Case No. S266344

SUPREME COURT OF THE STATE OF CALIFORNIA

STEPHEN K. DAVIS,

Plaintiff and Respondent,

v.

FRESNO UNIFIED SCHOOL DISTRICT, AND
HARRIS CONSTRUCTION CO., INC.

Defendants and Petitioners.

After A Published Decision By The Court Of Appeal
Fifth Appellate District
Case No. F079811

From the Superior Court,
County of Fresno,
Case No. 12CECG03718
The Honorable Kimberly Gaab

PETITIONER FRESNO UNIFIED SCHOOL DISTRICT'S REPLY TO RESPONDENT'S ANSWERING BRIEF

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Petitioner Fresno Unified School District ("District") respectfully submits the following Reply to the Answering Brief filed by Respondent Stephen K. Davis ("Davis" or "Respondent").

INTRODUCTION

Respondent makes numerous arguments throughout his Answering Brief as to why this Court should affirm the decision of the Fifth District Court of Appeal ("Fifth DCA") in *Davis v. Fresno Unified Sch. Dist.* (2020) 57 Cal.App.5th 911 ("*Davis II*"). These arguments are primarily grounded in what Davis believes to be his right to bring a taxpayer's suit under Code of Civil Procedure section 526a. Section 526a permits tax-paying individuals to sue public entities and officials "to obtain a judgment, restraining and preventing any illegal expenditure of, waste of, or injury to" a local agency's funds or property." (§ 526a, subd. (a); see also *Weatherford v. City of San Rafael* (2017) 2 Cal.5th 1241, 1249.)

This Court should find Davis's arguments unpersuasive regarding the issue at hand - whether the subject lease-leaseback agreement, comprised of a Site Lease and Facilities Lease (jointly the "Lease-Leaseback Agreement") between the District and Respondent Harris Construction Company, Inc. ("Harris") for construction of the challenged Rutherford B. Gaston Sr. Middle School project (the "Middle School Project") is a "contract" within the meaning of that term under Government Code section 53511. Davis contends he is entitled to in personam relief under Code of Civil Procedure section 526a in an attempted end-run around the Validation Statutes,[1] as his desired disgorgement remedy would require the trial court to find the Lease-Leaseback Agreement was null and void from its inception.

[1] Code Civ. Proc. §§ 860-870.5 (hereafter the "Validation Statutes")

In arguing that the Lease-Leaseback Agreement is not a contract within the ambit of Government Code section 53511, Davis erroneously contends that District seeks a broad reading of the term. However, as District discussed in its Opening Brief, it recognizes that the term has been given a narrow interpretation under this Court's decision in *City of Ontario v. Superior Court* (1970) 2 Cal.3d 335 and subsequent appellate decisions following the rationale of this Court.[2] Nonetheless, consistent with this narrow interpretation, section 53511 has been found to cover those agreements that are *inextricably intertwined* with the financial obligations of a public entity or are *directly related* to the issuance of the bonds of a public entity. The subject Lease-Leaseback Agreement is both inextricably intertwined and directly related to the issuance of the general obligation bonds used to fund the construction.

As a direct result of Davis's strategic decision not to seek injunctive relief to prevent the construction from moving forward, a cloud has hung over the Middle School Project for years. Davis explains his choice by claiming he did not want to impair District's ability to operate, notwithstanding many years of litigation and hundreds of thousands of dollars of legal fees incurred by the District, and because he had an "adequate remedy at law" through disgorgement. The Fifth DCA found that Davis has standing under Code of Civil Procedure section 526a and the common law to bring a taxpayer's action, which District contends was incorrect in that District did not have a duty under Government Code section 1090 to pursue a legal claim based upon the alleged conflict-of-interest involving Harris.

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[2] See e.g., *Graydon v. The Pasadena Redevelopment Agency* (1980) 104 Cal.App.3d 631.

While it is an unsettled question of law whether a disgorgement remedy is available to Davis under Code of Civil Procedure section 526a,[3] in light of the exclusivity of the Validation Statutes under Code of Civil Procedure section 869,[4] this Court should find any action that would require invalidating the Lease-Leaseback Agreement, regardless of the form of the action or the particular remedy sought, subject to the Validation Statutes. Because the gravamen of Davis's conflict-of-interest claims requires invalidation of the Lease-Leaseback Agreement, such claims fall within the purview of the Validation Statutes.

Davis contends that the District's "arbitrage arguments in favor of validation" are "red-herrings." However, events occurring after the date of a municipal bond issuance can result in an IRS determination that the interest on what would have otherwise been tax-exempt bonds has become taxable. Moreover, prompt action under the Validation Statutes is integral to ensuring that municipal bonds meet the tests mandated by federal tax law for issuing the bonds on a tax-exempt basis.

Davis contends that the decision in *McGee III* [5] should be disapproved by this Court, as Davis's actions in this case are virtually identical to those taken by McGee in challenging a similar lease-leaseback agreement. However, *McGee III* was correctly decided in light of this Court's holding in *City of Ontario, supra*, and the lineage of cases that

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[3] In *San Diegans for Open Gov't v. Pub. Facilities Fin. Auth. of City of San Diego*, (2019) 8 Cal.5th 733, this Court noted, but did not decide, the question of whether the taxpayer organization's claim of a conflict in interest brought as a taxpayer action could seek disgorgement of payments received. That question was remanded. (*Id.* at p. 747.)

[4] Code Civ. Proc. § 869 provides in relevant part "No contest except by the public agency or its officer or agent of any thing or matter under this chapter shall be made ***other than within the time and the manner herein specified*** [emphasis supplied]."

[5] *McGee v. Torrance Unified Sch. Dist.* (2020) 49 Cal.App.5th 814, review denied (Aug. 26, 2020) ("*McGee III*").

followed. Davis's failure to seek an injunction and calendar preference places him squarely within the holdings of both *McGee III* and *Wilson & Wilson v. City Council of Redwood City* (2011) 191 Cal.App.4th 1559, as do his arguments (identical to those made by McGee) that he did not impair District's ability to operate or seek injunctive relief because he has an adequate remedy at law.

