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DEPARTMENT OF INDUSTRIAL RELATIONS

OFFICE OF THE DIRECTOR

455 Golden Gate Avenue, Tenth Floor

San Francisco, CA 94102

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**To All Interested Parties:**

**Re:   Public Works Case No. 2006-021**  
***Hilton San Diego Convention Center Hotel***  
***Port of San Diego Unified Port District***

The Decision on Administrative Appeal, dated June 20, 2008, in PW 2006-021, *Hilton San Diego Convention Center Hotel*, was affirmed in a published Fourth District Court of Appeal opinion dated July 26, 2011. See *Hensel Phelps Construction Co. v. San Diego Unified Port District* (2011) 197 Cal.App.4th 1020.

## DEPARTMENT OF INDUSTRIAL RELATIONS

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April 1, 2008

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Re: PW Case No. 2006-021  
Hilton San Diego Convention Center Hotel  
Port of San Diego Unified Port District

Dear Messrs. Kersh and Carroll:

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 California Code of Regulations, title 8, section 16001(a). Based on my review of the facts and analysis of the applicable state law, it is my determination that the construction of the Hilton San Diego Convention Center Hotel and related development as described below ("Project") is a public work subject to prevailing wage requirements.

#### Background

The Project is being built under a December 2005 lease between the Port of San Diego Unified Port District ("District") and Hilton San Diego Convention Center, LLC ("Hilton").<sup>1</sup> The Project entails construction of a hotel, banquet and conference rooms and ballroom, restaurant and cocktail lounge, and retail shops. It also includes related development on the leased site, including a public park/plaza and supporting facilities and amenities.

The December 2005 lease was negotiated over a 43 month period. In February 2002, District submitted a Request for Proposals ("RFP") for the construction of a "four-star, convention center-oriented headquarters hotel" on state tidelands administered by District ("Project Site"). In the RFP, District proposed a term of 66 years, with minimum rent during construction (the first two years of the lease) of \$2.25 million per annum, and minimum rent upon opening (the 3d through the 20th years of the lease) of \$4.5 million per annum. District proposed that it construct at its

<sup>1</sup>The members of Hilton San Diego Conference Center, LLC are Hilton Hotels Corporation, Sanport, LLC, and Phelps Portman Management, LLC. Hilton subsequently assigned its interests in the Project to One Park Boulevard, LLC ("OPB"). OPB's members include Hilton Hotels Corporation and East Harbor Properties, Inc., an ING Clarion Partners, LLC entity. For purposes of the discussion below, references to Hilton include OPB as successor-in-interest.

expense a public parking structure ("Parking Facility") on a site adjacent to the hotel and make approximately 800 spaces available for the hotel's use.

Hilton informed District that it projected total Project costs to be approximately \$292.5 million and that it would need financial support from District. Hilton originally suggested the support come from District building the Parking Facility and Hilton keeping the parking revenues. An alternative proposal was that District provide a \$26.5 million cash subsidy to the Project in addition to Hilton retaining 20 to 30 percent of the Parking Facility revenues and paying market rate rent for the entire term. Eventually, Hilton and District agreed that Hilton would receive a \$46.5 million rent credit from District for the Project.

District's real estate staff set forth its analysis of the proposals submitted by each of the four developers who responded to the RFP in a Memorandum dated April 30, 2002. The analysis included a summary of the "District subsidy" requested by each of the developers. For Hilton's proposal, the District subsidy was estimated to be \$52.3 million in "present value dollars." In August 2002, Karen Weymann, District's Assistant Director for Real Estate Development, notes that "the \$46.5 million rent credit has a present value of approximately \$26.5 million at an 8.4 percent interest rate."<sup>2</sup>

On January 8, 2003, while the lease was being negotiated, District entered into a design/build contract with Hensel Phelps Construction Co. ("Hensel Phelps"), the licensed contracting entity for Hilton,<sup>3</sup> for the design and construction of the Parking Facility at a cost to District of between \$25 and \$30 million. The work to be performed under the design/build contract also included improvements to 8th Avenue and other improvements benefiting the Project site (collectively the "Design-Build work"). District entered into a separate construction contract for other off-site roadway improvements, including improvements to Harbor Drive (the "Off-site improvements").<sup>4</sup> Hilton was required to pay District \$700,000 toward the cost of the Off-site improvements.

