Office of
The City Attorney
City of San Diego

MEMORANDUM
MS 59

(619) 533-5800

DATE: September 26, 2011

TO: The Honorable Mayor and City Council Members

FROM: City Attorney

SUBJECT: Proposed First Amendment to the Third Rehabilitation Grant Agreement Between the City and the NTC Foundation

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INTRODUCTION

The Redevelopment Agency of the City of San Diego (Agency) and McMillin-NTC, LLC, are parties to the Naval Training Center Disposition and Development Agreement dated June 26, 2000, as amended (DDA). The DDA requires that the Agency lease to the NTC Foundation (Foundation) certain real property within the Naval Training Center Redevelopment Project Area (NTC Redevelopment Project Area) sometimes referred to as the Civic, Arts and Cultural Center (CACC), including those certain lots designated by building identification numbers 2-5, 12, 14-19, 22, 25, 26, 35, 175-178, 198 and 200 – 202 (the Property).

The Foundation and the Agency entered into the Rehabilitation Grant Agreement dated January 16, 2004 (First Grant Agreement) under which the Agency provided a grant of funds in the amount of $5,850,000 for the Stage One Rehabilitation (as defined in the DDA) of four historic buildings on the Property.

The Foundation and the Agency entered into the Second Rehabilitation Grant Agreement, dated December 20, 2007 (Second Grant Agreement), under which the Agency provided funds in the amount of $6,000,000 to finance a portion of the cost of rehabilitating certain buildings within the Property. The rehabilitation and buildings are described in the Second Grant Agreement as the "Second Segment". The Second Grant Agreement was amended by the First Amendment to Second Grant Agreement dated April 28, 2008, under which Agency agreed, subject to certain conditions, that an eligible use of funds provided by the Second Grant Agreement shall be the carry-over of any remaining funds to combine such funds with any Third Segment grant or Foundation Funds (as defined in the Third Grant Agreement) for the rehabilitation of designated historic buildings and exterior spaces within the Property.

On September 20, 2010, the Foundation and the Agency entered into the Third Rehabilitation Grant Agreement (Third Grant Agreement), under which Agency provided an additional $4,000,000 to assist in financing a portion of the development costs for Phase Two (as defined in the DDA) of the CACC. Phase Two includes the rehabilitation of the eight historic buildings within the CACC designated by building identification numbers 2, 3, 14-17, 26 and Officers' Quarters D (Phase Two Project). The Third Grant Agreement funds were designated for the rehabilitation of buildings 2 and 3 and Officers' Quarters D, but are also being used as leverage to create a $20 million financing package combining bank financing, new market tax credits and historic tax credits to be used to finance the development of the entire Phase Two Project.

When formulating the budget for the Phase Two Project, the Foundation originally assumed that only the work on the buildings that would be rehabilitated with Third Grant Agreement funds (i.e, buildings 2 and 3 and Officers' Quarters D) would be subject to prevailing wage requirements. However, as a result of recent court decisions and determinations by the Director of the California Department of Industrial Relations, work on all of the eight buildings comprising the Phase Two Project is most likely subject to prevailing wage requirements, creating a shortfall of approximately $995,000 in the Phase Two Project budget (Phase Two Project Shortfall). City of San Diego (City) staff and the Foundation believe that the additional funds are required to ensure the completion of the rehabilitation of the entire Phase Two Project in accordance with the DDA and all applicable laws and requirements. The Foundation has indicated it cannot obtain such additional funding through loans or additional equity contributions due to current economic conditions.

Pursuant to Agency Resolution Number R-04612 approved on February 11, 2011, the Agency, as "Landlord" under certain ground leases relating to buildings 19, 175-177 and 200-202 of the CACC (Ground Leases), paid to the San Diego County Tax Assessor (County Assessor) property taxes, including penalties and interest, which were past due and payable with respect to the aforementioned buildings in the total amount of $1,133,801.83. This Agency payment was made using NTC Redevelopment Project Area tax increment revenue. As a result of the Foundation's successful property tax appeal with the County Assessor in connection with buildings 19, 175-177 and 200-202, it is anticipated that the County Assessor will issue a partial refund in an amount not to exceed $800,000 (County Assessor Refund).

