

## DEEPER INQUIRY MAY BE REQUIRED TO DETERMINE WHETHER PROJECT IS SUBJECT TO PREVAILING WAGES

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### Introduction

California's Court of Appeal has interpreted recent legislative changes to California's prevailing wage law to find that courts must look beyond the mere terms of an agreement when determining what constitutes a "public work" for which state prevailing wage law applies. In particular, the payment of "public funds" can be found where a public agency provides rent reductions or other subsidies in lieu of direct payment for construction work.

### Case History

In *Hensel Phelps Construction Co. v. San Diego Unified Port District*, a public agency executed a 66-year lease agreement with a developer for vacant waterfront property for the purpose of building an upscale "convention-center-oriented" hotel in San Diego. The lease required the developer to pay rent based on percentages of income-producing activities by the hotel with a guaranteed minimum annual rent for the first two years of the lease at \$2,250,000, and for the third through twentieth years of the lease at \$4,500,000. The lease also provided for a "rent credit" of up to \$46.5 million. The rent credit consisted of (1) 100% of the monthly rent until the thirty-fourth month of the lease or until construction was completed, and (2) 60% of the rent thereafter.

The issue before the Court of Appeal was whether the lease agreement constituted construction done under contract and, if so, whether the construction was paid for in whole or in part out of public funds. The court answered yes on both counts. Therefore the prevailing wage law



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applied to work performed under the "lease."

### **Although the Port District Did Not Pay Directly for the Work of Construction, the Project Was Still Found to Involve "Construction Done Under Contract"**

Labor Code section 1720, subdivision (a)(1), sets forth two separate statutory requirements for a project to be considered a "public work." First, a public work must involve construction done under contract. Second, the construction must be paid for in whole or in part out of public funds.

The developer argued that there was no construction done under contract, as required by Labor Code section 1720, because the Port District did not enter into a construction contract to build the project. Rather, it entered into a ground lease with the developer, and then the developer entered into a construction contract with a third-party contractor. The developer also argued that there was no construction done "under contract" because none of the rent reductions provided to the developer were used to pay the actual costs of

construction. The court dismissed both arguments.

The court held that although the agreement between the developer and the Port District was a ground lease, the lease clearly required the construction of a hotel according to the Port District's specifications. Additionally, the court emphasized the fact that the Port District required a written guarantee from the general contractor for the purpose of guaranteeing completion of the project, which showed that the Port District was focused on obtaining construction of the project, not just leasing the land.

As to the second argument that the construction must be paid for in whole or in part out of public funds, the court found that the 100% rent credit was dependent upon the date construction was completed, thereby establishing that the credit was given for the purpose of subsidizing construction. The court held that nothing in the statutory language of Labor Code section 1720 required a public agency to make direct payments for construction. Therefore, the Port District's subsidy in lieu of direct payment for construction work was sufficient to find that the work performed pursuant to the ground lease constituted "construction done under contract."

### **The Construction Was Paid for in Whole or in Part Out of Public Funds**

The developer also argued that construction was not paid for with public funds because the Port District did not give up any tangible economic asset when it agreed to the rent credits. Rather, during negotiations, the Port District had merely reduced the amount of rent it had originally requested. Therefore, the developer

argued, there was no transfer from a public agency of anything that possessed independent objective economic value so as to constitute the out-of-pocket expenditure of public funds.

Based on the 2003 legislative amendments to Labor Code section 1720, the court distinguished prior case law, holding that for there to be payment of public funds the public agency must transfer or give up something of independent objective economic value. The court interpreted amended Labor Code section 1720, subdivision (b)(4), as defining the term “paid for in whole or in part out of public funds” as including a waiver or forgiveness of rent or other obligations that would normally be required in the execution of a construction contract regardless of whether the rent reduction or waiver has a realizable monetary

worth. Accordingly, the court held that a rent is reduced when the amount of the rental obligation is set at a certain amount by agreement or by operation of law, and a discount is given from that amount.

### **The Impact**

While in most instances determining what constitutes a public work is a relatively straightforward matter, the decision in *Hensel Phelps Construction Co. v. San Diego Unified Port District* makes clear that additional analysis of underlying contractual terms may be necessary to determine whether the prevailing wage laws apply to a project. In any instance where a public agency is involved in a project, however tangentially, the public agency’s relationship to the project must be examined to determine (1) whether the work being performed involves construction work under a

contract with a public agency, and (2) whether the work is being paid for in whole or in part by public funds, even when there is no indication that public funds are directly paying for the work.

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