STATE OF CALIFORNIA GAVIN NEWSOM, *Governor*

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April 5, 2022

Steven A. McGinty, Hearing Officer
Office of the Director – Legal Unit
355 S. Grand Ave., Suite 1800
Los Angeles, CA 90071

RE: Public Works Case No. 2020-011
Neptune Marina Apartments Project
County of Los Angeles

Dear Mr. McGinty:

This constitutes the determination of the Director of Industrial Relations regarding coverage of the above-referenced project under California's prevailing wage laws and is made pursuant to Labor Code section 1773.5[1] and California Code of Regulations, title 8, section 16001, subdivision (a). Based on my review of the facts of this case and an analysis of the applicable law, it is my determination that the Neptune Marina Apartments Project on land leased from the County of Los Angeles is public work and therefore subject to prevailing wage requirements.

Facts

The Project entails development by GS Neptune Marina Apartments, LLC on Parcel 10R and Parcel 14 (also known as Parcel FF) located in the City of Marina Del Rey owned by the County of Los Angeles (County). On Parcel 10R, work included demolition of the existing 136 apartment units, 182 boat slips, and 8 end-ties, and construction of 400 new apartments including 62 inclusionary affordable housing units, 161 boat slips, and 7 end-ties. On Parcel 14, work included construction of 126 new apartments including 19 inclusionary affordable housing units.

The Project has a long history and dates back to a Request for Proposal in 1998 and the subsequent authorization by the County in 2004 to enter into exclusive negotiations with GS Neptune Marina Apartments, LLC's predecessor, to develop, construct, and operate apartments and anchorage facilities on Parcels 10R and 14.[2] At

[1] All statutory references are to the Labor Code unless otherwise indicated.

[2] The County initially entered into exclusive negotiations with Neptune Marina Joint Venture, a joint venture comprised of the original lessee, Legacy Partners Neptune Marina, L.P. and Neptune Marina, a limited partnership. In 2016, the existing leasehold

the time, Parcel 10R had already been leased and improved with apartments and anchorage facilities. On the other hand, Parcel 14 was not yet leased and was being used as the County's public parking lot. The initial development plan was for the construction and operation of apartments and new anchorage facilities to be structured as a traditional lease extension with rental terms. The plan was delayed for several years in part due to the presence of wetlands on another County parcel that affected Developer's obligation to build a park as a condition of building on Parcel 14. Further, the plan underwent several modifications due to environmental restrictions, financing delays, and changes in the County's affordable housing policy.

For example, around 2007, it became evident that instead of paying an in-lieu fee for its affordable housing agreement, Developer would be required to build 81 affordable housing units on the parcels to comply with the affordable housing policy requiring 15 percent of new units to be reserved as inclusionary units (1/3 reserved for very low income, 1/3 for low income, and 1/3 for moderate income renters). The original development plan was also modified. In addition to paying not less than half the cost to design and construct a wetland park as a condition of building on Parcel 14, Developer had to construct new public docks at the end of Basin B and 103 replacement public parking spaces.

On August 19, 2008, the County and Developer signed an option to amend the lease agreement, granting Developer the right to extend the terms of its existing ground lease on Parcel 10R for an additional 39 years from February 28, 2022 to February 28, 2061, upon the fulfillment of agreed conditions. Developer also obtained the option to lease parcel 14 for a term co-terminus to the extended lease for Parcel 10R subject to the fulfillment of agreed conditions. Developer agreed to pay a nonrefundable option fee of $100,000 for each option. Additionally, Developer was subject to a $1 million extension fee on Parcel 10R with the $100,000 option fee applied as a credit.

As part of this negotiation process, the parties specified that rent would be calculated as a percentage of gross receipts generated, including but not limited to 10.5 percent from apartment rent and 25 percent from rentals of boat slips and other anchorage facilities. More importantly, the parties agreed to an affordable housing rent credit of $26.97 million plus interest on unapplied amount at 3.125 percent per annum from the stabilization date, for up to ten years, applicable to the lease extension fee and to all rents in excess of $500,000 per year until fully amortized.[3] In a letter to the County Board of Supervisors, the Board explained that the credit was intended to "offset the

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interest in Parcel 10R and the options for both parcels were assigned to GS Neptune Marina Apartments, LLC. For the purposes of our discussion, the entities will be referred to as Developer or Lessee.