Davis did not, as he contends, file an in personam action. Rather, Davis's taxpayer's lawsuit was filed as an in rem reverse validation action where one theory for invalidation of the challenged agreements is an alleged violation of Government Code section 1090.

LEGAL ARGUMENT

I. Davis Does Not Have Standing Under Code Civ. Proc. Section 526a or the Common Law to Maintain a Taxpayer Action.

The Fifth DCA found that Davis's taxpayer's action is appropriate because the Lease Leaseback Agreement does not fall within the scope of the Validation Statutes given its lack of a financing component. As such, Davis alleges standing exists under Code of Civil Procedure section 526a and the common law. However, under either Code of Civil Procedure section 526a or the common law, "[t]axpayer suits are authorized only *if the government body has a duty to act and has refused to do so. If it has discretion and chooses not to act, the courts may not interfere with that decision.*" (*Daily Journal Corp. v. County of Los Angeles* (2009) 172 Cal.App.4th 1550, 1557–1558 [italics added]; accord *Gilbane Building Company v. Superior Court* (2014) 223 Cal.App.4th 1527, 1532; *California Taxpayers Action Network v. Taber Constr., Inc.* (2017) 12 Cal.App.5th 115, 141–142.) "It has long been held that a government entity's decision whether to pursue a legal claim involves the sort of discretion that falls outside the parameters of waste under section 526a and cannot be enjoined

by mandate." (*Daily Journal*, *supra*, 172 Cal.App.4th at p. 1558.) Because deciding whether to pursue a legal claim is generally an exercise of discretion, rather than "a duty specifically enjoined," the common law too *does not* provide a taxpayer a cause of action to pursue a legal claim on behalf of a government entity. (*Silver v. City of Los Angeles* (1962) 57 Cal.2d 39, 40–41; *San Bernardino Cty. v. Superior Court* (2015) 239 Cal.App.4th 679, 686–687.)

The *Gilbane* court explained the rule:

> "Where the thing in question is within the discretion of such body to do or not to do, the general rule is that then ***neither by mandamus, quo warranto, or other judicial proceeding***, can either the state or a private citizen question the action or nonaction of such body; nor in such cases can a private citizen rightfully undertake to do that which he thinks such body ought to do. ***It is only where performance of the thing requested is enjoined as a duty upon said governing body that such performance can be compelled, or that a private citizen can step into the place of such body and himself perform it.***'" (*Gilbane, supra*, 223 Cal.App.4th at pp. 1532-1533 [bold and italics supplied].)

Schaefer v. Berinstein (1956) 140 Cal.App.2d 278, exemplifies an exception to the general rule. In *Schaefer*, a taxpayer brought suit in representative capacity under the common law, alleging the city failed to instigate legal action relating to transactions with private defendants that the taxpayer contended were made in violation of Government Code section 1090. (*Id.* at pp. 291–292.) The Court of Appeal allowed the lawsuit to proceed, noting that the facts alleged showed a "failure of the city council to perform a specifically enjoined duty," as the city charter included a provision *requiring the city council to declare such transactions void*. (*Id.* at p. 295.) Similarly, in *Miller v. McKinnon* (1942) 20 Cal.2d 83, 96, which Davis relies on, a provision of the former Political Code made it the "*imperative duty*" of the county district attorney to "institute suit, in the name of the county" where contracts were awarded in violation of

competitive bidding laws. (*Id.* at pp. 86–87, 95; see also *Daily Journal*, *supra*, 172 Cal.App.4th at p. 1559; *San Bernardino Cty.*, *supra*, 239 Cal.App.4th at p. 687; *People ex rel. Younger v. County of El Dorado* (1971) 5 Cal.3d 480, 491, [suit by attorney general to compel two counties to pay their share of support costs to a regional planning agency *as required by statute*, also noting that mandate does not lie for discretionary acts]; *Marshall v. Pasadena Unified School Dist.* (2004) 119 Cal.App.4th 1241, 1252 [mandate petition to compel school district to put construction contract up for bid, as required by statute].)

This situation is readily distinguishable from *Schaefer* and *Miller*. The issue in this case is the District's discretion with respect to bringing suit on the basis of an alleged violation of Government Code section 1090. (See *San Bernardino Cty.*, *supra*, 239 Cal.App.4th at p. 687.) Davis cites no law requiring District to pursue any claim it might have against Harris under Government Code sections 1090 or 1092, because there are no such provisions. Section 1092 states that a contract made in violation of section 1090 "*may be avoided at the instance of any party* ..." and does not suggest that a public agency party must bring any such claim it may have. (*Ibid;* Gov. Code, § 1092, subd. (a), [italics added].) Accordingly, the Fifth DCA's conclusion that "[D]avis may pursue a taxpayer's action alleging the illegal expenditure of public funds based on conflicts of interest ...." contravenes established precedent as does Davis's contention that he has standing under section 526a.

II. Assuming Arguendo That Davis Has Standing Under Code Civ. Proc. Section 526a or Under the Common Law, the Alleged Violation of Section 1090 Falls Within the Purview of the Validation Statutes.

Davis asks this Court to "disapprove of" the holding in *McGee III,* a published opinion decided just months before the decision was rendered in

Davis II.[6] *McGee III* was argued by the same legal counsel representing Davis, and such "disapproval" is requested because the Second District Court of Appeal came to the opposite conclusion from that the Fifth DCA came to in *Davis II*, under almost identical facts.

As in *McGee III*, the centerpiece of Davis's argument is that his conflict of interest claims are in personam taxpayer claims brought pursuant to section 526a and that these claims fall outside the Validation Statutes. (See *McGee III*, 49 Cal.App.5th at p. 825.) Davis contends, as did McGee, that he may use section 526a to assert conflict of interest claims pursuant to common law and Government Code section 1090. (See *McGee III*, *supra*, 49 Cal.App.5th pp. at 825–26.) While "[S]ection 526a is, as a general rule, available to taxpayers who wish to challenge government contracts affected by financial conflicts of interest," including pursuant to Government Code section 1090,[7] as the court noted in *McGee III* "… section 526a taxpayer claims alleging violations of section 1090 may still fall within the validation statutes. (*Regus v. City of Baldwin Park* (1977) 70 Cal.App.3d 968, 972.)" The form of the claim does not govern; rather a court must examine "[t]he gravamen of a complaint and the nature of the right sued upon," in order to determine whether a taxpayer's claims fall under the Validation Statutes. (See *McGee III*, *supra,* 49 Cal.App.5th at p.826.) The ultimate question here is whether Davis's claim "go[es] beyond the determination of the validity of the challenged matter" or is merely a "request for invalidation ... in other words." (*Katz v. Campbell Union High School Dist.* (2006) 144 Cal.App.4th 1024, 1034.)

