, charter school leaders should inquire with lenders who have experience working with charter schools to discuss options for providing security that do not include any personal guarantees.

Before the lease commences, it is important for the charter school to determine whether the space is safe and compliant with applicable laws. As an employer, the school is required to provide facilities that are safe for employees. Environmental hazards such as mold, lead and asbestos must be avoided. Landlords have a basic obligation to provide space that is habitable, with operable heating and cooling, and free of hazardous conditions. Where the space has never been used for educational purposes, it may be necessary to make alterations to conform to Building Codes. Before issuing a building permit for alterations, the local city or county will also review the zoning of the site, and determine whether a discretionary use permit is required to allow a school to use the building. Compliance with local regulations is the subject of a companion Guide, *Planning and Permitting the Construction of New Facilities for Charter Schools in California*.

Most leases assign responsibility to the tenant for alterations to accommodate the tenant's use. Often the local jurisdiction will require a building permit for tenant improvements. During the building permit process, the city may find that additional improvements are needed to bring the building "up to code" in order to allow occupancy for a school. Typically a local jurisdiction sets a threshold which triggers a requirement to bring the existing building into compliance with the then-current building code. This threshold may be a square footage or dollar amount. Therefore, if the school only proposes minor interior alterations, it is generally not subject to any requirement to replace outdated building systems to conform to present standards. Because of

this risk, however, it is important that the lease clearly assign responsibility for all of the building's alterations, both foreseen and unforeseen, between the landlord and tenant. Any permanent improvements to the building typically remain in place when the lease terminates. Typically, the tenant is responsible for all of its own trade fixtures, which must be removed from the building at the end of the lease.

Commercial lease agreements tend to be long and complex and charter leaders should spend time reviewing the entire document carefully. However, through our experience representing hundreds of charter schools on leasing transactions, we know that certain lease provisions can have a particularly large impact on the charter school's tenancy, and those provisions merit additional consideration. The provisions that warrant additional consideration include the following:

**Contingencies.** As discussed above and in Planning and Permitting the Construction of New Facilities for Charter Schools in California, charter school uses often require lengthy permitting processes related to zoning, land use, and building code compliance. A lease document should include provisions that provide charter schools with adequate time to successfully complete the permitting process, as well as provide the charter school with good options for terminating the agreement should permitting obstacles become insurmountable or cost prohibitive. The charter school should also have options to amend or perhaps terminate the agreement should other problems arise, for example in the event that building or property defects are discovered by the school. Finally, all California charter schools are subject to petition renewals and authorizer oversight, and leases should include provisions providing charter schools with flexibility should renewal challenges or other authorizer-related difficulties develop.

**Property Maintenance and Repairs.** Unlike facilities use agreements for school district-owned facilities that typically assign major maintenance and repair obligations to the school district, boiler plate commercial lease agreements very frequently require the tenant to assume responsibility for maintaining, repairing and replacing major building components such as heating, cooling and ventilation systems (HVAC). Giv-



en the significant costs associated with these types of repairs, charter school leaders should carefully consider the budgetary impacts of these maintenance requirements, and consider negotiating for lease terms that protect charter school tenants from major costs associated with maintenance.

**Renewal Options.** Moving a school and developing community ties and consistent enrollment in a new neighborhood is a major undertaking for charter schools and can have significant impacts on the long-term success of the school. Ideally, charter school leaders will be able to identify and secure a school site that provides a stable, affordable, long-term home for the school. In order for a leased facility to provide that type of stability, the charter school must be able to ensure that the term of lease can be renewed periodically. Most commercial landlords are accustomed to offering lease terms in five- or ten-year increments, and will in most cases be willing to provide tenants with extension or renewal options. Charter leaders should work with their legal counsel to ensure that lease renewal provisions provide the school with the maximum amount of discretion to extend the term under terms and conditions that are suitable to the school.

