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California Prevailing Wage Update

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California Court of Appeals Reaches an Important Decision Regarding Prevailing Wages

In [Hensel Phelps Construction Company v. San Diego Unified Port District](#) (2011) ___ Cal.App.4th ___, 2011 WL 3058889, the California Court of Appeal reached an important decision regarding application of California's Prevailing Wage Law ("PWL") to a privately developed hotel project constructed on land leased from a public entity where the lease provided a rent credit of up to \$45.6 million during the first eleven years of the lease. The Court of Appeal held that the project was a public work requiring the payment of prevailing wages because (1) it constitutes construction done under contract for the purposes of the PWL and (2) the construction was "paid for in whole or in part out of public funds" due to the rent credit in the lease.

Under the PWL, a "public work" is defined as any construction, alteration, demolition, installation or repair work done under contract and paid in whole or part out of public funds. Section 1720(b)(4) specifically provides that the phrase "paid for in whole or part out of public funds" includes fees, costs, rents, loans or other obligations that would normally be required under the contract, that are paid, reduced, waived or otherwise charged at less than fair market value by the public entity.

In *Hensel Phelps Construction*, the San Diego Unified Port District (the "Port") entered into a ground lease of property with One Park Boulevard LLC ("OPB") for the exclusive purpose of an "upscale major convention-center-oriented headquarters hotel." The lease provided a "rent credit," which was to be applied until the credit equaled \$46.5 million or December 31, 2016, whichever occurred first. OPB subsequently contracted with Phelps Portman San Diego LLC ("Phelps Portman") to serve as the developer, who in turn contracted with Hensel Phelps Construction Company ("Hensel Phelps") as the construction manager.

Upon a request submitted to the Department of Industrial Relations (“DIR”) by two labor affiliated groups, the DIR determined that the project at issue was paid for in whole or in part out of public funds and was subject to prevailing wages. Hensel Phelps and Phelps Portman (the Petitioners”) filed a petition with the superior court for a writ of mandate directing the DIR to rescind and vacate the determination, which the court granted. The superior court held that the rent was not “reduced, waived or forgiven” because there was no baseline established in the record by which to measure the rent. The court further determined that an appraisal obtained by Hensel Phelps and the fact that the lease was reached after arm-lengths negotiations between sophisticated parties established that the rent was not charged at less than fair market value.

On appeal, the California Court of Appeal reversed the decision of the superior court. In its decision, the appellate court addressed two principal arguments raised by the Petitioners. First, the Petitioners argued that the project was not “construction . . . under contract” pursuant to the PWL because, among other things, OPB only entered into a ground lease with the Port. OPB thereafter entered into its own contract with the Phelps Portman, who in turn, entered a construction contract with the Hensel Phelps. The Court of Appeal rejected this argument, finding that the lease constituted a contract for construction for the purpose of the PWL because: (i) the lease required construction of a hotel; (ii) the lease required that OPB spend at least \$220 million on the project; and (iii) failure to comply with any contractual provision concerning the construction project would constitute a breach of the lease.

The Petitioners’ second argument was that under section 1720(b)(4), rents are “reduced,” and the project is a public work, only if there is a preexisting contract to pay rent, which is later reduced. Here, Petitioners argued that the rent credit at issue fell outside the scope of Section 1720(b)(4) because the credit and the agreement to pay rent occurred in the same agreement, i.e., there was no preexisting agreement to pay rent which was later reduced. Petitioners also argued that such a “reduction” should come within the statute only if the rent was reduced below fair market value.

The Court of Appeal rejected this argument as cumbersome and contrary to common sense and the plain meaning of the statute. The Court noted that to accept Petitioners’ argument would essentially adopt the logic of a prior appellate court decision, which was abrogated by the Legislature in adopting, among other provisions, the statutory language set forth in section 1720(b)(4). The appellate court also rejected the contention that in order to show a rent reduction, it must also be shown that the rent is below market value. In particular, court held that “a public agency may pay for construction out of public funds either by reducing rent or by charging rent at less than fair market value. There is no requirement that both conditions be present.”

Construction Industry Insight

Any developer or contractor considering construction work on a project pursuant to an agreement with a public entity, including a lease agreement or purchase agreement, whose object is construction of a project that is financed in any way with public funds, should be extremely careful in structuring, reviewing, bidding or executing the work on the agreement. Moreover,

public entities must take care in drafting agreements with developers to ensure the public entity does not incur liability if prevailing wages are not paid on such projects. In order to ensure compliance with the PWL and for clear contractual allocation of liability for compliance, the public entity, developer or contractor should seek the advice of a labor law attorney.

[Link to Hansel Phelps Construction Company v. San Diego Unified Port District Published Opinion](#)

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