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[6] *Davis v. Fresno Unified Sch. Dist.* (2020) 57 Cal.App.5th 911, as modified on denial of reh'g (Dec. 16, 2020.) ("*Davis II*")

[7] *San Diegans, supra,* 8 Cal.5th at p. 746.

For example, in *McLeod v. Vista Unified Sch. Dist.* (2008) 158 Cal. App.4th 1156, a taxpayer brought a suit pursuant to section 526a to challenge aspects of a school district's measure authorizing the issuance of construction bonds. (*Id.* at p. 1160.) The taxpayer sought declaratory and injunctive relief but did not plead a claim under the Validation Statutes. (*Id.* at p. 1163.) The suit was filed well beyond the 60-day statute of limitations for a validation claim, so the issue was whether the section 526a claim was subject to that limitations period or some longer period that would have made it timely. The court held the 60-day period for filing validation claims applied because the section 526a claim attacked a decision that was subject to the Validation Statutes. (*Id.* at pp. 1164–1165.) Recognizing section 526a claims and validation claims are not mutually exclusive, the court held the taxpayer action "directly challenged the validity of a planned bond issuance, and the lack of a prompt validating procedure would impair the District's ability to operate." (*Id.* at p. 1169.)

The court in *Katz*, *supra*, reached a similar conclusion. There, the taxpayer filed a complaint to invalidate a newly passed tax and alleged additional claims for a declaration defining a term in the new tax provision and for an injunction restraining imposition of the tax. (*Katz*, *supra*, 144 Cal.App.4th at p. 1029.) The publication of the summons was defective under the Validation Statutes, and the court rejected the taxpayer's argument that his declaratory and injunctive relief claims were not subject to validation. (*Id.* at p. 1033.) The court noted that the taxpayer's complaint did "not seek relief unrelated to the parcel tax he claims is invalid." (*Id.* at p. 1034.) Instead, the declaratory relief claim was "merely a request for invalidation of the tax stated in other words." (*Ibid.*)

As in *McLeod*, *supra*, and *Katz*, *supra*, regardless of Davis's characterization of his conflict of interest claims or the relief sought, the gravamen of his action is the invalidity of the Lease-Leaseback Agreement. Davis admits he seeks "a finding that the contracts were ultra vires, illegal, void, and unenforceable due to a conflict of interest." A judgment finding Harris violated section 1090 would render the Lease-Leaseback Agreements "void from [their] inception." (See *McGee v. Balfour Beatty Constr., LLC* (2016) 247 Cal.App.4th 235, 247.) Although Davis focuses on the claim that he seeks disgorgement directly from Harris, any judgment ordering disgorgement would require that the Lease-Leaseback Agreement be invalidated.

Because Davis's conflict of interest claims are subject to the Validation Statutes, he cannot obtain effective relief through disgorgement. Davis cites *Thomson v. Call* (1985) 38 Cal.3d 633 as supporting authority, but that case is readily distinguishable. It involved a taxpayer's challenge to a city's fully performed real estate transaction alleging a violation of Government Code section 1090. The court held the city could retain title to the land and recoup the purchase price from the councilman with the alleged conflict of interest. (*Id.* at pp. 646–647.) *Thomson* did not arise under the Validation Statutes, so the court did not address whether the disgorgement remedy remains available when a Government Code section 1090 claim seeks to void a completed contract falling within the Validation Statutes.

III. Disgorgement is Not Available to Davis Under Code Civ. Proc. Section 526a, as it Would Necessitate that the Lease-Leaseback Agreement be Invalidated.

Davis contends that notwithstanding the exclusivity of the Validation Statutes under Code of Civil Procedure section 869, he is entitled to an in

personam disgorgement remedy.[8] Because the Fifth DCA found that the Lease-Leaseback Agreement was not a true lease subject to validation, which District contends was error, it failed to consider that seeking disgorgement is simply an "end-run" around the Validation Statutes, as any judgment ordering disgorgement would necessarily require that the Lease-Leaseback Agreement be invalidated. The Lease-Leaseback Agreement is a contract within the meaning of Government Code section 53511 and thus subject to the Validation Statutes, making the remedy of disgorgement unavailable to Davis.

IV. Events Occurring After Issuance of Tax-Exempt Municipal Bonds, Such as a Taxpayer's Suit, Can Result in the Interest on the Bonds Becoming Taxable at a Future Date.

Davis misinterprets the Internal Revenue Code provisions and Treasury Regulations applicable to the arbitrage exemptions for municipal bonds in arguing that "[P]etitioners incorrectly assert that a Taxpayer's action could hypothetically destroy the tax-exempt status of California School District Bonds …." Moreover, Davis incorrectly concludes that "…public entities are only at risk of having their tax-exempt bonds declared arbitrage bonds if they invest them in higher yielding investments in amounts or durations longer then the limited arbitrage exception summarized in *Weiss.*"[9] Davis also mistakenly assumes that the issuance of the "Anti-Arbitrage Certificate"[10] and the District's certification[11] provide

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[8] As this Court found that Government Code section 1092 by its terms is limited to enforcement by the parties to the contract, Davis is confined to arguing that he has a right to seek disgorgement under section 526a. (*San Diegans for Open Gov't v. Pub. Facilities Fin. Auth. of City of San Diego*, (2019) 8 Cal.5th 733, 745–47.) As such, Davis is subject to all limitations thereunder.

[9] See discussion of *Weiss*, *infra*.

[10] Referencing the "Anti-Arbitrage Certificate "signed under the penalty of perjury by the District's Superintendent at the time of the subject bond issuance on October 13, 2011."

absolute protection for the District under the "reasonable expectations" test set forth in 26 C.F.R. section 1.148-2(e)(2)(C).

