

SANTA MARIA-BONITA SCHOOL DISTRICT'S QUESTIONABLE CONSTRUCTION PLAN

The \$6,000,000 Fiasco

SUMMARY

After receiving a citizen complaint, the Grand Jury undertook an inquiry into the Santa Maria-Bonita School District contracting fiasco with TurnKey companies. The District undertook approximately 20 projects from 1999 to 2005 involving construction of new buildings and remodeling of others with a total cost of approximately \$100,000,000. The District entered into this extremely complex undertaking with an uninformed Board of Education and an inexperienced staff having little or no knowledge of public contract construction projects. The transactions were structured to avoid provision of protective bonds ensuring funds in the event of a default and eliminated almost all checks and balances of the construction process. This report describes the carelessness that resulted in the School District's problems that arose.

This report is a sad tale. It depicts a Board of Education and Superintendent that trusted and relied upon people who did not merit such confidence. This report is a message to public contracting authorities that care should be taken to prevent a breakdown of the requirements that were designed to protect the taxpayer and public contracting entities. The pressure of a rapidly increasing student population does not justify a less than alert approach to construction project arrangements and management.

INTRODUCTION

The Santa Maria-Bonita School District is the public school district for all K-8 children in Santa Maria. In response to a burgeoning student population, the District undertook an extensive program of construction projects to build and improve school facilities. In 2005, the Grand Jury received a complaint and noted media coverage concerning problems with these construction projects.

The complaint and media comments about the construction projects seemed to be simple enough: someone had failed to obtain performance and payment bonds that are designed to protect the District in the event of a default by the general contractor and its subcontractors. Upon investigation, the Grand Jury discovered a plan to avoid the protective requirements of State statutes¹. The District adopted the plan with little

¹ Plan explained beginning on page 5. circumvention on page 10.

Santa Maria-Bonita School District's Questionable Construction Plan

understanding or concern about the consequences of what was at risk.

The Grand Jury interviewed members of the Board of Education, current and former officials of the District, employees, contractors and legal advisors. The Grand Jury reviewed thousands of pages of official documents, contracts, State laws and litigation pleadings. In some cases, the Grand Jury re-interviewed witnesses to confirm information. The School District was not as cooperative as the Grand Jury believed was necessary, and the Grand Jury was required to authorize subpoenas to compel testimony.

OBSERVATIONS AND ANALYSIS

During 1999, the Santa Maria-Bonita Board of Education undertook an extensive construction program to provide needed facilities for its burgeoning student population. By the time the projects were completed, the District would have constructed 9 campuses and an additional 11 improvement projects. The work was defined by more than 40 contracts. Work included separate contracts with various trade contractors and, in addition, contracts with a designer/contractor/project manager. The estimated project cost exceeded \$100,000,000.

On-site supervision by the School District was relegated to a single individual. When additional staff was requested, District management denied the request. The Grand Jury was advised that the District's legal counsel did not participate in the preparation of the contracts. The contracts were prepared and/or reviewed by inexperienced District staff². It does not appear that the Board or the Superintendent reviewed or had any knowledge or memory of the provisions of the contracts.

Types of Construction Projects

To enable the reader to understand what went wrong for the School District, this section of the report is intended to be a primer on public construction contracting. Explanations of the following key terms are provided.

- contract manager
- factory-built buildings
- general contractor
- payment bond
- performance bond

² District employee staff does not include attorneys.

Santa Maria-Bonita School District's Questionable Construction Plan

- personal property
- piggy-back contract
- progress payments

There are many steps involved in completion of a construction project. A school district project generally includes the following steps:

- initial development of proposal by staff;
- review and approval of project by Board of Education;
- hiring of architect to prepare plans;
- Board approval and submission of plans to Division of State Architect, a branch of the State Department of General Services;
- authorization of a public bidding process to award construction to the lowest responsible bidder or bidders;
- public bidding process;
- approval and signing of construction contracts;
- construction under supervision of district architect and district on-site construction compliance officer.

