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Public-Private Partnerships:

Recent Trends and Potential Conflicts with Public Works Laws

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Public-Private Partnerships: Recent Trends and Potential Conflicts with Public Works Laws

Background

At an increasing rate, state and local governments are considering public-private partnerships, or "P3s," to finance, design and build public infrastructure projects. A P3 refers to a contractual agreement between a public agency and a private entity, whereby the private entity provides the financing, design, development, construction, operation, and/or maintenance of a public infrastructure project.¹ It could be said that the trend in the U.S. toward P3 financing structures began in 1989, when California enacted Assembly Bill 680, authorizing P3s for several transportation projects and leading to the construction of two toll roads in Southern California. Today more than half the states have P3-enabling legislation, and P3s are being considered for an increasing number of projects.² Canada has likewise seen the growth of P3s in recent years, with 27 such projects reaching financial closing between 2004 and 2007. Indeed, Canada now has a federal P3 office, and P3 agencies in Quebec, Alberta, Ontario and British Columbia.³

Unlike privatization, in a P3 agreement the public agency typically retains ownership of the project and oversight of its operation, and controls the amount of involvement of the private entity. Some of the benefits of a P3 are that the costs of the investment can be spread over the

¹ See Issue Brief of the California Debt and Investment Advisory Commission (CDIAC), *Privatization v. Public Private Partnerships: A Comparative Analysis*, Office of the California Treasurer (Aug., 2007), www.treasurer.ca.gov/cdiac/publications/privatization.pdf.

² See Deloitte Research Study, *Closing America's Infrastructure Gap: The Role of the Public-Private Partnership 1*, Deloitte Services, LLP (2007), [www.deloitte.com/dtt/cda/doc/content/us_ps_PPPUS_final\(1\).pdf](http://www.deloitte.com/dtt/cda/doc/content/us_ps_PPPUS_final(1).pdf).

³ See Julius Melnitzer, Canada.com Reports, *The P3 Boom: Legal Post Special Report*, (May 14, 2008), www.canada.com/reports/legal/story.html?id=512858.

life of the project, as compared to traditional "pay as you go" financing, and many of the risks of financing, construction and maintenance of the project are transferred to the private sector.⁴

There are, however, some areas of concern in a P3 structure that should be borne in mind by the public entity. First, regardless of who is legally responsible for which aspect of the project, because it is a public project the public agency will be held accountable for any of its failings by the general public. Second, public agencies will have to plan for longer-term contract management when entering into these sorts of arrangements. Third, there is a potential for job loss in the public sector in large P3 projects, as private entities assume responsibility for various facets of the project that would traditionally be carried out by the public sector.⁵

P3 projects may be procured through a variety of contractual structures. One of the more common P3 procurement types is a concession agreement, in which a private entity finances, designs, builds and operates the project under a long-term license from the public agency. Title remains with the public agency through completion of construction, but the private entity takes possession and continues to operate the project for the period of the license. Another common type of procurement is lease-leaseback, in which a private entity enters into a ground lease from the public agency, designs and builds a project, then leases it back to the public agency until the lease is fully paid, at which time the lease terminates. Here the agency remains in possession of the project and retains title to the project. In the former case, the concessionaire collects revenue from the operation of the asset and uses it to pay the cost of finance, design and construction. In the latter, the public agency is paying rent to the developer, who uses it to pay back the costs of the project. In both scenarios, however, the public agency retains title. This is a fundamental

⁴ *Id.*

⁵ CDIAC at 10-11.

difference between P3 and privatization, since in the latter, title transfers to the developer up front. Several permutations of the procurement structures described above are also possible.⁶ For more information and for case studies of various P3s planned and in use throughout the U.S., see The National Council for Public-Private Partnerships, *How Partnerships Work* (April 27, 2007), available at www.ncppp.org/howpart/index.shtml.

Statutory recognition of P3s

To date, P3 structures for the financing of public infrastructure projects are authorized by statute in at least sixteen states, and the use of P3s is under evaluation in several others.⁷ These statutes are predominately found under code provisions for transportation projects. One reason this type of project has been so well-suited to the P3 structure is that the public is used to and generally accepts transportation fees, such as those imposed by rail tickets and toll roads and bridges. Private financing of these projects is thus easier than other types of public projects because the direct fees of the project users can offset the cost of service.⁸

P3s have also been utilized for other public purposes, including water, wastewater, schools, and prisons, to name a few.⁹ In California, P3s are now authorized for use by local public agencies in such diverse fee-producing construction projects as energy or power production, water supply, treatment and distribution, commuter and light rail, highways and

⁶ Deloitte at 8.

⁷ See, e.g., Cal. Gov. Code § 5956, Colo. Rev. Stat. § 43-1-1201, Del. Code tit. 2, § 2001, Fla. Stat. § 341.8202, Ga. Code § 32-2-79, Ind. Code § 8-15.7-5-1, La. Rev. Stat. Ann. § 48:2020, Md. Code Ann. Transp. § 4-205, Minn. Stat. § 174.03(6a), Mo. Ann. Stat. § 227.669, N.J. Stat. Ann. § 27:1D-1, Ohio Rev. Code § 5540.15, R.I. Gen. Laws § 37-22-7, Utah Code Ann. § 72-6-201, Tex. Gov't Code § 488.006, Wash. Rev. Code Ann. § 47.46.030. See also Deloitte at 2, for a map of current and expected P3 activity.