It is helpful to understand the process for issuing municipal bonds and ensuring that they are tax-exempt under applicable federal tax law. Typically, bonds are approved by the public agency, following which all of the necessary documentation is completed and the bonds are sold to a bond underwriter or other financial institution. After this, the bond sale goes into an escrow period during which the parties proceed to assemble all of the certifications, opinions and other documents that are required for the bond closing. This includes all certifications from the public agency that are required by applicable federal tax law, on the basis of which a nationally-recognized bond counsel firm renders an opinion to the effect that interest on the bonds is tax-exempt. Without the necessary certifications from the public agency, the bond counsel firm cannot render its opinion and the bonds cannot be issued. If construction contracts which are funded from the proceeds of tax-exempt bonds are not entitled to the benefits of the Validation Statutes, it could result in uncertainty regarding whether the projects can be completed within the time frame required by federal tax law, which in turn could jeopardize the ability of the public agency to provide the necessary certifications upon which the tax-exempt status of the bonds depend.

The delivery of the required certifications by the public agency is not a guarantee of the bonds continuing tax-exempt status, and events following the issuance of the bonds can result in the bonds losing their tax-exempt status.[12] For as Administrative Law Judge Lillian A. McEwen points out in

[11] Referencing the Superintendent's certification of the "District's reasonable expectations as of the issue date regarding the amount and use of the gross proceeds of the issue" dated October 13, 2011."

[12] See discussion, *infra*.

the SEC's *Initial Decision In the Matter of Ira Weiss and L. Andrew Shupe II*, No. 3-11462 ("Initial SEC Decision")[13] between 1999 and 2001, in the State of Pennsylvania alone, the IRS determined *thirteen school districts had issued taxable arbitrage bonds* after running afoul of the requirements under 26 C.F.R. section 1.148-2(e)(2)(C). (Initial SEC Decision, p. 11.) In fact, the subject Pennsylvania school district involved in the decision, like the District in regard to its general obligation bonds, had issued both an anti-arbitrage certificate and certified the bond issuance as being tax-exempt.[14] (Initial SEC Decision, p. 9.) Moreover, the president of the school board, as well as the board itself, testified in the SEC proceedings that they had "reasonable expectations" that the subject capital projects would be completed within the three-year temporary period. (Initial SEC Decision, p. 8.) No hearing witness testified to the contrary. (Initial SEC Decision, p. 16.) Yet, notwithstanding these facts, the IRS concluded the school district had issued taxable arbitrage bonds. (Initial SEC Decision, p. 11.)

Judge McEwen explained that after the issuance of the bonds, the Board became paralyzed by a series of unanticipated, complex and emotionally charged events resulting in a failure to complete any of the planned capital projects. (Initial SEC Decision, p. 11.) For instance, the Board became involved in a crisis over the replacement of a popular senior

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[13] See https://www.sec.gov/litigation/aljdec/id275lam.htm

[14] Defendant Weiss prepared and gave a Non-Arbitrage Certificate to Solicitor Flannery, a school board member, for his review eight days before the closing date of the bond issuance, and Weiss relied upon it for the issuance of his opinion. (Initial SEC Decision, p. 9.) Weiss was familiar with the U.S. Treasury Regulations relevant to this transaction and concluded that the Non-Arbitrage Certificate met the applicable Treasury Regulations. Weiss prepared a standard opinion for the signature of Solicitor Flannery and issued his unqualified Bond Opinion as to tax-exempt status of the bonds. (*Ibid.*) "The purpose of the [Bonds] was to fund capital improvement projects." (Initial SEC Decision, p. 10.)

high school football coach, at a time when superintendent had been hired away as a result of "irregularities." The Board also became distracted from its capital projects by employee personnel problems that resulted in dismissals. Additionally, a student filed a complaint in federal court alleging a violation of privacy in reference to a cheating allegation. These and other events competed for the Board's time with the construction projects. (*Ibid.*)

As a result, on November 8, 2000, the IRS sent a letter to the subject school district stating that the IRS had determined that the district issued taxable arbitrage bonds. (Initial SEC Decision, p. 11.) In issuing her opinion, the Judge McEwen explained:

> "The Internal Revenue Service (IRS) has established a three-prong test for determining whether a bond complies with the arbitrage restriction rules that apply to municipalities. First, the expenditure test requires that eighty-five percent of the proceeds must be spent on capital projects within three years. Second, the time test requires that, within six months of issuance, the issuer must enter a substantial binding obligation to an outside party to expend at least five percent of the bond proceeds. And third, the due diligence test requires that the bond proceeds be used for completion of capital projects with due diligence. (citation omitted) **If the IRS concludes *that any one prong of the test is not met*, then the bonds will be classified as arbitrage bonds, and subject to federal income taxation.** [emphasis supplied]" (Initial SEC Decision, p. 11.)

> The determination of whether bonds meet the exception to the arbitrage bond rules "is based on the issuer's reasonable expectations as of the issue date." (26 C.F.R. § 1.148-2(b)(1).) The issuer's "expectations or actions are reasonable only if a prudent person in the same circumstances as the issuer would have those same expectations or take those same actions, based on all objective facts and circumstances." (26 C.F.R. § 1.148-2(b).) Bond counsel's role in issuing its bond opinion is to make sure that the bond issuance meets all the tax requirements. The bond lawyer accomplishes this by gathering information from the issuer to show that what the issuer is doing meets the requirements of the tax laws. (citation omitted) A ***bond opinion, however, is not a guarantee: it merely serves as the lawyer's informed judgment as to a specific question of law on the date of issuance: specifically, in this case, Treasury Regulation § 1.148-2.*** (citation omitted.) ***This is because "certain post issuance events may result in the interest on the bonds becoming taxable as of some future date after the date of issuance.*** [emphasis supplied]" (Initial SEC Decision, p. 15.)

Weighing the testimony, Judge McEwen concluded that "... at the time the Bonds were issued, the school district *reasonably expected to satisfy Treasury Regulation § 1.148-2* [emphasis supplied]" (Initial SEC Decision, p. 17). Nonetheless, the IRS determined that the bonds issued by the school district were not tax-exempt. The district ultimately settled with the IRS[15] and agreed to pay it $150,056.07.[16] (Initial SEC Decision, p. 11.)