**Lease Payment Escalation Clauses.** Commercial landlords typically ask tenants to agree to provisions in the lease that will automatically increase the required lease payments at set intervals. These lease payment escalators will take effect during the base lease term and/or when the tenant exercises the right to extend or renew the lease term. Charter school operators should be prepared to analyze the fiscal impact of rent escalation clauses and work with legal counsel to structure them in a way that maximizes the school's ability to maintain an affordable facilities arrangement. Schools that are eligible for government funding programs designed to provide facilities funding will have a greater ability to absorb lease payment increases, but all government programs are dependent upon legislative appropriations, and charter school operators should analyze the affordability of lease payments under various scenarios that do not assume that facilities funding or general per pupil funding will increase at the same pace as rent escalation clauses.

Rent escalators that are only triggered when a tenant exercises lease renewal options present additional challenges. Although in some cases these provisions will enact a set percentage increase—3% is typical—in other cases they will establish a process to determine what the lease payment increase will be. Escalation provisions that give the landlord the discretion to determine the new lease rates are clearly problematic, but provisions that require negotiations between the landlord and tenant, or that use real estate appraisers to determine lease increases might also result in unfavorable outcomes for charter schools depending upon local real estate market trends. A tenant's right to renew or extend a lease is only beneficial to the tenant if the lease payments required after renewal are affordable. By working with legal counsel as early as the letter of intent stage to address future lease payment increases, charter schools can develop lease payment increase clauses that provide sufficient amounts of predictability and control.



## PURCHASING A SCHOOL SITE

### **Purchasing Existing Buildings**

Some charter schools find existing buildings to purchase as permanent homes. The purchase of an existing commercial site presents many of the same challenges as in a leasing transaction, and yet the permanence of a purchase, and the sizeable financial investment it requires, amplifies the importance of ensuring that potential pitfalls are identified and addressed as soon as possible.

A purchase and sale agreement is used to support the transfer of the property from the seller to the buyer once the buyer is satisfied that the building is suitable for its needs. Typically, the contract is prepared by the seller, and specifies that the property is sold in an “as is” condition. Occasionally the seller will represent that the building is

free of defects, and provide a warranty period during which the seller will make repairs to the building or its systems. This is most likely to occur where the seller has constructed the building specifically for the buyer. Such representations and warranties are otherwise rare, as most sellers tend to minimize their responsibility for defects or problems that are discovered after the buyer assumes ownership.

Most purchase and sale contracts follow a standard structure. Once the contract is signed by both parties, an escrow company is selected to process the transaction. The buyer pays a portion of the purchase price as a deposit, which is held by the escrow company during the contingency period. The contract specifies the length of this contingency period, as well as any extensions of the period. Once the buyer completes its due diligence, at the end of the contingency period, the escrow holder releases or pays this deposit to the seller. At that point the buyer is committed to purchase the building and loses its deposit if it is unable to complete the purchase. The contract may also provide for portions of the deposit to be released to the seller in exchange for extensions of the due diligence period. It is preferable for the buyer to have enough time during the contingency period to complete due diligence without having to sacrifice any funds. However, in a competitive real estate market, sellers are often able to win this concession.

It is crucial that the charter school buyer have ample time during the contingency period to confirm that the building will be suitable for its needs. The buyer should be allowed to make this determination in its sole discretion. In most jurisdictions, a use permit will be needed to operate the charter school. This means that the school must file an application with the city or county in which the site is located, which must be approved before occupancy commences. The discretionary approval process is largely outside the control of the charter school and can be difficult to manage. A charter school should never commit to purchase a building within a timeframe that is unrealistic, taking into account the extent of discretionary approvals that will be needed. The permitting process is discussed in more detail *Planning and Permitting the Construction of New Facilities for Charter Schools in California*, which is a companion to this Guide.



Early in the contingency period, the seller will provide the buyer with any documentation that the seller has regarding the property. It is particularly important for the buyer of a charter school facility to investigate any environmental contamination, including lead-based paint, asbestos, and soil contamination, as the presence of these hazards can jeopardize third-party financing. The seller will also provide a preliminary title report for the property, which will list all liens and encumbrances on the property that have been recorded in the official records. Most contracts provide a limited number of days for the buyer to review this report and respond to the seller, after which point the buyer is generally deemed to have waived any objections. Buyers should pay close attention to encumbrances on the property such as easements and deed restrictions, as these may interfere with plans to move the buildings on the site, or impose other restrictions (e.g., parking) on the use.

