

DEPARTMENT OF INDUSTRIAL RELATIONS

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August 31, 2015

Nathan Schmidt, Hearing Officer
Department of Industrial Relations
Office of the Director – Legal Unit
P.O. Box 420603
San Francisco, CA 94142

Re: Public Works Case No. 2015-008
Kings Rehabilitation Center
City of Hanford

Dear Mr. Schmidt:

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 Labor Code section 1773.5¹ and California Code of Regulations, title 8, section 16001(a). Based on my review of the facts of this case and an analysis of the applicable law, it is my determination that the construction of the Day Training Activity Center at the Kings Rehabilitation Center (Project) is a public work subject to prevailing wage requirements.

Facts

A. The Project and Financing from the HELP II Loan Program.

Kings Rehabilitation Center, Inc. (KRC) is a nonprofit public benefit corporation which serves developmentally disabled persons. KRC planned to build the Project at an estimated overall cost of \$1,650,000. To help finance the Project, KRC applied for² and was granted a \$750,000 Healthcare Expansion Loan Program II (HELP II) loan from the California Health Facilities Financing Authority (CHFFA). The loan agreement, signed on January 1, 2012, provided for a 15-year, 3.00 percent fixed interest rate loan that charged a one-time 1.25 percent fee of the full loan amount (equivalent to \$9,375). The agreement required KRC to make 180 monthly payments of \$5,179.36 to fully repay the loan in 15 years. KRC hired contractors to perform the construction, which began shortly thereafter.

¹ Unless otherwise indicated, all further statutory references are to the California Labor Code and all subdivision references are to the subdivisions of section 1720.

² To defray costs, CHFFA charges a \$50 nonrefundable application fee.

B. CHFFA and the HELP II Loan Program.

CHFFA is the State of California's vehicle for providing "financial assistance through tax-exempt bonds, low-interest loans, and grants to health facilities in California, assisting in the expansion of the availability of health services and health care facilities throughout the state." (Gov. Code, § 15438.10, subd. (a)(4).) In furtherance of its statutory mandate, CHFFA launched the HELP II Loan Program in 1995 to provide direct low cost loans to eligible small and rural health facilities.

In 1999, the Legislature authorized CHFFA to transfer \$5 million from the CHFFA Fund and a matching \$5 million deposit from the State's General Fund to the HELP II loan fund, according to CHFFA. Loan repayments on HELP II loans are deposited into the HELP II loan fund. A health facility can currently borrow up to \$1,000,000 under HELP II. Borrowers can use HELP II loan proceeds to purchase, construct, renovate, or remodel real property and pay for associated preconstruction costs, or to purchase equipment and furnishings.

Discussion

Section 1720, subdivision (a)(1) defines "public works" as construction, alteration, demolition, installation, or repair work that is done under contract and paid for in whole or in part out of public funds. Workers employed on public works must be paid the prevailing wage. (Lab. Code, § 1771.)

The Project involves construction or related work that is done under contract and paid for in part out of HELP II loan proceeds. Those facts are undisputed. The disputed issue is whether the HELP II loan proceeds constitute public funds within the meaning of subdivision (b). KRC argues that HELP II loans are "conduit revenue bonds" as defined in Government Code section 5870, subdivision (c) and that such conduit revenue bonds are not public funds. KRC also argues that HELP II loans are not below market rate loans. The Division of Labor Standards Enforcement (DLSE), on the other hand, contends that HELP II loans charge below market rate interest and thus constitute public funds under subdivision (b)(4).

CHFFA, which runs these financing programs, states that "the HELP II Loan Program is a direct loan program utilizing funds provided by CHFFA." CHFFA explains that the Bond Financing Program, another CHFFA program, is a conduit tax-exempt bond program funded by private investors who purchase the bonds – a description that actually appears to describe a "conduit revenue bond" program. As discussed below, CHFFA knows its programs better than KRC does.

A. HELP II Loans are Direct Loans Funded through the CHFFA Fund.

The California Health Facilities Financing Authority Act (Gov. Code, § 15430, *et seq.*) (CHFFA Act) spells out CHFFA's statutory authority and duties. CHFFA is authorized to make secured loans to eligible small or rural health facilities to finance certain construction projects – precisely the type of loans offered through the HELP II loan program. (Gov. Code, § 15438, subd. (i).)