The construction work is done on-site and commences from the ground up.

In addition to the general construction elements, huge, multifaceted construction projects may also include environmental reviews, permit applications, bond elections, financing arrangements, proceedings related to the sale of bonds, and other complex and difficult tasks. For the purposes of this report, the Grand Jury was interested only in the process by which contracts for construction were authorized, approved, signed and implemented.

There are two general methods of proceeding with construction projects.

General Contractor: Under this method, a general contractor is awarded a contract. The general contractor submits a bid specifying by name each of the subcontractors who will perform the various trades required by the project; for example: electrical, plumbing and HVAC. The general contractor must use the named subcontractors. The general contractor is paid progress payments by the district during the work and is responsible for paying the subcontractors. The general contractor provides performance and payment bonds to the district, and each trade subcontractor provides performance and payment bonds to the general contractor.

Contract Manager: Under the other method of construction, the district bids the various trades and hires a construction manager to supervise the construction process.

Santa Maria-Bonita School District's Questionable Construction Plan

The district or the construction manager supervises the bid process, and the district awards contracts to the lowest responsible bidders. Each of the trade contractors provides performance and payment bonds to the district. The construction manager is not required to provide performance and payment bonds to the district.

In either construction management alternative, the tasks of design, construction and supervision generally are not combined in one entity. This division of labor and responsibility ensures that there are built-in checks and balances in the construction process. Without such checks and balances, there is a possibility that problems that arise in the project will not be fully disclosed and resolved.

Progress payments during construction are defined by contract. They are normally tied to performance and are paid upon the certification by the district architects and district staff and Division of State Architect. There is a holdback of funds to ensure compliance and performance.

Performance and Payment Bonds: Since the financial viability of any contractor cannot be ensured, public construction projects in excess of statutory thresholds require that the contractor provide the district with a performance bond and a labor and materials (payment) bond. A performance bond covers the district if the contractor is unable to complete the job. On default, the surety company that issued the bond will pay for the completion of the project up to the value of the bond. A labor and materials bond is issued by a surety company and is provided by the contractor to pay the providers of materials (lumber, plumbing supplies, etc.) and labor. As will be seen, if the district has made a progress payment to the general contractor, and the general contractor does not pay the subcontractors or materialmen, the subcontractors or materialmen may seek payment from the district. A district could be required to pay more than once for the same work.

If performance and payment bonds are required, it is essential that the bonds be physically delivered to the district at the time of signing of the construction contracts. In addition, the bonds must be checked to determine that they have been validly issued. The surety company should likewise be checked to determine that it has a rating, issued by a recognized rating service, attesting that the surety company has sufficient unencumbered capital to cover the face value of the bond issued. Accepting a large surety bond from a small company may place the bond at risk.

Personal Property: Construction contracts generally involve real property—that is, buildings and structures that are affixed to land. Personal property is generally property moved, used, consumed, handled, or packaged. Examples of personal property include furniture, computers and automobiles. The purchase of personal property is different from the process used for the construction of buildings. If the amount of the contract is large enough, personal property purchases are subject to a public bid process with the award of the contract made to the lowest responsible bidder. Personal property can be purchased in two ways: 1) by the purchaser district

Santa Maria-Bonita School District's Questionable Construction Plan

developing specifications and making a request for sealed bids or, 2) if permitted, the purchasing district can “piggy-back” on another public corporation or agency’s bid and purchase the item from the other public corporation or agency. If the piggy-back process is used, the purchasing district does not have to undertake a bid process of its own. The piggy-back process is quick and direct. The items purchased pursuant to a piggy-back bid have to comply with the original contract. An item that did not comply or was materially different from the item described in the original bid would not be eligible for a piggy-back bid process.

Factory-built Buildings: State law allows a school district to use factory-built buildings for the construction of school buildings not exceeding 1,000 square feet. Factory-built buildings are delivered in sections, bolted together and permanently installed on a foundation on the construction site. This makes them different from conventional construction. The Division of State Architect must approve all factory-built school buildings. While there is site work that is subject to prevailing wage rules, the construction of a factory-built school is not subject to either prevailing wage rules or the requirement to provide performance and payment bonds.