[3] Based on the draft lease attached to a Letter to the Board of Supervisors, Lessee could apply the rent credit against the portion of annual rent and percentage rent that exceeded the base amount of $500,000 in any lease year after the stabilization date defined as the first day of the month following the month in which the apartment units constructed are 90% physically occupied by tenants for three (3) consecutive months.

economic effect of constructing the affordable housing units." (August 12, 2008 Letter to the Board of Supervisors.)

In 2011, the options to redevelop Parcel 10R and develop Parcel 14 were renewed in part due to unanticipated delays in completing an environmental impact report. Thereafter, Developer continued to face delays in satisfying all conditions needed to exercise its options.

Due to the lengthy and complex history, it is unclear exactly at what point prevailing wages were discussed and required. In 2015, the parties renegotiated the rental terms with the understanding that prevailing wages were required on the project as a result of the rent credits. On May 1, 2015, Developer wrote to the County proposing various modifications to the lease terms. The proposed changes included a request to reduce the percentage rent from 10.5 percent to 2 percent on apartment rent. The letter states in relevant part, the following:

> As a follow on to our discussions relative to the impact of prevailing wage labor requirement on the construction of the apartment units at Neptune Marina, we are proposing a modification of the terms of the Option and Amended and Restated Lease Agreement for the property. (*Sic.*) As a point of reference; the unanticipated prevailing wage requirement will increase construction costs by approximately 25%. This fact, coupled with the low remaining lease term of 46 years has rendered the project infeasible and not financeable.

The negotiation history is further revealed by a Memorandum prepared by Allan D. Kotin & Associates (Kotin), a real estate consulting firm for the County. In relevant part, the September 2015 states the following:

> The rent credit solution adopted in 2007 to mitigate the impact of affordable housing now appears to require prevailing wage. This memo compares County revenues in the previously approved transaction (2007 with rent credit) to the current transaction. The critical changes between the two transactions include first accounting for a cost increase in excess of $26 million attributable to prevailing wage combined with a relatively short remaining term (41 years). The lessee stated that the initially approved rent credit, which necessitated prevailing wage, would not be appropriate or acceptable to potential capital sources and that instead a substantially lower permanent ground rent percentage was needed.

In comparing the previously negotiated lease terms with the renegotiated terms, Kotin projected that the County would begin to see real differences in years 21 to 30 when the County's rent for the renegotiated value would be $15 million while the projection for the prior version would be $41.5 million. The $26.5 million difference is equivalent to the anticipated shortfall created by the prevailing wage obligation.

In November 2015, John P. Laurain, a certified general real estate appraiser, prepared an appraisal report based on the terms of the proposed lease extension. The report concluded that the County's leased fee value and the return on the underlying land and water areas under the terms of the proposed lease extensions were at fair market value "considering the affordable housing and prevailing wage requirements." The appraisal's purpose was not to "estimate the 'as-is' value of the County's leased fee interest." Rather, the appraiser considered three assumptions under the proposed lease extension: (1) the affordable housing requirement for 81 units, (2) a prevailing wage requirement for the proposed development, and (3) the understanding that the County has determined it is in the best interest to develop the subject site at this time. The report stated that these assumptions have a "direct impact on the underlying land value" and opined that although the apartment rent rate in Marina del Rey is predominantly 10.5 percent, a reduction to 2 percent was appropriate "given the significant negative impact on the land value due to the affordable housing and prevailing wage requirements."[4] Specifically, the appraisal states:

> [T]he prevailing wage requirement will increase the total construction costs (without adding a commensurate increase in the rental income). Hence, the added prevailing wage requirement further reduces the underlying land value, as it is a direct additional cost incurred by the developer without any monetary return.

Ultimately, the appraiser concludes that "although the subject property has an inordinately low apartment percentage rate of 2.0%," the return on the land under the proposed lease extension is at or above fair market value considering the terms of the lease extension.