In mid-March 2011the Agency transferred to the City fee ownership of the Property, and assigned to the City, all rights, title, interest and obligations under all agreements relating to the development and use of the Property, including the Third Grant Agreement, ground leases, and all other Agency assets, including accounts receivable, to allow the City to complete redevelopment projects and other related activities (Agency/City Asset Transfer).[1] As a result of the Agency/City Asset Transfer, the City is now entitled to the County Assessor Refund.

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[1] The Agency transferred , and the City accepted, fee ownership of the Property and the associated rights and obligations pursuant to Agency Resolution Number R-04654 adopted on March 15, 2011, City Resolution Number R-306680 adopted on March 15, 2011, the First Agreement Regarding General Assignment, Assignment of Accounts Receivable and other Assets, and Assignment and Assumption of Contracts and Other Items between the City and Agency dated March 16, 2011, the Second Agreement Regarding General Assignment, Assignment of Accounts Receivable and other Assets, and Assignment and

The proposed First Amendment to the Third Grant Agreement (First Amendment) would grant the County Assessor Refund, including any refund of interest and penalties, in an amount not to exceed $800,000, to the Foundation to cover a portion of the Phase Two Project Shortfall. This grant would be contingent on receipt of the County Assessor Refund by the City and on issuance of a City Comptroller's Certificate authorizing the use of such funds. The Foundation may cover any remaining shortfall by securing additional tax credit allocation and making other adjustments within the financing transaction, making other adjustments to the construction budget, or securing additional sources of funds.

QUESTIONS PRESENTED

1. Is the Phase Two Project subject to state prevailing wage requirements?

2. May the City use the County Assessor Refund for any purposes other than redevelopment purposes within the NTC Redevelopment Project Area?

SHORT ANSWERS

1. Most likely. There is a strong likelihood that the Director of the Department of Industrial Relations or a court would determine that the Phase Two Project is subject to prevailing wage requirements because it will be paid for in part out of public funds.

2. No. The City may only use the County Assessor Refund for redevelopment purposes within the NTC Redevelopment Project Area.

DISCUSSION

I. THE PHASE TWO PROJECT IS MOST LIKELY SUB JECT TO STATE PREVAILING WAGE REQUIREMENTS BECAUSE IT WILL BE PAID FOR OUT OF PUBLIC FUNDS.

Prevailing wages generally must be paid to all workers employed on "public works." Cal. Lab. Code § 1771. "Public works" are broadly defined to include, among other things, "construction, alteration, demolition, installation, or repair work done under contract and paid for in whole or in part out of public funds . . . ." Cal. Lab. Code § 1720(a)(1). "[P]aid for in whole or in part out of public funds" includes "[t]he payment of money or the equivalent of money by the state or political subdivision directly to or on behalf of the public works contractor, subcontractor, or developer." Cal. Lab. Code § 1720(b)(1). The Agency provided $4 million in NTC Redevelopment Project Area tax increment funds to the Foundation under the Third Grant

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Assumption of Contracts and Other Items between the City and the Agency dated March 17, 2011, and the Third Agreement Regarding General Assignment, Assignment of Accounts Receivable and other Assets and Assignment and Assumption of Contracts and Other Items between the City and the Agency dated March 18, 2011.

Agreement. These are public funds under California Labor Code Section 1720(b)(1).[2] When formulating the budget for the Phase Two Project, the Foundation was originally assumed that only the buildings that would be rehabilitated with Third Grant Agreement funds (i.e., buildings 2 and 3 and Officers' Quarters D) would be subject to prevailing wage requirements. While no case has addressed this specific factual circumstance, given recent court decisions and determinations by the Director of the California Department of Industrial Regulations as discussed below, a could would likely find that the entire Phase Two Project is subject to prevailing wage requirements.

California case law indicates that a project cannot be segmented by contract into multiple projects to avoid application of prevailing wage requirements. The California Supreme Court has rejected a contract-based definition of public work, and held that the obligation to pay prevailing wages cannot be circumvented through contract: "To construe the prevailing wage law as applicable only when the contractor and the public entity have included in the contract language requiring compliance with the prevailing wage law would encourage awarding bodies and contractors to legally circumvent the law, resulting in payment of less than the prevailing wage to workers on construction projects that would otherwise be deemed public work." *Lusardi Construction Co. v. Aubry*, 1 Cal. 4th 976, 987-88 (1992).