CHFFA Act provisions expressly permit the HELP II loan program to obtain its funding from the CHFFA Fund. (See *id.*, Gov. Code, § 15439.) Since all moneys accruing to CHFFA from any source are deposited in the CHFFA Fund, a special fund in the State Treasury (Gov. Code,

§ 15439, subd. (a)), and HELP II derives its funding from CHFFA Fund money, HELP II loan funds come out of the State Treasury.

Despite these statutory provisions, KRC nonetheless asserts HELP II loans are actually “conduit revenue bonds” under Government Code section 5870, which defines “conduit revenue bond” as “any municipal security the proceeds of which are loaned to any nongovernmental borrower . . . for purposes that are permitted for qualified private activity bonds under applicable federal law.” (Gov. Code, § 5870, subd. (c).) The statute does not define the terms “municipal security” or “qualified private activity bonds.” Those terms are defined instead under federal law.

Under the Securities Exchange Act of 1934, “municipal securities” are “securities which are direct obligations of, or obligations guaranteed as to principal or interest by” a state or local public entity. (15 U.S.C. § 78c(a)(29).) Under the Internal Revenue Code, “qualified private activity bonds” are generally tax-exempt bonds that are issued by a state or local public entity, where the net proceeds are used by a private entity for certain exempt activities. (See 26 U.S.C. §§ 103, 141.) In the hospital context, at least 95 percent of the net proceeds from a private activity bond must be used for a 501(c)(3) organization’s exempt activities for that bond to be tax-exempt. (26 U.S.C. § 145.)

Taking these federal statutory provisions together in the healthcare context applicable here, a “conduit revenue bond” is a tax-exempt revenue bond that a public entity issues, where *all or nearly all* the proceeds are lent to a private entity for use with respect to a hospital.

The Department previously explained how this type of conduit revenue financing works. In PW 2004-016, *Rancho Santa Fe Village Senior Affordable Housing Project* (February 25, 2005), the California Statewide Communities Development Authority (CSCDA) issued tax-exempt bonds at a lower interest rate appropriate for tax-exempt bonds, then loaned the bond proceeds at the same lower interest rate plus an annual fee to an affordable housing developer. Under an indenture of trust for the bonds, CSCDA assigned all its rights to the bond repayments to a third party bond trustee. The developer, who received the bond proceeds, was contractually obligated to make payments to the bond trustee. CSCDA never had possession of the bond proceeds or bond repayments from the developer. The bondholders’ sole recourse was against the developer and the housing project. Because the bond proceeds never entered public coffers, those bonds were not “public funds” within the meaning of subdivision (b).

While the CHFFA Act authorizes CHFFA to issue conduit revenue bonds and enter into an indenture with a trustee whereby the bond proceeds do not enter public coffers (see Gov. Code, §§ 15441-15444), KRC presents nothing to show that the HELP II loan at issue here involves any type of bond financing, let alone conduit revenue bonds.³ Indeed, CHFFA issues the HELP II loan proceeds to KRC directly from the HELP II loan fund. That money comes directly out of public coffers and constitutes public funds. (See PW 93-054, *Tustin Fire Station* (June 28, 1994).)

³ CHFFA states that it offers a “Standard Bond Financing Program” and a “Pooled Bond Financing Program.” These bond financing programs contain a litany of requirements, such as the need for the borrower to form a finance team consisting of underwriters, bond counsel, financial advisors, and others and to obtain an Investment Grade Rating from a nationally recognized rating agency on the bonds to be issued. The Bond Financing programs are distinct from the HELP II loan program.

B. KRC and DLSE's Arguments Regarding Whether KRC's HELP II Loan is Below Market Rate are Unsupported and Unconvincing.

Although HELP II loans are direct loans from public coffers, they are still, unremarkably, only loans. A loan, alone, does not a public subsidy make. Loans normally must be repaid with interest. (Civ. Code, §§ 1914-1915.) A loan from a public entity that charges interest at less than market rate is deemed public funds. Subdivision (b)(4) recognizes this simple financial fact: "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" constitute a public subsidy to a public works project. (§ 1720, subd. (b)(4).)

DLSE argues that the HELP II loan at issue here is "clearly below market rate." DLSE refers to the California Infrastructure and Economic Development Bank's methodology in setting interest rates for Infrastructure State Revolving Fund loans to demonstrate that HELP II loans are below market rate. That methodology, however, is inapplicable to HELP II loans issued by CHFFA, which are a different type of loan issued by a different public entity.