Around December 2015, Developer was granted a one-year extension to exercise the options. As explained in a letter to the County Board of Supervisors with the Board approving the extension and the amended lease terms, it was documented that the reduction of apartment percentage rent from 10.5 percent to 2 percent would "replace the prior Board-approved $26.97 million affordable housing rent credit and compensate Lessee for approximately $26 million of incremental construction costs related to paying prevailing wages." (December 1, 2015 Letter to the Board of Supervisors.)

On December 9, 2016, the lease agreements were executed.

Discussion

All workers employed on public works projects must be paid at least the prevailing wage rates applicable to their work. (§ 1771.) Section 1720, subdivision (a)(1) (hereafter section 1720(a)(1)), defines "public works" to mean: construction, alteration, demolition, installation, or repair work done under contract and paid for in whole or in part out of public funds. "There are three basic elements to a 'public work' under section 1720(a)(1): (1) 'construction, alteration, demolition, installation, or repair work'; (2) that is done under contract; and (3) is paid for in whole or in part out of public funds." (*Busker v. Wabtec Corporation* (2021) 11 Cal.5th 1147, 1157 (*Busker*).) It is undisputed that the construction

[4] Based on the appraisal, other rental categories including rates applicable to boat slips and "other income" are at market levels as "[s]aid property components are not impacted by the affordable housing and prevailing wage requirements."

of the Project meets the first two elements, in that it constitutes "construction" that is "done under contract." Thus, the only issue presented is whether the Project is "paid for in whole or in part out of public funds."

Public funds in this context are not limited to a direct payment of money from a public entity to a contractor. Instead, section 1720, subdivision (b) provides in relevant part that "paid for in whole or in part out of public funds" also means:

> Fees, costs, rents, insurance or bond premiums, loans, interest rates, or other obligations that would normally be required in the execution of the contract, that are paid, reduced, charged at less than fair market value, waived, or forgiven by the state or political subdivision.
> (§ 1720, subd. (b)(4).)

A. Reduction of Percentage Rent Constitutes Reduction in Rent Under Subdivision (b)(4).

Section 1720, subdivision (b)(4) (hereafter section 1720(b)(4)) makes clear that rent that is reduced constitutes public funds. The reduction of percentage rent from 10.5 percent to 2 percent falls squarely within the plain language of this section and is a public subsidy that renders the Project "paid for in whole or part out of public funds."

Neither the County nor the Division of Labor Standards Enforcement (DLSE)[5] stated a position as to whether the Project is a public work. On the other hand, Developer's position is that the Project is not a public work because it was entirely funded by private equity and conventional debt financing. Developer argues that rent paid to the County was not "reduced" because: (1) there was never a fixed base from which a credit or reduction could have been given; and (2) during the negotiation process, the County never had a right to any greater rent than was provided for in the final leases.

Section 1720 (b)(4) does not require a preexisting contractual obligation to pay rent that is later reduced, waived, or forgiven in a subsequent agreement. (*See Hensel Phelps Construction Co. v. San Diego Unified Port Dist.* (2011) 197 Cal.App.4th 1020, 1038 (*Hensel Phelps*).) In *Hensel Phelps*, the San Diego Unified Port District leased a waterfront parcel to a developer for the development of a hotel. The lease provided for $46.5 million in rent credits. In arguing that this rent credit was not a reduction or waiver under section 1720(b)(4), the developer claimed that prior to signing the lease, there was never any obligation to pay any amount of rent and there could not be a reduction, waiver, or forgiveness of rent that is not yet owed. The Court of Appeals rejected this argument, finding "no indication in the statute that a *preexisting* legal contract to pay rent must exist before a public agency can agree to a reduction or waiver of rent within the meaning of section 1720, subdivision (b)(4)." (*Id.*, original italics.)

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[5] As authorized by section 1741, DLSE conducted an investigation and issued civil wage and penalty assessments against contractors working on the Project. In section 1742 proceedings to review the assessments, the contractors and Developer disputed coverage of the Project under the prevailing wage law. Thereafter, the matter was referred for a coverage determination under section 1773.5.