Accordingly, should litigation cause an unanticipated delay in completion of one or more capital projects being financed by municipal bonds, notwithstanding the "reasonable expectations" test and issuance of an anti-arbitrage certificate and school board certification, there is a risk that the IRS could find the issuer's bonds to be taxable arbitrage bonds. Moreover, if the reality was that protracted litigation could be expected as a result of an attack on the validity of contracts such as the Lease Leaseback Agreement at issue in this case which were not subject to prompt resolution under the Validation Statutes, the bond lawyer would be required to make that disclosure in the offering statement for the bonds, which could potentially expose the bond holder to unacceptable risk factors. Language would also have to be included in the related closing certificates to the effect that a significant risk exists that litigation initiated beyond sixty (60) days,

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[15] In the closing agreement between the school district and the IRS, the IRS noted that the school district "contend[ed] that it issued the [Bonds] with the reasonable expectations to use the bonds for governmental purposes." (Initial SEC Decision, p. 17) Obviously, the IRS disagreed with the school district's contention.

[16] The settlement was possible because the school district had undertaken a nonpurpose investment. Section 148(f)(6)(A) of the Code defines a "nonpurpose investment" as any investment property which (a) is acquired with the gross proceeds of an issue and (b) is not acquired in order to carry out the governmental purpose of the issue. Nonpurpose investments are investment securities such as treasury bonds, bank deposits or privately negotiated guaranteed investment contracts. Nonpurpose investments are subject to the basic yield restriction and arbitrage rules applicable to gross proceeds generally. Purpose investments are not. (See ABCs of Arbitrage, Tax Rules for Investment of Bond Proceeds By Municipalities (2018 Ed.) Frederic L. Ballard, Jr.)

and potentially over two years, after contract award could delay the completion of the work beyond three years and cause the bonds to lose their tax exempt status. This would prevent the bond lawyer from issuing an unqualified Bond Opinion as to the tax-exempt status of the bonds. Without a clean tax opinion the bonds will not be able to be sold.[17]

In forming incorrect conclusions regarding the potential for losing tax-exempt bond status, Davis misguidedly relies on a Federal District Court's review of the aforementioned SEC enforcement action in *Weiss v. SEC* (D.C.Cir.2006) 468 F.3d 849. In *Weiss, supra*, the court found that "[A] broker-dealer cannot avoid responsibility for unfounded statements of a deceptive nature, where recklessly made, merely by characterizing them as opinions or predictions or by presenting them in the guise of a probability or possibility." (*Id.* at p. 855.) Other than reciting portions of 26 C.F.R. section 1.148-2, the decision in *Weiss* has nothing to do with the general arbitrage yield restrictions or its exceptions under the provisions set forth in 26 C.F.R. section 1.148-2. Davis failed to address the Initial SEC Decision which explains that notwithstanding the "reasonable expectations" test under 26 C.F.R. section 1.148-2(e)(2)(C), the IRS can determine that the bonds issued by a school district were not tax-exempt even if there is an initial expectation that the projects will be timely completed, but after arising events prevent compliance with 26 C.F.R. section 1.148-2(e)(2)(C).

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[17] District Co-Counsel in this Reply, Charles F. Adams, has been the District's Bond Counsel and Tax Counsel for over 25 years. Mr. Adams has been practicing bond law since 1976, and he supports this statement and concurs with the opinions set forth herein. He serves as bond counsel, disclosure counsel and underwriter's counsel in financings that include general obligation bonds, among others, and has served as bond counsel on hundreds of financings during the course of his practice.

A school board could easily become distracted by litigation, such as Davis's current suit against the District, and, as a result, unwittingly fail to meet its obligations under the three-prong test for determining whether a bond issuance complies with the arbitrage restriction rules. Further, litigation such as Davis's suit could delay a project in a manner that could, for example, prevent the necessary percentage of funds from being expended within the three-year time period and, which, the IRS could conceivably conclude should have been anticipated by the issuer. Davis is incorrect in making his unsupported assertion that no subsequent taxpayer litigation could alter the tax-exempt nature of municipal bonds.

V. Prompt Action Under the Validation Statutes is Integral to Ensuring that Municipal Bond Issuers are Able to Issue Tax-Exempt Bonds.

Davis argues that even if a public entity does receive yield earnings in excess of the statutory arbitrage limitations, or, should *post issuance events* disqualify the bonds from tax-exempt status (such as those discussed in Section IV above), 26 U.S.C. section 148(f) and 26 C.F.R. section 1.148-3 allow the public entity to pay a rebate to the federal government to maintain the bond's tax-exempt status. This allegation is not correct. If a bond issuer is unable to certify that it reasonably expects to spend the bond proceeds within three years, the bonds will become taxable and a rebate payment cannot cure the defect. It should be pointed out that all arbitrage earnings on a tax-exempt bond issue (not just earnings received after the three-year expenditure period) must be rebated to the U.S. Treasury every five years, so making a rebate payment could hardly cure a finding that the bond issue has become taxable as a result of post-issuance events.

For this reason, among others, prompt action under the Validation Statutes is integral to a lease-leaseback arrangement in which construction is

financed through tax-exempt bond proceeds. It makes little sense from a public policy perspective to allow litigation like Davis's suit years after issuance of the bonds to potentially jeopardize the tax-exempt status of a bond issue.[18] This Court should construe the Validation Statutes so as to uphold their purpose, i.e., the acting agency's need to settle promptly all questions about the validity of its action. Resolving challenges such as those made by Davis promptly ensures that a bond issuer can reasonably certify its expectations to spend bond proceeds within the required three-year period and thereby maintain the tax-exempt status of its bond issue.

VI. The Decision in *McGee III* Comports with the Requirement that Courts Read Government Code Section 53511's Reference to Contracts Narrowly, and it Should Not be Disapproved by this Court.