Certain California laws require sellers of commercial properties to provide specific information to buyers. Since July 1, 2013, sellers have been required to inform buyers if an inspection has been performed on the building to determine its accessibility for individuals with disabilities under the Americans with Disabilities Act (“ADA”). This is particularly important for charter schools, as all public school facilities must be accessible to persons with disabilities. The local government will almost certainly require accessibility upgrades if the buyer makes significant alterations to the building. Similarly, local governments often require the lighting and HVAC systems of older buildings to be upgraded in order to conserve electricity. Finally, the local government will also require the installation of water-conserving plumbing fixtures in the event that an alteration is performed. Building owners have until January 1, 2019 to replace older plumbing fixtures with higher performance faucets and toilets.

Once the contingency period is over, the initial deposit becomes non-refundable. Most purchase and sale contracts identify the retention of this deposit as a form of agreed-upon or “liquidated” damages in the event of a breach by the buyer. Similarly, during the contingency period, the seller is not allowed to enter into any new contracts to sell or lease the building, as these would interfere with buyer’s ability to complete the purchase.

As a remedy in the event that the seller breaches the contract, some agreements provide for the seller to reimburse the buyer for the costs of plans and studies that it prepared during the contingency period. However, as most agreements are prepared by the seller, this remedy is not usually included, and any costs incurred by the buyer during its due diligence cannot be recovered for a seller's breach except at the conclusion of a lawsuit. Where the seller arbitrarily refuses to honor the agreement, the buyer can seek "specific performance," which is a court order directing the seller to honor the agreement. A purchase and sale agreement may allow the prevailing party in a lawsuit to recover its attorneys' fees.

### **Purchasing Land**

Special consideration must be given to those situations where the property which a charter school desires to purchase contains raw land or a structure which will be demolished and replaced. Unless the seller has already completed the entitlement process for the school, the charter school will need to obtain a number of different permits and approvals from the local government to build the school. For large school projects, or more challenging sites, this process can take years to complete.

Another concern arises where the seller offers a portion of a larger parcel of land for sale to the charter school. This may occur where the seller intends to retain ownership of a portion of the site. In such cases the seller must first obtain the approval of a parcel map from the local government in accordance with the Subdivision Map Act. Until the parcel map is recorded in the official records, it is unlawful for the property owner to sell only a portion of the land. It is critical that the purchase and sale agreement in such circumstances include an express condition that the contingency period remain open until the parcel map is recorded. Without such a condition, the transaction can be considered void.



## **CONSIDERATIONS REGARDING FACILITIES FUNDING OPTIONS AVAILABLE FOR CHARTER SCHOOLS**

Charter schools have access to a wide range of financing sources that are available for facilities projects. Various private finance options are available from Community Development Financial Institutions, traditional banks, credit unions, and tax-exempt private activity bond investors.

Several state and federal programs are also available to finance the acquisition and development of charter school facilities. Although a full discussion of all of the facilities finance and funding sources available to charters is beyond the scope of this guide,

developing a working knowledge of the regulations governing some of these programs will help charter school operators as they work with their legal counsel during negotiations to purchase or lease property for school facilities.

### **The Charter School Facility Grant Program (SB 740)**

Legislation from 2001 (Senate Bill 740) enacted a program designed to provide lease reimbursement for charter schools that serve disadvantaged populations. As initially created, the program provided funding assistance of up to \$750 per ADA or up to 75% of the total facilities costs, whichever was lower, to eligible charter schools. To qualify under the program as originally created, charter schools were required to serve a population of students in which at least 70% of pupils were eligible for free or reduced-price meals, or the school must have been located in the attendance area of a district elementary school with at least 70% or more of such students.