A court of appeal decision expanded on this holding and held that a developer cannot avoid application of prevailing wage requirements to a portion of the public improvements included in an overall project by allocating public funds only to certain public improvements in the project. *Azusa Land Partners v. Department of Industrial Relations*, 191 Cal. App. 4th 1, 35 (2010). In *Azusa*, a city contributed Mello-Roos bond proceeds towards the cost of public improvements that were required as a condition of development of a large master planned community project. The court first held that the entire master planned community project was a "public work" subject to prevailing wage requirements because it was paid for in part with public funds. "Once the determination is made that the Project is a public work under subdivision (a)(1), the entire Project is subject to [prevailing wage requirements]." *Id.* at 29. The court next concluded that the exception in California Labor Code Section 1720(c)(2) applied to the project because the

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[2] As a charter city, the City is not required to comply with general laws of the state, such as the state prevailing wage law, in matters that are purely municipal affairs. *See Vial v. City of San Diego*, 122 Cal. App. 3d 346, 348 (1981); City Att'y MOL No. 2005-23 (Nov. 22, 2005). However, the Agency is a separate legal entity existing under state law. Therefore, this charter city exception does not apply to the Agency. Although the City assumed all rights and obligations related to the Phase Two Project buildings pursuant to the Agency/City Asset Transfer, the Phase Two Project will be carried out using the $4 million in NTC Redevelopment Project Area tax increment funds which the Agency previously provided to the Foundation. While the City, rather than the Agency, is now in a position to proceed with the Phase Two Project pursuant to the Agency/City Asset Transfer agreements, those agreements expressly state that the Agency transferred the assets to the City to allow the City to complete redevelopment projects and other related activities. Therefore, the Phase Two Project remains a redevelopment project, and redevelopment is considered a governmental function of statewide concern, not a municipal affair. *Redevelopment Agency v. City of Berkeley*, 80 Cal. App. 3d 158, 169 (1978). It should also be noted that the California Supreme Court could issue a decision at any time deciding whether purely municipal affairs are subject to prevailing wage requirements. *State Building and Construction Trades Council v. City of Vista*, 173 Cal. App. 4th 567 (2009), *depublished by* 99 Cal. Rptr. 3d 559 (2009).

public funds contributed were less than the cost to construct the public improvements included in the otherwise private development, and therefore, prevailing wage requirements applied only to work on the public improvements in the project.[3] *Id.* at 31, 37. The developer sought to further limit application of prevailing wage requirements and argued that because the city had contributed an amount less than the cost of the public improvements in the project, only the public improvements directly funded with public funds should be considered a "public works." The court relied on the holding in *Lusardi* stated above, and concluded that prevailing wage law "does not permit parties to an agreement to carve up the individual components of an overall project into publicly and privately financed pieces." *Id.* at 36.

While *Azusa* differs from the instant case in that the public funds were contributed only for public works of improvement in an otherwise private development, the principles set forth by the court are instructive. In *Azusa*, the court held that prevailing wage requirements cannot be circumvented by segregating public improvements within a private development to avoid application of prevailing wage requirements to the privately financed public improvements. Therefore, a court would likely find that prevailing wage requirements cannot be circumvented by arbitrarily segmenting the Phase Two Project and using public funds in only one segment of that Project.

In addition to the courts' holdings on prevailing wage requirements, the Director of the California Department of Industrial Relations (Director) provides administrative determinations regarding applicability of prevailing wage requirements to specific projects. While past determinations by the Director are not precedential, and therefore not binding on the Department of Industrial Relations or on courts, they provide examples of how similar situations were treated by the Director in the past.[4]

In a letter to Ray Van der Nat dated January 12, 2009 (Re: Public Works Case No. 2007-010), regarding coverage of a redevelopment project in Glendale under prevailing wage law, the Director found that a developer could not avoid application of prevailing wage requirements to a portion of a larger project by treating that portion as a separate and distinct project. The project was a mixed use development including commercial, entertainment, and residential uses. Under a disposition and development agreement, the developer constructed the entire project except for a movie theatre. The developer assigned its rights and obligations under the disposition and

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[3] California Labor Code section 1720(c)(2) provides an exception to that general rule where the public funds are contributed only for certain public works of improvement, and the amount of those public funds does not exceed the cost of the improvements: "If the state or political subdivision requires a public developer to perform construction, alteration, demolition, installation, or repair work on a public work of improvement as a condition of regulatory approval of an otherwise private development project, and the state or political subdivision contributes no more money, or the equivalent of money, to the overall project than is required to perform this public improvement work, and the state or political subdivision maintains no proprietary interest in the overall project, then only the public improvement work shall thereby become subject to this chapter."