Developer attempts to distinguish *Hensel Phelps* by arguing that, contrary to the lease in *Hensel Phelps* where there was a baseline rent within the lease document itself, the lease between Developer and the County does not establish any baseline rent and without any baseline rent in the lease to reduce from, there cannot be a "reduction" under section 1720(b)(4). However, *Hensel Phelps* never limited the application of section 1720(b)(4) to leases with a baseline rent. In fact, the *Hensel Phelps* court would have examined the parties' negotiating history had it not been apparent from the terms of lease itself that the port district was granting a rent reduction. (*Id*. at p. 1039, fn. 5 ["Although CCCC advocates that we examine the parties' negotiating history to determine whether the Port District agreed to a reduction in rent, because the terms of the Lease set forth a clear baseline rent, from which OPB is granted a reduction, we need not look to the parties' negotiating history."].)

Here, examining the negotiating history reveals that there was undoubtedly rent that was reduced to compensate Developer. Around 2007, the County agreed to provide Developer with $26.97 million in rent credits in exchange for building 81 affordable housing units. While the lease itself was not executed, the parties entered into an option agreement and agreed on specific terms of the lease which included percentage rent from gross receipts – inclusive of 10.5 percent from apartment rent. At some point during negotiations, the parties discovered that rent credits would trigger prevailing wage requirements. In 2015, Developer proposed, and the County agreed to, a reduction of apartment percentage rent from 10.5 percent to 2 percent to address the increase in construction costs brought forth by the "unanticipated prevailing wage requirement [which would] increase construction costs by approximately 25%." Other documents in the record confirm that the County understood that the reduction of apartment percentage rent replaced the previously approved rent credit and compensated Developer for increased costs related to paying prevailing wages. Based on a projection completed by a real estate consulting firm, reducing the percentage rent was estimated to result in a revenue shortfall to the County of $26.5 million.

Developer's attempts to distinguish *Hensel Phelps* also fails because the facts in *Hensel Phelps* parallel the facts in this case. The court found that the facts in *Hensel Phelps* "establish that the rent credit was given for the purpose of subsidizing construction" in part because the developer "appealed to the Port District to subsidize some of those increased costs so that the Project could go forward." (*Hensel Phelps, supra,* 197 Cal.App.4th at p. 1034.) In similar fashion, Developer asked the County to reduce apartment percentage rent from 10.5 percent to 2 percent. If the rental terms had not been modified, the project would be "infeasible and not financeable." As can be seen, the rent reduction was meant to subsidize Developer's increase in construction costs, a subsidy that falls squarely within section 1720(b)(4).

B. The Percentage Rent is Charged at Less Than Fair Market Value.

The drop in percentage rent from 10.5 percent to 2 percent is not only a rent reduction but it alternatively qualifies as a public subsidy because the rent, post-reduction, is being "charged at less than fair market value." (§ 1720, subd. (b)(4).) "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." (*Hensel Phelps, supra,* 197 Cal.App.4th at p. 1037.) "There is no requirement that both conditions be present" (*ibid.*), nor is there is any prohibition against both conditions being met under the same set of facts, as in this case.

Developer's own appraisal unequivocally states that the apartment rent rate in Marina del Rey, where the Project is located, is "predominantly" 10.5 percent, which should normally represent the fair market value. Even though the appraisal admits that 2 percent is an "inordinately low apartment percentage rate," the appraisal nonetheless arrives at 2 percent as fair market value, and the primary justification for that conclusion is that the construction is subject to prevailing wages, thereby raising construction costs.

Developer cites PW 2003-042, *East Campus Student Apartments – University of California, Irvine* (July 28, 2006) (*East Campus Student Apartments*) ostensibly for the propositions that (1) the Department should accept bona fide appraisals without question; and (2) conditions the public agency imposes on the development, such as student rent restrictions, impact the fair market value analysis. The argument appears to be that, because a prevailing wage requirement is being imposed (not unlike student rent restrictions that were imposed in *East Campus Student Apartments*), the fair market value for the transaction is necessarily lower. The appraisal, which is allegedly unassailable,[6] confirms Developer's theory. Because the fair market value of the rent charged is lower by virtue of the prevailing wage requirement, no public subsidy exists, even if the County accepted less rent than it would have. And without a public subsidy, the construction is not a public work and therefore not subject to prevailing wage requirements.