What the District Did

Moving from the abstract to the situation at hand, Snowline Joint Unified School District, a district in Phelan, California, accepted a bid from Turnkey for factory-built schools. These arrangements could be piggy-backed by other districts that wanted to buy the factory-built schools as described in the Snowline bid. The Santa Maria–Bonita School District thought it was piggy-backing on the Snowline arrangements in buying most of the schools erected by TurnKey.

District management assumed that ordering a factory-built building was similar to ordering personal property like computers and desks. The award of such a contract could then be made to the lowest responsible bidder after a public bid process or the purchase could be made pursuant to the piggy-back process.

The California Education Code eliminated from factory-built building construction projects many of the supervisory, inspection and review protections required for conventional construction. In addition, although factory-built buildings are limited to buildings not over 1,000 square feet, the Santa Maria-Bonita School District constructed buildings and facilities exceeding this statutory limit. It was beyond the scope of the Grand Jury’s investigation to examine the California Department of General Services review process.

On January 24, 2006, the California Attorney General rendered an opinion on one of the issues involved in this investigation. The Attorney General opinion held that the purchase of manufactured school buildings to be installed on permanent foundations required a public bid process and not the piggy-back bid process. The Attorney General did not state whether factory-built school buildings or portable school

Santa Maria-Bonita School District's Questionable Construction Plan

buildings were personal property or subject to the requirements of traditional construction contracts.

While school districts should follow the Attorney General's opinion in the future, the actions in Santa Maria-Bonita must be examined in light of the circumstances that existed at the time the District undertook the construction projects. Although the piggy-back process was believed to be legal at the time, it was, as will be seen, an extremely dangerous way to proceed on such a large and complicated series of projects.

Based on the documentation that the Grand Jury examined, it appears that the Santa Maria-Bonita School District was imprudent given the nature of the projects and TurnKey's involvement. Buildings are dissimilar to other forms of personal property. Substantial design costs were incurred. The buildings varied substantially from those awarded in the underlying bid, in that the original bid was for one-story buildings and the purchases by Santa Maria-Bonita included two-story buildings. There may be other substantial variations as well. It appears to the Grand Jury that the piggy-back process as undertaken by the District was so similar to conventional construction that the piggy-back process was questionable.

But There's More

This section provides specific data about several of the projects to demonstrate how the failures occurred. Much of the following discussion is derived from allegations contained in a lawsuit by the District against the TurnKey principals.

TurnKey is the generic name of a group of entities: TurnKey Schools of America, now TurnKey, Inc. and affiliated companies TurnKey Forces, Inc., TurnKey Building Systems, Inc., and TurnKey Companies, Inc., which were commonly owned. The District claims that TurnKey management represented to the District that it had found a better way to finance, design and construct school facilities. The District relied on these representations.

The School District thought it was entering into a contract in which, for a fixed price, it would literally receive the keys to fully completed and operational school buildings. In actual fact, however, after the section covering what was called the "Guaranteed Maximum Price," the contracts listed many exceptions that allowed the "maximum price" to be exceeded. The exceptions are similar to those that drive conventional construction costs over the original planned cost.

The Grand Jury examined several projects.

Taylor School: During 2000, the Ida Redmond Taylor Elementary School was constructed and completed using certificate of participation financing pending reimbursement by Proposition 1A school funding bond proceeds.

Santa Maria-Bonita School District's Questionable Construction Plan

The buildings were purchased directly from TurnKey using a piggy-back process without bids which, according to the Attorney General, may have violated State law. Apparently the school was completed on schedule. In 2002, District approved the completion of the Taylor project believing that it was on budget, but discovered almost three years later that the project was \$500,000 over budget. In its lawsuit, the District accuses its business manager of concealing the cost overrun. The District had no process that could detect cost overruns on a timely basis.