Davis argues that *McGee III* should be disapproved by this Court, contending that such decision is contrary to the standard emanating from this Court in *City of Ontario, supra,* under which Government Code section 53511 is to be narrowly construed. Davis's argument is far afield from the Court's construction of Government Code section 53511 in *McGee III*. In response to McGee's argument that the lease-leaseback agreements were not "contracts" under section 53511, the Court of Appeal explained:

> "California courts have read [Government Code] section 53511's reference to 'contracts' 'narrow[ly]' to reach only those contracts that 'are in the nature of, or *directly relate[d] to a public agency's bonds, warrants or other evidence of*

[18] Moreover, there could be further ramifications for an issuer. For example, the school district in the *Initial SEC Decision*, *supra*, was also alleged to have violated section 17(a) of the Securities Act and section 10(b) of the Exchange Act, for mispresenting the tax status of the bonds to potential purchasers, including, but not limited to the representation that they were "Not Arbitrage [Bonds]." (Initial SEC Decision, p. 18.) The *Initial SEC Decision*, *supra*, notes that that "[T]he School District also entered into a settlement with the SEC on April 22, 2004, in which it agreed to pay disgorgement, plus pre-judgment interest, in the amount of $28,904." (Initial SEC Decision, p. 12.)

> *indebtedness*.'" (citation omitted) But contracts "involving financing *and financial obligations*" fall within this provision (citation omitted), as do contracts that are "'*inextricably bound up*'" *with bond funding and financing* (citation omitted). (*McGee III, supra*, 49 Cal.App.5th at p. 824).

Davis disagrees with the decision in *McGee III* largely on public policy grounds. He argues that because the bonds issued in *McGee III* were general obligation bonds, a public entity's ability to operate cannot be impaired, because litigation cannot "impair the tax assessed value of the properties in an entire school district to such a degree as to impair the district's ability to operate." This argument is flawed, as litigation can readily impair a district's ability to complete much needed capital projects.

This argument is a façade for Davis's real dissatisfaction with the decision in *McGee III*, as the plaintiff in *McGee III* used the same strategy as Davis adopted in this case. As such, Davis understands the implication of his tactics, as the court in *McGee III* explained:

> A judgment in McGee's favor would … undermine the very purpose behind the validation statutes. A cloud has hung over the challenged projects for *years*, destroying any hope in prompt validation of the underlying lease-leaseback agreements. That delay is largely attributable to McGee, who ***strategically chose not to prevent the projects from moving forward***. Beyond the specific projects here, a judgment in McGee's favor would ***threaten future projects with the prospect of lawsuits long after completion. That would undoubtedly inhibit the District's ability to obtain financing for them***. (citing *Friedland v. City of Long Beach* (1998) 62 Cal.App.4th 835 *supra,* 62 Cal.App.4th at p. 843 … "'[T]he essential difference between those actions which ought and those which ought not to come under [the validation statutes] **[is]** ***the extent to which the lack of a prompt validating procedure will impair the public agency's ability to operate. The fact that litigation may be pending or forthcoming drastically affects the marketability of public bonds'" and likely would have "'a chilling effect upon potential third party lenders, thus resulting in higher interest rates or even the total denial of credit***.'" (citing *McLeod v. Vista Unified School Dist.* (2008) 158 Cal.App.4th 1156.) (*Id.* at p. 828.)

Consistent with this Court's analysis in *City of Ontario*, *supra*, the Court of Appeal concluded that the lease-leaseback agreements challenged by

McGee were within the scope of "contracts" covered by Government Code section 53511. (*Ibid.*) The Court of Appeal went on to explain:

> As in *Wilson* [*& Wilson v. City Council of Redwood City* (2011) 191 Cal.App.4th 1559, 1579], McGee's reverse validation action was rendered moot by the completion of the challenged projects. McGee filed his first lawsuit as far back as 2013, and the trial court did not dismiss the cases until 2019. During those six years, McGee did nothing to stop the projects from moving forward while the validity of the lease-leaseback agreements was litigated. He tries to explain that choice by claiming he did not want to "impair District's ability to operate" and he had an "adequate remedy at law" through disgorgement. Even if true, that does not change the fact that the projects were completed. ***As Wilson recognized, this years-long delay destroyed the very purpose behind the validation statutes— "to settle promptly all questions about the validity of an agency's action***." (citing *Wilson*, *supra*, 191 Cal.App.4th at p. 1580, 120 Cal.Rptr.3d 665, italics added.) Having sought no stay or injunction, he is in no position "'to complain of the very change in circumstances that [he] might have prevented by seeking such relief.'" (*McGee III*, *supra*, 49 Cal.App.5th at p. 823.)

Davis's actions in this case are virtually identical to those taken by the plaintiff in *McGee III*. *McGee III* was correctly decided consistent with *City of Ontario, supra,* and the lineage of following cases. Davis's failure to seek an injunction and calendar preference places him squarely within the holdings of both *McGee III* and *Wilson*, as do his claims that he did not impair District's ability to operate and he has an adequate remedy at law through disgorgement.

VII. McGee's Mootness Holding can be Readily Reconciled with *Thomson v. Call*, as the Court in *Thomson* did not have In Rem Jurisdiction Over the Parties.

Davis fails to point out that *Thomson v. Call* (1985) 38 Cal.3d 633 was not a reverse validation action where the court had in rem jurisdiction over the parties, as was the case in *Wilson*, *supra*, where the only thing to be decided by the court was the validity of the subject development agreement.

In *Thomson*, *supra*, the owner ("IGC") of a 36-acre parcel of land in Albany, California, proposed to build a high-rise residential development on the land. There followed a lengthy period of discussions and negotiations between IGC, the city, and several other parties. In the final agreement, the city required IGC to acquire some small parcels of land adjacent to its 36 acres for use as a public park as a condition for granting IGC a use permit. One of these parcels belonged to Call, an Albany city councilman. As part of a complex sequence of transactions in escrow to carry out the agreement, IGC bought Call's property for what was arguably a generous price, and then conveyed it to the city. (*Thomson*, *supra*, 38 Cal.3d at pp. 638-643.)

A taxpayer group brought an action to invalidate the deal on the ground Call's involvement created a conflict of interest in violation of Government Code section 1090. The trial court agreed. It ordered Call to forfeit to the city the money he was paid for the property but permitted the city to retain title to it. Call appealed from the forfeiture order. (*Thomson*, *supra*, 38 Cal.3d at p. 638.) He maintained the purchase of his land by IGC was not a condition of the contract between IGC and the city. This Court disagreed and held that, however complex the whole arrangement, it was all part of a single multiparty agreement. (*Id.* at p. 644.)