KRC contends that DLSE mistakenly compared HELP II loans to conventional loans. Using the mistaken premise that HELP II loans are conduit revenue bonds, KRC claims that the proper comparison should be between HELP II loans and tax-exempt bonds. KRC's argument implicitly concedes that HELP II loans are below market rate when compared to conventional loans. KRC offers no other argument why HELP II loans are market rate, other than its assertion that the 3.00 percent interest rate was "comparable with what other lenders were offering at the time" and that the 1.25 percent fee was higher than for other lenders.

DLSE alternatively contends that, since the prime rate at the relevant period was 3.25 percent, it is "unclear how a bank could borrow money from the Federal Reserve at 3.25% and lend the funds to Moore [KRC's contractor] at 3% without losing money." This line of argument seems to misunderstand what the prime rate represents. The Federal Reserve does not loan money to banks at the prime rate. Rather, banks generally use the prime rate as a baseline to decide what rate to lend to borrowers.⁴ In other words, the prime rate generally represents the lowest rate a bank could conceivably lend to its most creditworthy customers.

Aside from the above argument, no compelling evidence or expert opinion on the market rate has been submitted by any party. While no party presents a convincing argument, DLSE does put forward evidence of the prime rate, which the Department can use to help determine the interest rate of construction loans during the relevant period. Due to the lack of evidence, the Department can look only to comparable construction loans when KRC's HELP II loan was made to determine the applicable market rate. The Department's approach comports with CHFFA's statement that

⁴ On its website, the Federal Reserve explains the prime rate: "The prime rate is an interest rate determined by individual banks. It is often used as a reference rate (also called the base rate) for many types of loans, including loans to small businesses and credit card loans. [. . .] Although the Federal Reserve has no direct role in setting the prime rate, many banks choose to set their prime rates based partly on the target level of the federal funds rate--the rate that banks charge each other for short-term loans--established by the Federal Open Market Committee" (Information obtained from the Federal Reserve's Web site at http://www.federalreserve.gov/faqs/credit_12846.htm) [as of May 1, 2015].)

there “have been periods of time where CHFFA’s 3% rate (recently changed to 2%) was below commercially available rates for similar loans” and that whether HELP II loans are below market rate “depends on the market.”

C. The HELP II Loan Made to KRC in This Case is a Below Market Rate Loan and Therefore Constitutes Public Funds.

KRC’s \$750,000 HELP II loan carries with it a 3.00 percent interest rate and 180 monthly payments of \$5,179.36.⁵ Because CHFFA charges fees for the HELP II loan, an accurate measure of the cost of credit must take those fees into account. (See 12 C.F.R. § 1026.22(a)(1) (2015).) Factoring in the 1.25 percent fee of \$9,375 and the \$50 nonrefundable application fee, the annual percentage rate – as a measure of the cost of credit – is approximately 3.18 percent.⁶

From January 2009 to now, the prime rate has stood at 3.25 percent. The prime rate is the “interest rate most closely approximating the riskless or pure rate for money.” (*Till v. SCS Credit Corp.* (2004) 541 U.S. 465, 488 fn. 2.) At least one court has found the prime rate to be the interest rate at which pre-judgment interest should be assessed. (See *Atmel Corp. v. Silicon Storage Tech., Inc.* (N.D.Cal. 2002) 202 F.Supp.2d 1096, 1101, affd. (Fed.Cir. 2003) 76 Fed.Appx. 298) (see also *Uniroyal, Inc. v. Rudkin-Wiley Corp.* (Fed.Cir. 1991) 939 F.2d 1540, 1545 (a court “may award interest at or above the prime rate” and “[t]he court’s selection of the prime rate was not an abuse of discretion.”)) The *Amtel* court reasoned that “[a]s the rate charged by banks to its most credit-worthy customers, Atmel would have been more than generous in applying the [prime] rate to a fellow corporation.” (*Ibid.*) Using the prime rate, which generally represents the rate a bank could offer its best customers, is appropriate in this case as the starting point to determine the market rate for comparable construction loans.