Preisker School: In 2001, the District undertook the construction of the North Preisker Ranch Junior High School. The Grand Jury examined contracts provided by Turnkey and none indicated that they had been reviewed by counsel. Witness testimony and other evidence corroborated the absence of such review. The estimated cost of the project was \$17,500,000. TurnKey was hired as the project manager for the following fees:

TurnKey Project Manager Fees

Basic Fee	\$700,000	
Engineer Fee	98,400	
Lump Sum Fee	875,000	
Total Management	\$1,673,400	
In addition, TurnKey was paid	240,000	for design services
In addition, TurnKey was paid	42,500	for consulting services related to technology services
Total paid to TurnKey	\$1,955,900	

Additionally, TurnKey was entitled to expenses not exceeding \$3,000 per month under the contract.

The District entered into separate contracts with the various trades for plumbing, electrical and other services, the costs of which were included in the estimated cost.

Subject to changes requested by the District and certain unanticipated work, the contract prices were essentially fixed.

Conforming the factory-built building to the site incurred the substantial fee for architectural services. The TurnKey architectural obligation ended with approval of the construction documents. For this school, TurnKey's architectural affiliate apparently had no duties with respect to the construction phase.

The contract provided that it was intended "to procure manufactured building components purchased by Snowline Joint Unified School District or other

Santa Maria-Bonita School District's Questionable Construction Plan

similar cooperative purchase agreements...” The contract further states, “nothing in this agreement shall prevent the District from procuring said building components or other products from the Project Manager’s bid, for the purchase of Project Manager’s manufactured building components.” This provision of the purchase agreement appears to violate State law.

Although the contract provided for payment of construction management fees to TurnKey, TurnKey was not required to provide performance or payment bonds for any services it provided to the District. The contract did have several important safeguards for the District, however. The District could make progress payments to the trade contractors directly. There was an independent architect named in the contract. Trade contractors were required to participate in a public bid process and to provide performance and payment bonds to the District.

In the contract, TurnKey acknowledges that the District is inexperienced in construction projects of the size and complexity contemplated and understands that the District relies upon TurnKey for its experience, advice and guidance. This is the fox-in-the-chicken-coop provision.

GAP5: By 2004, the contracts with TurnKey dealing with improvements to the Rice, Adam, Bruce, Ontiveros and Oakely Schools (so-called GAP5 Contracts) were different than the contracts governing Preisker. The projects had an estimated aggregate cost of \$11,463,000. In an unusual provision, the fees to be paid to TurnKey as project manager were concealed by inclusion in the “Guaranteed Maximum Price.” By including the fees in the project price without bids, there can be no effective cost control for the District. TurnKey was not required to provide performance or payment bonds for *any* services performed. TurnKey had assumed greater authority over the projects. The architect was now a TurnKey affiliate that performed construction-related services including review and certification of claims for progress payments.

Unlike the Preisker School contract, all progress payments were made to TurnKey, which had broad contractual authority to review the work and allow payment of subcontractors. Because payments for TurnKey’s project management services were included in the purchase price, there would be no way to stop payment to TurnKey in the event of a breach of contract. This is a highly unusual and inappropriate provision.

Payments to the architect for its services were \$411,633 for the design work and \$32,177 for the construction phase.

Although it appears that much of the work was performed adequately, that subcontractors were paid in a timely fashion, and that the District obtained several serviceable schools, the District abdicated its responsibility to apply adequate and

Santa Maria-Bonita School District's Questionable Construction Plan

proper management and controls. The District permitted the consolidation of design, review, modification, construction, payment and certification of completion in a single outside entity. The District thereby eliminated the usual checks and balances inherent in the construction process.