This Court found that Call, in his capacity as a city councilman, had participated in the making of the contract that created the conflict of interest. "The prospect that performance of the contract would involve acquisition of the Calls' land and conveyance of that land to the city was contemplated by all parties." (*Thomson*, *supra*, 38 Cal.3d at p. 644.) This Court also noted in any event that "the policy goals of section 1090 support the rule that public officers are denied the right to make contracts in their official capacity with themselves or to become interested in contracts thus made." (*Id.* at p. 645.)

After the sale was found to have violated section 1090, the city was allowed to retain the land and was awarded a money judgment against the council member for the full sale price of the land with interest, with no deduction for the original price his family had paid for the land in 1970. (*Thomson*, *supra*, 38 Cal.3d at p. 652.) The trial court found, inter alia, that the city council member was interested in the transaction in violation of section 1090. (*Id.* at p. 637.)

In *Wilson*, *supra*, the First DCA dismissed a reverse validation action as moot because, like in this case, the plaintiff failed to halt the challenged project which was ultimately completed before the trial court determined the validity of the underlying agreements. (See *Wilson*, *supra*, 191 Cal.App.4th at 1575.) In *Wilson*, *supra*, Redwood City (the "City") adopted a redevelopment plan and entered into a disposition and development agreement ("DDA") with a developer to construct a retail-cinema component of a larger project (*Id.* at pp. 1563-1564.) The City and the developer amended the DDA so the developer would pay $7,500,000 for the acquisition of a parcel needed to complete construction with the City contributing the remaining costs (*Ibid.*) The City adopted resolutions approving the DDA (*Id.* at p. 1566.) The plaintiff filed a reverse validation action against the City seeking invalidation of the DDA on grounds it was too costly to taxpayers and improperly beneficial to the developer (*Id.* at pp. 1566-1567.) The plaintiff's operative complaint requested the court determine the City's approval of the DDA was *invalid, illegal, void, and of no effect*, and direct the city to seek reimbursement for "all monies illegally and improperly spent on the [p]roject..." (*Id.* at p. 1567.)

Following trial, but before entry of judgment, the court directed the parties to submit post-trial briefs on certain issues (*Wilson*, *supra*, 191

Cal.App.4th at 1568-1569.) The hearing was continued several times and did not occur until two years after trial (*Ibid.*) However, by that time the challenged project had been completed (*Id.* at p. 1569.) The City argued the case had become moot, but the trial court ruled in favor of the plaintiff, prompting an appeal by the City (*Id.* at pp. 1570-1571.)

The Court of Appeal reversed, finding completion of a challenged construction project "moots requests to set aside or rescind resolutions authorizing the project." (*Wilson, supra*, 191 Cal.App.4th at p. 1576.) The Court noted it would be "unreasonable to expect the City and the [d]eveloper to hold the [p]roject in abeyance for five years as they awaited a final judgment ...." (*Id.* at pp. 1580-1581.) Finally, the Court noted the plaintiff was partially responsible for the dismissal because, like Davis, *it failed to request a stay of the project's construction and did not seek a preliminary injunction restraining construction* (*Id.* at p. 1581.) Thus, the plaintiff was unable to complain about the change in circumstances that rendered the action moot (*Ibid.*)

VIII. The Court Has In Rem Jurisdiction Over the Lease-Leaseback Agreement, and as such, Davis is Not Entitled to a Trial on Any of His In Personam Claims.

Validation actions and reverse validation actions are in rem proceedings in which the only thing to be examined is a public agency's act. (See *Ivanhoe Irr. Dist. v. All Parties* (1960) 53 Cal.2d 692, 699; see also *Millbrae School Dist. v. Super. Ct.* (1989) 209 Cal.App.3d 1494, 1497.) The Validation Statutes confer in rem jurisdiction upon a court hearing a validation action or reverse validation action. (See Code Civ. Proc. § 860; *Committee for Responsible Planning v. City of Indian Wells* (1990) 225 Cal.App.3d 191, 197, citing *Millbrae School Dist.*, *supra*, 209 Cal.App.3d at p. 1497 ["[a] validating proceeding differs from a traditional action

challenging a public agency's decision because it is an in rem action whose effect is binding on the agency and on all other persons".] The subject of a validation action is the matter to be validated, i.e., a specific action taken by a public agency (*San Diegans for Open Gov't v. City of San Diego* (2015) 242 Cal.App.4th 416, 428.) The specific matter to be validated may be a contract. For example, in an in rem proceeding to confirm a contract between an irrigation district and the United States for delivery of water and construction of a water distribution system, ***the only issue involved was the validity of the contract.*** (*Ivanhoe Irr. Dist., supra*, 53 Cal.2d at p. 699; see also *Community Youth Athletic Center v. City of Nat. City* (2009) 170 Cal.App.4th 416, 427 [An action under Code of Civil Procedure section 860, et seq., to either validate or challenge a contract, is recognized as a proceeding "in rem."].)

Davis did not file an in personam action under Government Code section 1090. Rather, Davis's lawsuit is an in rem reverse validation action in which one theory for invalidation of the challenged contracts is an alleged violation of Government Code section 1090. As such, the validity of the challenged Lease-Leaseback Agreement is the only thing to be decided. (See Code Civ. Proc. §§ 860, et seq.) Finally, Davis's explanation in his Footnote 4, p. 24, regarding the meaning of "ordering of the improvement or acquisition," is unsupported by that statute's plain language which provides another basis for this action being subject to the in rem jurisdiction of the Validation Statutes.

IX. District Properly Raised the Fifth DCA's Erroneous Interpretation of Education Code Section 17406.

District is entitled to raise any "issues fairly included" within the issue designated by this Court for briefing. (Cal. Rules of Court, rules 8.516

and 8-520(b); [see also *People v. Alice* (2007) 41 Cal.4th 668, 677].) A threshold question before this Court is whether a Lease-Leaseback Agreement that otherwise meets the statutory prerequisites under the plain language of Education Code section 17406 should be excluded from the definition of what constitutes a "contract" under Government Code section 53511 because it lacks a financing component, notwithstanding that other Courts of Appeal interpreting section 53511 have held that contracts involving financial obligations outside of the agreement itself that are *directly related* or *inextricably intertwined* with an agency's bonds, warrants, or other evidences of indebtedness fall within the definition of "contracts" under section 53511. No California court, other than the Fifth DCA, has excluded a lease-leaseback agreement from consideration as a "contract" under Government Code section 53511 simply because it does not contain an express financing component.

