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Public Subsidies: Not Allowing the Tail to Wag the Dog

By MATTHEW FOGT

As California's cities and counties acknowledge the dramatic decline in development and corresponding fee revenue within their jurisdictions, many are re-evaluating their development fee structure and/or providing incentives to get projects moving and revenue coming in again. Local governments appear to be more willing to work with developers today than a few years ago when they were inundated with development proposals. Also, the strained financial markets have caused developers to look into alternative sources of funding, such as affordable-housing funds and public-private ventures. However, developers and local governments need to be aware of the unintended consequences of this cooperation.

While public funds and concessions are welcome relief during difficult economic times, the assistance, even if minor, can trigger a prevailing wage requirement for the entire project. California labor law requires the payment of prevailing wages to workers employed on "public works" projects. Prevailing wages can be significantly higher than market wages and can cancel the benefit of the public subsidies or, worse, lead to costs in excess of the benefit received. Carefully structuring transactions can allow the receipt of public funds or concessions without the entire project being deemed a public work and thereby subject to a prevailing wage requirement.

Red Flags to Watch For

For purposes of prevailing wage law, a "public work" is any project that falls within any of the categories of public works found in California Labor Code Section 1720. While this column focuses only on the first category of public works set forth in Section 1720(a)(1) - those that are paid for in whole or in part out of public funds - developers and local governments should also be mindful of the following categories: (i) improvement work done for an improvement district (1720(a)(2)); (ii) improvement work directed or supervised by a government agency (1720(a)(3)); (iii) laying carpet in a public building (1720(a)(4) and (5)); (iv) construction for government use (1720.2); and (v) hauling refuse for state projects (1720.3).

Section 1720(a)(1) is the most common category of public works that private developers confront. It defines "public works" to include "construction, alteration, demolition, installation or repair work done under contract and paid for in whole or in part out of public funds." As nearly every development project involves construction, alteration, demolition, installation, or repair work done under contract, the key element of this category is whether the project is paid for in whole or in part out of public funds. In 2002, this element was expressly defined and codified in Section 1720(b) to include the following:

(1) the payment of money or the equivalent of money by a state or political subdivision directly to or on behalf of the public works contractor, subcontractor or developer;

(2) performance of construction work by the state or political subdivision in execution of the project;

(3) transfer by the state or political subdivision of an asset of value for less than fair-market price;

(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, which are paid, reduced, charged at less than fair-market value, waived or forgiven by the state or political subdivision;

(5) money loaned by the state or political subdivision that is to be repaid on a contingent basis; and

(6) credits that are applied by the state or political subdivision against repayment obligations to the state or political subdivision.

Any payment, assistance, concession or subsidy that falls within any of the foregoing six sections should immediately raise a red flag for developers and local governments. As the negotiations and agreements for such assistance typically occur in the early planning stages, spotting the potential issue soon enough could allow creative structuring to resolve the issue as noted in the following section. However, many developers and local governments catch the issue too late in the process, resulting in fines, delays and/or costly restructuring of the project.

Project Structuring Ideas

Section 1720(c) provides several exceptions for projects that otherwise fall within the definition of public works under Sections 1720(a) and (b). Structuring a project to qualify for one of the exceptions could allow for the receipt of public funds and/or concessions without the project being classified as a public work and thereby subject to a prevailing wage requirement.

For example, to the extent the conditions of approval for an otherwise private project require improvements to a public work, such as road improvements, and the local government maintains no proprietary interest in such public work following its completion, the local government can contribute funds and other benefits such as fee waivers to the project up to the cost of the public work improvements without the project being classified as a public work. Thus, even though the payment or fee waiver should raise a red flag as noted, the benefit can be structured within the above-described exception set forth in Section 1720(c)(2) to avoid the project being classified as a public work.

Another common example is the de-minimus exception set forth in Section 1720(c)(3). While it is unclear exactly what is and is not de-minimus, the Department of Industrial Relations determined that a 5 percent project subsidy was not de-minimus in one instance, while a 1/64 percent subsidy was de-minimus in another instance. This exception allows for a minimal amount of public funding or concessions without triggering a prevailing wage requirement for the entire project.

In addition to the two exceptions noted here, developers and local governments should evaluate whether the following exceptions apply: private residential projects on private property (1720(c)(1)); financing from set-aside funds for affordable housing (1720(c)(4)); low-income, homeless, or transitional shelters (1720(c)(6)); and volunteer labor and paid supervisors from conservation corps (1720.4). Charter cities have also historically been exempt from the payment of prevailing wages under certain circumstances.

When a development contains multiple projects, some of which may be public works, carefully structuring the development and associated transactions could limit the payment of prevailing wages to the public work portions of the development. Once again, this type of structuring must take place early in the planning process as it is difficult to accomplish later in the process.

Developers and local governments must understand and watch for the potential triggers and exceptions in determining whether a project is a public work under Section 1720. With competent assistance, carefully crafted public subsidies and concessions can help projects pencil in today's difficult economy without allowing the public subsidy to control the development.

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