In the years following the enactment of the program, the eligibility threshold was reduced to include schools where 55% or more of the student population is eligible for free and reduced-price meals. In addition to the reduced eligibility threshold, the funding level was also increased from \$750 per unit of ADA to \$1,117, which is indexed to increase annually with inflation. For the 2016-17 school year, more than 360 schools received funding under the program statewide, and the total funding level for the program was \$112 million.

Although the SB 740 program, administered by the California School Finance Authority (CSFA) has proven to be an exceptionally important program for providing more affordable school facilities for charter schools, the regulations governing the program include a few restrictions that charter school leaders should carefully consider before committing to a particular facility project. The first and most obvious consideration should be whether or not the charter school's student population (or projected population for new schools) will meet the minimum 55% free and reduced-price meal threshold. If not, or if a school's number is close enough to 55% that it may drop be-



low 55% during the term of the lease or loan, the charter school should strongly consider finding a facility that is within the attendance area of a district elementary school that is safely above the 55% threshold.

In addition to considerations related to the student population-based eligibility requirements, there are a few additional significant restrictions under the program. For example, charter schools receiving facilities through Proposition 39, or which occupy existing school district or county office of education facilities, are not eligible for SB 740 funding in most cases.

Charter school operators should also understand, prior to entering facilities acquisition negotiations, that loan payments for facilities financing are not eligible for reimbursement under the SB 740 program. As a result, charter schools that are interested in the purchase and development of permanent school facilities will need to ensure that the school facility is owned by a legal entity that will lease the property to the charter school. Charter school operators should work with legal counsel early in the facilities development process to ensure that the legal entity and the arrangement between the parties is established in a way that will ensure eligibility for SB 740 funding. Information regarding this important program is available online at <http://www.treasurer.ca.gov/csfa/csfgp/index.asp>

***Charter School Facilities Incentive Grant Program.*** In addition to the SB 740, CSFA administers a related program known as the State Charter School Facilities Incentive Grants Program. This federal grant program is intended to supplement SB 740 and assist high-performing charter schools with facilities-related expenses. Although the program is designed to work in conjunction with the SB 740 program, there are some important differences between the two programs. First, in addition to lease payments, debt service or loan payments are eligible for reimbursement under this program. Another important difference between the programs is that schools located in district-owned facilities pursuant to Proposition 39 are also eligible to receive funding for pro-rata payments or costs related to design, new construction, and renovation.

Finally, applicants for funding under this program are more likely to receive funding from this competitive and typically oversubscribed program if they serve a population with a large percentage of students that are eligible for free and reduced-price meals. However, unlike SB 740, the Incentive Grants program does not set a specific free and reduced price meal eligibility threshold. Additional information regarding the Incentive Grants Program can be found online at <http://www.treasurer.ca.gov/csfa/incentive.asp>

**Proposition 51 (2016).** In 2016 California voters passed Proposition 51, which authorized \$500,000,000 in bonds for charter school facilities. These funds are available for site acquisition and construction or rehabilitation of charter school facilities. Funds are provided as a reservation of funds to reimburse the school for its project costs. Program funds pay for half of eligible costs, with half provided by a local match. Low interest loans made available through CSFA are available to fund the local match. The amount of the grant is determined by the number of pupils served by the facilities, with higher amounts available for higher grade-level students. Additional funds are available for schools in urban and geographically-isolated areas. The program is competitive as funds are limited; schools serving disadvantaged populations or located in districts with unhoused pupils will receive more preference points. The application window for this program closed on June 5, 2017. However, it has been common under previous state bond measures for the state to elect to accept additional applications at a later date as additional state bond funds become available in a subsequent funding round.

**CSFA Revolving Loan Fund.** The Charter School Revolving Loan Fund Program provides funding in the form of low-interest loans of up to \$250,000 for new charter schools in California. The purpose of the Program is to assist new charter schools with meeting the purposes of the school's charter. The Program is not available to any charter school that is a conversion of an existing public school. To qualify, the charter school must be in the first term of a new charter. The charter school must be in good standing with its authorizer and not have any material legal issues. The Program is administered by CSFA, which gives priority to first-year charter schools for start-up costs.