In September 2004, TurnKey defaulted. The District stopped payment on all work. Thereafter, the District agreed to make partial payments to ensure that construction was completed. In 2005, TurnKey was involuntarily placed in bankruptcy. Although the bankruptcy proceeding was dismissed, it does not appear that any money can be collected from TurnKey. Claims have been made by the District against TurnKey management in litigation filed in the Bankruptcy Court. Several contractors have been unable to collect money due under their contracts and have sued the District. The District is a party to more than 20 lawsuits claiming payment due to subcontractors. The District has paid evaluators to confirm the level of completion of construction. The District has incurred legal costs in excess of \$1,000,000 and will incur additional legal costs in the future. The final accounting is not in, but the District claims that the extra cost to the District of the TurnKey projects will be about \$5,000,000 to \$6,000,000.

The District alleges in its lawsuit that the Assistant Superintendent permitted TurnKey to be paid in excess of the percentage of completion of the project, knew that funds were diverted from subcontractors, made unauthorized changes for which additional costs were incurred, participated in false claims and over-billing, and knew of "phony" design fees. The District alleges a "conspiracy". The Assistant Superintendent denies all allegations. It is not the Grand Jury's purpose to determine the validity of the allegations. The Grand Jury's intent is to provide information to the public for its consideration.

The Superintendent claimed that what occurred was the result of a system failure. This would be true if there were a system in place. Indeed, the combination of construction approval and payment in one agency under a single official ensured that there were no internal checks and balances within the District when payment was to be made. The use of one overworked person to review construction was inadequate. Complaints about the quality of the work were disregarded. The handling of contract administration in other than the usual course likewise invited disaster.

Trust

The Grand Jury was confronted on numerous occasions with the statement that the Board of Education or the Superintendent relied upon an employee because of trust in that employee to perform his or her job correctly and effectively. To the extent that the Board or the Superintendent placed trust in its staff when dealing with costly, complex and important construction projects, trust alone is never appropriate. The Grand Jury believes that every construction project must have in place procedures

Santa Maria-Bonita School District's Questionable Construction Plan

that independently ensure compliance with the law, policies and proper construction practices. Although these procedures may add some cost to the project, the cost seems to be a wise investment.

The Superintendent's Testimonial

At the apparent request of TurnKey, the Superintendent provided an effusively complimentary testimonial for TurnKey which was used by TurnKey on its website and as promotion of further business for TurnKey. The testimonial was dated prior to the completion of the Santa Maria-Bonita projects. The District indicated that such testimonials could rise to the level of conflict of interest.

The Grand Jury believes that such testimonials are improper.

Final Implications for the District

Even assuming that the piggy-back process was applicable to the Santa Maria-Bonita projects, the process was implemented in a manner that avoided the requirements of law and exposed the District to financial harm. The final cost to the District could have been a lot worse. It seems that the District avoided a financial catastrophe by sheer luck and good fortune.

The Grand Jury has some sympathy for the Board of Education, which consists of laypersons who could only rely upon its staff and the professionals retained by the District to protect it.

The Grand Jury asked a member of the Board of Education how it might avoid these failures in the future. The response was that the President of the Board could examine the documentation to determine compliance. Unfortunately, the members of the Board demonstrated little or no knowledge or experience in construction, financing or the structure of such transactions. While board members are not expected to have such knowledge, the Grand Jury believes public entities must rely on competent and experienced counsel who are directed to examine the documentation not only as to form but also as to substance.

Although the Grand Jury was not provided with copies of all of the construction and financing documents, it is usual for counsel for the various parties to issue opinions attesting and certifying to the appropriateness and legality of the transactions. It is also usual for District officials to certify to the validity of the transactions. The purchase of factory-built buildings under the piggy-back process from the vendor was apparently illegal. The Grand Jury searched yet found no indication that anyone questioned the fact that the District was purchasing the factory-built buildings directly from TurnKey rather than through the Snowline district as required by Public Contract Code 20118 which provides in part as follows:

Santa Maria-Bonita School District's Questionable Construction Plan

“...the governing board of any school district without advertising for bids...may authorize by contract...any public corporation to...purchase materials, supplies, equipment, automotive vehicles, tractors and other personal property for the district in the manner in which the public corporation ...is authorized by law to make the leases and purchases. Upon receipt of any such personal property, provided the property complies with the specifications set forth in the contract...the school district may draw a warrant in favor to the public corporation ...in the amount of the approved invoice, including the reasonable cost to the public corporation ...for furnishing the services incidental to the lease or purchase of the personal property”