On November 1, 2005, District agreed to apply the \$700,000 Hilton owed it against the rent credit and to accelerate the rent credit during construction from 60 percent to 100 percent of the rent due. Weymann notes in a Power-Point presentation to the District's Board of Commissioners that the "restructuring of the rent credit provides additional savings to the project of about \$4.5 million during construction."

On December 30, 2005, District and Hilton entered into a 66-year ground lease ("Lease"). The Lease includes the following provisions: (1) construction of the Project is to commence no later than two months after commencement of the Lease and is to be substantially completed in accordance with plans and specifications approved by District no later than 34 months from

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<sup>2</sup>Lease Information Summary attached to the Agenda Sheet for Agenda Item No. 3 dated August 6, 2002. A January 5, 2003, Financing Memorandum prepared by Secured Capital Corp for Hilton notes that the rent credit approved by the Board in August 2002 "reduced" lease payments "by 60% for the first eleven (11) years of the lease term up to a maximum savings of \$46.5 million."

<sup>3</sup>Hensel Phelps was also a partner with Hilton Hotels Corporation in the development of the Project.

<sup>4</sup>District required that prevailing wages be paid for the Design-build work and the Off-site improvements.

commencement of the Lease; (2) District will operate the Parking Facility and allot 894 parking spaces to Hilton for the exclusive use of the hotel guests, for which Hilton will pay District 10 percent of the gross income from parking charges collected by Hilton for those parking spaces plus 1.5 percent of revenue from room charges; (3) Hilton will pay minimum or percentage rent, whichever is greater; (4) Hilton will receive a rent credit of \$700,000 applied against its payment obligation to District for the Off-site improvements; a monthly rent credit of 100 percent of the rent due from the commencement of the Lease through the 35th month of the Lease, and a rent credit each month thereafter of 60 percent of the rent due until Hilton receives a total rent credit of \$46.5 million or December 31, 2016, whichever occurs first; and (5), in the event actual gross income exceeds projected gross income, Hilton will pay additional rent in the total amount of \$940,000 from the 4th through the 14th years of the Lease.<sup>5</sup>

Construction commenced in 2006 and is to be completed in the fall of 2008.

#### Discussion

Labor Code section 1771<sup>6</sup> generally requires the payment of prevailing wages to workers employed on public works. 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 ... ."

Section 1720(b) provides, in part, that "paid for in whole or in part out of public funds" means:

\* \* \*

(4) 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.

The Project involves construction done under contract. The issue is whether it is paid for in whole or in part out of public funds. Because the rent credit constitutes "payment out of public funds" for construction, the Project is a public work; and it is not necessary to address or decide the other issues raised by the interested parties.<sup>7</sup>

The Legislature has listed in section 1720(b) specific types of public subsidies that constitute payment out of public funds for construction. "[P]aid ... out of public funds" includes rent that is

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<sup>5</sup>The additional rent, if paid, is to reimburse District for the Design-Build work.

<sup>6</sup>All further statutory references are to the Labor Code unless otherwise indicated.

<sup>7</sup>Because the rent reduction is a sufficient basis for finding that the Project is a public work, it is not necessary to address the parties' other contentions such as whether the scope of the Project includes the publicly-funded Design-Build work or the Off-site improvements or whether the Lease is a transfer of an asset for less than its fair market price under section 1720(b)(3). Additionally, it is not necessary to determine whether the Project is a public work under section 1720(a)(2).

“reduced, charged at less than fair market value, waived, *or* forgiven.” (§ 1720(b)(4) (emphasis added).) The rent credit here falls within the plain language of this section.