Financing for construction usually consists of two loans: a short-term construction loan to pay construction costs during the course of construction, and then a permanent “take-out” loan which pays the balance due on the construction loan after construction is completed that is paid by installments over a longer period of time. (See 12 Miller & Starr, Cal. Real Estate (3d ed. 2013) § 36:16.) The HELP II loan program is unique in that it is styled as a 15-year construction loan. In that sense, HELP II loans can be described as a “combination construction and take-out loan.” (*Ibid.*) Whatever the case may be, construction loans are typically short term. They also have variable rates that move up and down with the prime rate. And because of the risk inherent in construction loans, their rates are higher than rates available for permanent mortgage loans. For a long term fixed rate loan, the rate is undoubtedly higher as compared to an adjustable rate

⁵ The monthly payment is likely calculated using the following formula: $\text{Monthly Payment} = (\text{Rate} + [\text{Rate} / ([1 + \text{Rate}]^{\text{Months}} - 1)]) \times \text{Loan Principal}$. ‘Rate’ is the monthly interest rate expressed as a decimal and is calculated by dividing the annual interest rate by 1,200. Here, the loan carries a 3 percent annual interest rate, and so the monthly interest rate would be $3 / 1,200 = 0.0025$. With all the variables plugged in, the formula is expressed like so: $5,179.36 = (0.0025 + [0.0025 / ([1.0025]^{180} - 1)]) \times 750,000$.

⁶ By analogy to consumer closed-credit transactions governed by the Truth in Lending Act, the annual percentage rate was derived using the following method: The \$9,375 fee and \$50 application fee are subtracted from the \$750,000 loan principal amount to obtain a total of \$740,575. (See 12 C.F.R. § 1026.18(b)(3) (2015).) Plugging that reduced figure into the formula in footnote 5 and solving for the Rate, the annual percentage rate comes out to approximately 3.18 percent. ($5,179.36 = (0.00265 + [0.00265 / ([1.00265]^{180} - 1)]) \times 740,575$) ($0.00265 \times 1,200 = 3.18\%$)

mortgage (ARM) loan. A review of construction loans on offer reveals that they are nearly always adjustable rate loans, but with options to extend a locked-in rate for a period of up to ten years.

To determine the increase in the rate attributable to having a locked-in rate, the Department compared rates available on e-constructionloan.com. According to that website, an ARM loan fixed for 2 years is 3.375 percent at 1 point compared to an ARM loan fixed for 5 years which comes out to 3.500 percent at 1 point. The difference between a 5 year lock and a 2 year lock is 0.125 percent. As indicated on that website, the 5 year lock is the best lock rate available. An ARM loan fixed for 7 years is 3.875 percent at 1 point, a half percent (0.500) greater than the 2 year lock. To obtain a 10 year lock, however, the rate is 4.375 percent at 1 point. The borrower therefore pays 1 percent more to obtain a 10 year lock over a 2 year lock.

KRC's loan term is 15 years. To arrive at the rate increase per year for a fixed rate lock, the Department averaged the percentage increases between 2 years and 5 years, 2 years and 7 years, 2 years and 10 years to arrive at 0.088 percent per year.⁷ A 15 year lock would accordingly require a 1.32 percent increase on top of the construction loan's underlying rate.⁸ By using the 3.25 percent prime rate as the underlying rate,⁹ this hypothetical market fixed rate construction loan would therefore increase by 1.32 percent for an interest rate of 4.57 percent. At an annual percentage rate of 3.18 percent, the HELP II loan in this case is a below market interest rate loan that, under subdivision (b)(4), constitutes a public subsidy to the Project.

For the foregoing reasons, the construction of the Day Training Activity Center at the Kings Rehabilitation Center in the City of Hanford is a public work within the meaning of section 1720 and is subject to prevailing wage requirements.

I hope this letter satisfactorily answers your inquiry.

Sincerely,



Christine Baker
Director

⁷ $0.125 / 3 \text{ years} = 0.0416$ (2 year to 5 year lock); $0.500 / 5 \text{ years} = 0.100$ (2 year to 7 year lock); $1.000 / 8 \text{ years} = 0.125$ (2 year to 10 year lock). The average is $0.266 / 3 = 0.088$ percent per year.

⁸ 15 years multiplied by 0.088 percent per year = 1.32 percent.

⁹ In this case, the Department used the prime rate as the underlying rate because no other appropriate interest rates were presented by the interested parties. In other cases, evidence may demonstrate that the interest rate is below or above the prime rate.