[4] The DIR no longer designates public works coverage determinations as "precedential." See California Department of Industrial Relations, *Corrections of the Important Notice to Awarding Bodies and Interested Parties Regarding the Departments Decision to Discontinue the Use of Precedent Determinations,* http://www.dir.ca.gov/dlsr/09-06-2007(pwcd).pdf. The DIR's interpretation of statutes, regulations, and court decisions on public works and prevailing wage coverage issues are advisory only as specific cases and current only as of the date each letter is issued. While determinations are not binding on courts, they are entitled to considerable weight. *City of Long Beach v. Department of Industrial Relations*, 34 Cal. 4th 942, 951-52 (2004).

development agreement to a different private entity, which in turn constructed the theatre according to the scope of development under the disposition and development agreement using only private funding. The Director found that the project of which the theatre was a part was paid for in part out of public funds, and the fact that the developer met its obligation to construct the theatre through a contractual arrangement with another entity does not change the statutory obligations owed to workers under prevailing wage law.

> Based on Developer and Agency's agreement to exchange public funds for construction of certain defined elements under the DDA, the construction of the Center, including the movie theater, is a single public works project paid for "in part" out of Agency's . . . contribution to the overall development. Lessee's contention that the movie theatre construction is a separate project is rejected because section 1720 provides no support for finding there to be two projects.

Letter at 4.

In this case, the Phase Two Project consists of buildings 2, 3, 14-17, 26 and Officers' Quarters D; not just buildings 2, 3, and Officers' Quarters D. While the Third Grant Agreement ostensibly provided funding only for rehabilitation work on three of the eight buildings in the Phase Two Project, the financing for the Phase Two Project is structured such that the funding for rehabilitation of all eight structures is dependent upon the Agency's contribution under the Third Grant Agreement. Furthermore, the Foundation used Agency funds provided under the Second Grant Agreement to cover design and preconstruction costs for all eight buildings in the Phase Two Project. The plan is for all eight buildings to be rehabilitated concurrently, and without the Agency's contribution, rehabilitation of the other five would not be financially feasible for the Foundation at this time. In short, the Agency provided funds to the Foundation to effectuate the entire Phase Two Project, not just the rehabilitation of the three buildings. Therefore, the Director or a court would most likely find that the designation of the public funds for use on only three out of eight buildings in what is effectively one single project does not spare the work on the other five buildings from application of prevailing wage requirements.

II. THE CITY MAY NOT USE THE COUNTY ASSESSOR REFUND FOR ANY PURPOSE OTHER THAN REDEVELOPMENT PURPOSES WITHIN THE NTC REDEVELOPMENT PROJECT AREA.

The City's right to use the County Assessor Refund is limited by language in the agreement by which the City acquired the right to receive the County Assessor Refund. The First Agreement Regarding General Assignment, Assignment of Accounts Receivable and Other Assets, and Assignment and Assumption of Contracts and Other Items, dated March 16, 2011, under which the City acquired the right to the County Assessor Refund, contains a provision in Section 18 which requires that all proceeds and revenues generated from the transferred assets and assigned contracts shall be used exclusively for the redevelopment purposes associated with those assets

and contracts, and otherwise within the redevelopment project areas. Therefore, the City may only use the County Assessor Refund for redevelopment purposes in the NTC Redevelopment Project Area.

CONCLUSION

The Phase Two Project is most likely subject to state prevailing wage requirements because it will be paid for in part out of NTC Redevelopment Tax Increment funds. The City may not use the County Assessor Refund for any purposes other than redevelopment purposes within the NTC Redevelopment Project Area.

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