The Attorney General in a footnote to his January 24, 2006, opinion stated

“By its terms, section 20118 applies only to a school district’s contracts with, and payments to *another* ‘public corporation or agency’ to lease or purchase personal property ‘for the district’ where the other entity ‘is authorized by law to make the leases or purchases’ The statute provides *no* authority for a school district to contract directly with a lessor or vendor.”

The Grand Jury believes that the District must authorize a complete review of the construction and financing transactions using independent counsel to determine if these transactions have been validly consummated. It may be that representations and warranties contained in the documents have been violated which would justify the declaration of default.

Lessons With Broader Applicability

The Grand Jury does not intend to convey the impression that what occurred in Santa Maria-Bonita is limited to the specific facts of that District. Rather, based on the information that the Grand Jury learned from its investigation, similar issues could arise in other districts and municipalities. In many cases, there was an unwillingness to recognize that a single person controlling the contracting and documentation could fail, intentionally or unintentionally, and bring financial hardship to a district.

School and special districts are especially vulnerable to the Santa Maria-Bonita syndrome. School and special districts with small, limited and inexperienced staffs sporadically undertake construction projects. Often these small districts lack even the knowledge of what issues should be of concern.

Santa Maria-Bonita School District's Questionable Construction Plan

In contrast, the County and the cities are continually undertaking construction projects. The County and the cities generally have experienced staff in public works, finance, legal and administrative departments familiar with the construction process not only as it relates to buildings but also with respect to roads, parks, sewers and water systems. The County and the cities appear to have more checks and balances built into their operations than do the school and special districts.

The Grand Jury believes that it is incumbent upon all municipalities and districts to ensure that they have systems in place to incorporate the required checks and balances needed to successfully complete a construction project. Even the County and the cities should annually review and train personnel in the construction process to ensure that each official knows the applicable law and the duties that each such official is expected to carry out.

FINDINGS

Finding 1

The Santa Maria-Bonita School District undertook a complex \$100,000,000 construction project with a Board of Education and staff that were lacking knowledge and experience in construction. The District lacked procedures to manage and control a project of such size and complexity.

Finding 2

Public Contract Code 20118 did not authorize the purchase of factory built school buildings directly from a vendor.

Finding 3

By purchasing buildings that did not comply with the specifications of the original contract, the purchase by the District was not eligible for the piggy-back process.

Finding 4

The Santa Maria-Bonita School District did not require performance and payment bonds to be provided by TurnKey as project manager, architect or contractor.

Finding 5

Although TurnKey had not provided payment bonds, the District paid money due trade contractors to TurnKey and TurnKey did not pay the trade contractors, opening the District to financial liability to the trade contractors.

Santa Maria-Bonita School District's Questionable Construction Plan

Finding 6

The Santa Maria-Bonita School District failed to provide adequate supervision of the construction projects.

Finding 7

The Santa Maria-Bonita School District has incurred estimated additional costs of more than \$1,000,000 for legal expenses and will incur costs related to construction of approximately \$5,000,000 to \$6,000,000.

RECOMMENDATIONS

Recommendation 1

The Santa Maria-Bonita School District should review the construction and finance transactions related to the TurnKey projects to determine the validity of such transactions.

Recommendation 2

The Santa Maria-Bonita School District should establish internal procedures with a separation of duties and functions under more than one official to ensure that a proper check and balance procedure exists.

REQUEST FOR RESPONSE

In accordance with Section 933(c) of the California Penal Code, each agency and government body affected by or named in this report must respond in writing to the findings and recommendations in a timely manner. The following are the affected agencies for this report, with the mandated response period for each:

Santa Maria-Bonita Board of Education – 60 days

Findings	1, 2, 3, 4, 5, 6,7
Recommendations	1, 2