Moreover, the interpretation of Education Code section 17406 is a significant issue of widespread importance to school districts across the state, and it is in the public interest to decide the issue at this time. Delaying an analysis of the Fifth DCA's interpretation of Education Code section 17406 would be wasteful of the resources of both this Court and future litigants, for other parties would likely litigate similar cases on the assumption that Fifth DCA's interpretation governs, notwithstanding the conflicting rulings between different Courts of Appeal.[19]

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[19] It should be noted that when this Court denied review of *Davis v. Fresno Unified Sch. Dist.* (2015) 237 Cal.App.4th 261, 291-292, as modified (June 19, 2015) ("*Davis I*") that decision then presented no conflict with any other Court of Appeal opinion. Thereafter, the conflict arose, with *California Taxpayers Action Network v. Taber Constr., Inc.* (2017) 12 Cal.App.5th 115, and with *McGee III*.

Finally, the Fifth DCA did not state that its interpretation of Education Code section 17406 was law of the case until late last year.[20] Accordingly, one would not expect that the Legislature would have addressed Petitioner's criticisms of *Davis I*'s Education Code section 17406 interpretation *in 2016*, as Davis argues.

X. Davis Confuses Subject Matter Jurisdiction, Personal Jurisdiction and In Personam Remedies.

A court must have jurisdiction to enter a valid, enforceable judgment on a claim. Personal jurisdiction is the requirement that a given court has power over a defendant. Subject-matter jurisdiction is the requirement that a court have the power to hear the specific kind of claim that is brought before that court. (See *In re Rubin* (9th Cir. 1985) 769 F.2d 611, 614 [subject matter jurisdiction is "a court's competence to hear and determine cases of the general class to which the proceedings in question belong"]; see, e.g., *Donaldson v. National Marine Inc.* (2005) 35 Cal.4th 503, 511-512 [contrasting "subject matter jurisdiction" with "personal jurisdiction".] The trial court had subject matter jurisdiction over this lawsuit. Code of Civil Procedure section 860 states that validation actions are to be brought "in the superior court;" reverse validation actions are brought "in the court specified by Section 860." (See Code Civ. Proc, §§ 860, 863).

The requirement that a court have subject-matter jurisdiction means that the court can only assume power over a claim which it is authorized to hear under the laws of the jurisdiction. The fact that a court has personal

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[20] While the Fifth DCA states its interpretation of Education Code section 17406 is law of the case, the District disagrees. For the law of the case doctrine to apply, the point of law involved must have been necessary to the prior decision (*People v. Cooper* (2007) 149 Cal.App.4th 500.) In the context of the District's demurrer, the Fifth DCA's interpretation was unnecessary to the prior decision in *Davis I.*

jurisdiction over a defendant *does not expand subject matter jurisdiction.* The purpose of an in rem action is not to impose a personal liability or obligation upon anyone but to affect the interests of all persons in a thing.

Davis confuses the above concepts, arguing that because Harris and the District made general appearances in this matter that this somehow expanded the Court's subject matter jurisdiction to include in personam remedies. This is an incorrect statement of the law. Validation actions and reverse validation actions are in rem proceedings in which the only thing to be examined is a public agency's act. (See *Ivanhoe Irr. Dist.*, *supra*, 53 Cal.2d 692, 699.) Davis cites numerous cases in support of this spurious contention, none of which involve validation actions or in rem jurisdiction. Davis's contentions should be rejected outright.

CONCLUSION

This Court should find that the Lease-Leaseback Agreement is a "contract" that falls within the meaning of Government Code section 53511, thereby providing school districts with the certainty that comes from the Validation Statutes' limitations period and being the exclusive means for challenges to such arrangements financed through issuance of tax-exempt bonds. On this basis, this Court should reverse the Fifth DCA's decision.

Respectfully submitted,

Dated: July 22, 2021

LANG RICHERT & PATCH, PC

By: */s/ Mark L. Creede*
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Respectfully submitted,

Dated: July 22, 2021

JONES HALL

By: */s/ Charles F. Adams*
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CERTIFICATE OF WORD COUNT

Pursuant to California Rules of Court, rule 8.520(c)(1), the text of this Petitioner Fresno Unified School District's Reply to Respondent's Answering Brief, including footnotes and excluding the cover information, table of contents, table of authorities, signature blocks, and certificate, consists of 8371 words in 13-point Times New Roman type. In making this certification, I have relied on the word count of the Microsoft Word program used to prepare the brief.

Dated: July 22, 2021

By: */s/ Mark L. Creede*
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I am employed in the County of Fresno; I am over the age of 18 years and not a party to the within above-entitled cause; my business address is 5200 North Palm Avenue, Suite 401, Fresno, California 93704; and my business e-mail address is yvette@lrplaw.net.

I served a true and correct copy of the **PETITIONER FRESNO UNIFIED SCHOOL DISTRICT'S REPLY TO RESPONDENT'S ANSWERING BRIEF** on the interested parties in this action:

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[X] **(BY ELECTRONIC SERVICE)** On July 22, 2021, I instituted service of the above-listed document(s) by submitting an electronic version of the document(s) via file transfer protocol (FTP) through the upload feature at www.tf3.truefiling.com, to the parties who have registered to receive notifications of service of documents in this case as required by the Court. Upon completion of the transmission of said document, a confirmation of receipt is issued to the filing/serving party confirming receipt from info@truefiling.com for TrueFiling.

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YVETTE CORONADO

STATE OF CALIFORNIA
Supreme Court of California

PROOF OF SERVICE

STATE OF CALIFORNIA
Supreme Court of California

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Case Number: **S266344**
Lower Court Case Number: **F079811**

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7/22/2021

Date

/s/Yvette Coronado

Signature

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