This type of argument places conditions like student rent restrictions and affordable housing requirements in the same category as prevailing wage requirements. But prevailing wage requirements are in general directly tethered to the existence of a public subsidy. (§ 1771; *Lusardi Construction Co. v. Aubry* (1992) 1 Cal.4th 976, 986 (*Lusardi*).) If a public entity provided funds to subsidize construction through charging lower rent, a contractor would be required to pay prevailing wages. For the Department to treat the reverse situation differently – where a public entity first requires a contractor to pay prevailing wages and is then later forced to lower rent to subsidize the increased cost of compliance with the prevailing wage – would be a contortionist exercise that "incentivize[s] gamesmanship" and is contrary to the overall purpose of the prevailing wage law. (*Cinema West, LLC v. Baker* (2017) 13 Cal.App.5th 194, 216 (*Cinema West*).)

Over 30 years ago, the California Supreme Court recognized that "the awarding body and the contractor may have strong financial incentives not to comply with the prevailing wage law." (*Lusardi, supra,* 1 Cal.4th at p. 986.) One can imagine a circumstance where a public entity wishes to provide a subsidy to a project and does so

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[6] Contra, PW 2020-017, *Fort Ord Medical Officer's Barracks, Parker Flats Cutoff Road – City of Seaside* (Dec. 30, 2021) ["The inaccuracy of the extraordinary assumption of [the] $1,694,404 credit to Glover calls into question the validity of the appraisal report and significantly limits its utility in determining the market price."]

by imposing a toothless[7] prevailing wage requirement, then claiming that the market value of the project has been lowered due to the requirement. The savings from the subsidy can then further the developer's and the public entity's development objectives to the detriment of the worker. Under the specific circumstances in this case, interpreting the prevailing wage law in a way that lends support to Developer's argument "cannot have been the Legislature's intent." (*Cinema West, supra,* 13 Cal.App.5th at p. 216.)

Given the reasons above, Developer's argument must be rejected.[8] Charging percentage rent at the "inordinately low apartment percentage rate" of 2 percent when the going rate is "predominantly" 10.5 percent is such a significant deviation that it cannot be attributed to factors other than the requirement to pay prevailing wages, which cannot be the basis for lowering the fair market value under the facts of this case, as explained above. Accordingly, charging 2 percent is a public subsidy because it is less than fair market value within the meaning of the statute. (§ 1720, subd. (b)(4).)

Conclusion

For the foregoing reasons, the construction of the Neptune Marina Apartments Project on land leased from the County of Los Angeles is public work and subject to prevailing wage requirements.

I hope this determination satisfactorily answers your inquiry.

Sincerely,

Katrina S. Hagen

Katrina S. Hagen
Director of Industrial Relations

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[7] The prevailing wage law provides an efficient, cost-effective administrative procedure to enforce statutory prevailing wage requirements that is unavailable in circumstances where there is only a "promise" to pay prevailing wages. (See §§ 1726, 1771.5, 1771.6, 1741-1743; see also footnote 5, *ante*, page 5.)

[8] Developer's ancillary argument that the overall rent as a whole constitutes fair market value is also rejected. The overall rent is comprised of several components, including "supplemental rent" that could increase the apartment rent, *if* Developer's rent revenue exceeds projections. The supplemental rent that could possibly raise the apartment rent paid is speculative particularly in light of the fact that the parties' projections do not deem it a likely possibility – it is more like an unexpected "bonus" on top of the 2 percent apartment rent. At any rate, the possibility that the rent *may* increase in the future cannot serve as the basis for denying workers the prevailing wage now, when the work is performed. (See *Cinema West*, *supra,* 13 Cal.App.5th at pp. 215-216.)