District has agreed to provide Developer a rent credit over the first 11 years of the Lease totaling up to \$46.5 million. Throughout their negotiations, District and Hilton themselves characterize the rent credit as a “subsidy” or “rent abatement or reduction” that provides “financial” or “economic” support for the Project. Although it is District’s leasing policy to “seek market rent,” District has the right “to grant rent discounts, waivers or other concessions,” which it has done here. When District granted Hilton an option to Lease in August 2002, it approved a rent reduction (in the form of a rent credit) valued by District in then-current dollars at \$26.5 million.<sup>8</sup> After development/construction costs escalated, District agreed in November 2005 to accelerate the rent credit, thus affording additional cost savings to the Project.

Hilton’s January 2003 Financing Memorandum characterizes the credit as a rent “reduction.” District’s web site notes that its agreement to accelerate the rent credit “will allow the project to proceed.”<sup>9</sup> Further, District acknowledges that:

The Port helped make the project financially feasible by giving the development parties a *rent reduction* of \$46.5 million that would be applied over the first 11 years of the Project.<sup>10</sup>

Contractors<sup>11</sup> have presented a “Market Rent Analysis and Self-Contained Appraisal Report of the Leasehold Interest” prepared by Jones Lang LaSalle Hotels as of December 30, 2005 (“JLL Report”). The JLL Report is dated June 7, 2007, and Contractors claim it demonstrates that Hilton was not charged rent at less than fair market value under section 1720(b)(4). The stated purpose of the JLL Report is to assist the determination of “whether the state’s laws regarding prevailing wage should be enforced during the construction” of the Project. Contractors’ fair market value argument is that the total Lease payments over the life of the Lease are at the fair market value for a 66 year Lease of this sort. Contractors also argue that the Director cannot look at only that “slice” of the Lease period during which little or no rent is paid.

In response to the JLL Report, Carpenters has submitted an appraisal consulting report prepared by Integra Realty Resources dated September 17, 2007 (the “Integra Report”). The Integra Report

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<sup>8</sup>The Minutes of the August 6, 2002 District’s Board meeting reflect that in support of the rent credit, District provided “an outline of the District’s history of providing *subsidies to stimulate economic development* and to bring major regional impact.” (Emphasis added.) District approved the rent credit because of “the importance of working with the developer to keep this project moving forward.”

<sup>9</sup> <http://www.portofsandiego.org/projects/Hiltonhotel/>.

<sup>10</sup>Ibid. (emphasis added.)

<sup>11</sup>Phelps Portman and Hensel Phelps, individually and collectively, will be referred to herein as “Contractors.” Associated General Contractors of California and the Associated Builders and Contractors of California filed submissions in support of Contractors. The San Diego Port Tenant’s Association submitted a letter in support of the position that District is not the type of district contemplated under section 1720(a)(2).

concludes that the \$46.5 million rent credit “represents a subsidy which is inconsistent with the prevailing market terms . . . for similar properties in this area” and that the “rent structure” in the Lease “reflects a situation where the ground lessee is “charged at less than market value” with regard to its ground rent obligations.”

There is no need to choose between these two appraisals to decide the question presented. Under section 1720(b)(4), it is not necessary that a rent be reduced **and** be for less than its fair market value. The plain language of section 1720(b)(4) merely requires that rent be reduced to qualify as the payment out of public funds. However one might characterize the Lease, it is clear that – as the parties themselves understood – the rent to be paid by Hilton under the Lease is up to \$46.5 million less than it would be without the rent credit.

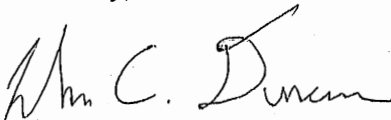
In essence, Contractors argue that there is no public subsidy because District got the best deal it could. The “best deal it could get” required that District reduce the rent if District wanted the Project built; nothing in section 1720(b) provides that a public subsidy loses its status as such simply because it has been negotiated by the public entity and the developer. District and Hilton each recognized from the outset that substantial public financial incentives were essential to the Project going forward. Hilton was chosen in part because the “economic support” it required from District was less than the economic support required by other bidders.

#### Conclusion

The rent credit provided by District to Hilton constitutes payment out of public funds for the construction of the Project. Accordingly, the Project, which is built under contract, is a public work subject to the prevailing wage laws.

I hope this determination satisfactorily answers your inquiry.

Sincerely,



John C. Duncan  
Director