⁸ Deloitte at 21.

⁹ CDIAC at 11.

bridges, and buildings not used primarily for sports or entertainment events.¹⁰ (However, the enabling statute for these projects expressly excludes state agencies from its provisions.) The Natomas school district in Sacramento, for example, employed a P3 financing structure to build a new high school, using a lease-leaseback model to lease part of its land to a private developer, who financed and built the school.¹¹ Another example of a successful P3 project in California is the Alameda Corridor Rail Project, in which a collection of bridge, rail and street improvements were accomplished along a 20-mile stretch of railway in southern California using a P3 financing structure between a joint powers agency and the user-railroads which paid fees to finance design and construction.

Potential Conflict with Other Public Works Laws

P3s and Prevailing Wage Laws

The advent of public-private partnership agreements in turn gives rise to potential conflict with other statutes regulating procurement of public works projects. For example, is the P3 infrastructure project a "public work," and are "public funds" used to fund the project? If the answer to one or both of these questions is yes, then the private entity may incur liability if the design, construction and/or operation of the project would result in the violation of any local regulations pertaining to public works. For example, a "public work" could be subject to state prevailing wage laws, whereas a privately funded work would not.¹² Thus, the definition of "public work" and "public funds" as applied to P3s may lead to litigation if not addressed up front.

¹⁰ Cal. Govt. Code § 5956 et seq.

¹¹ CDIAC at 17.

¹² See, e.g., Cal. Lab. Code § 1771 ("[N]ot less than the general prevailing rate of per diem wages . . . shall be paid to all workers employed on public works.")

For example, in the case of *Greystone Homes, Inc. v. Cake*, the determination of whether the project was a public work and hence subject to California's prevailing wage law turned on the definition of "publicly funded."¹³ Although not specifically a P3 case, it is illustrative of the care that must be taken when structuring funding for private-public works, and may be analogous in the context of P3s. In that case the appellate court held that the development at issue, although built on land purchased with public funds, was not a public work under state law. The holding of the case turned on the definition of "construction," which, under the law at the time of the developer agreement (former California Labor Code § 1720(a) (amended 2000 and 2001)), did not include pre-construction design efforts, but "only the actual physical act of building the structure."¹⁴ Because "construction" by the private developer, as was then legally defined, did not begin until after conveyance of the property from the public sector to the developer, no public funds were used in construction, the development was not a "public work," and hence no liability for prevailing wages accrued to the developer.

Subsequent to the amendment of California Labor Code § 1720(a)¹⁵ and at the time of this writing, the issue whether there was public funding of pre-construction efforts of a P3 or otherwise private project (thus making it subject to prevailing wage laws) has been little litigated in California. *City of Long Beach* is one case in which the public agency's financial contribution to the project was limited to pre-construction expenses, in this case design and architecture.¹⁶ The case was litigated after amendment of § 1720(a) and its broadening of the definition of

¹³ 135 Cal. App. 4th 1, 3 n.1 (2005).

¹⁴ *Id.* at 9 (citing *City of Long Beach v. Dep't of Indus. Rel.*, 34 Cal. 4th 942, 950 (2004)).

¹⁵ Cal. Lab. Code § 1720(a)(1) (2002) ("'[C]onstruction' includes work performed during design and preconstruction phases of construction including, but not limited to, inspection and land surveying work.").

¹⁶ *City of Long Beach* at 948.

"construction." Based on the public funding of pre-construction expenses, the appellate court held that the project *was* a public work, and hence subject to the prevailing wage law.¹⁷

However, the Supreme Court of California reversed. Similar to the project in *Greystone*, the Supreme Court held that this project was not a public work as defined by the statute in effect *at time of the conveyance of public funds*. Because no publicly funded construction was involved, the court reasoned that the project was not subject to the prevailing wage law.¹⁸

Clearly, companies considering a P3 agreement in California today must take note that the term "construction" now encompasses the *pre-building* phases of a project. If funding of the *Greystone* and *City of Long Beach* projects were at issue today, under the current statute their respective holdings might be different. One might argue that "construction" of the *Greystone* project, for example, began at conveyance of public land to the developer ("pre-construction phase"), thus turning it into a "public work" for purposes of prevailing wage laws. And the project in *City of Long Beach* initially was held to be subject to the prevailing wage law, but was ultimately held not subject to that law because the public funding occurred before the amendment was enacted. Query whether the private developer of a California P3 agreement that includes project design could be subject to prevailing wage liability if design efforts or land conveyance is publicly funded, even where the actual construction is privately funded.

Public funding

As demonstrated above, careful structuring of a P3 transaction may be needed to avoid the possible creation of statutory "public funding" for a project and the liability this entails. *San*

¹⁷ *Id.* at 949.

¹⁸ *Id.* at 954.

Antonio Bldg. and Constr. Trades Council v. City of San Antonio illustrates the point.¹⁹ In this case, the city created a non-profit finance corporation to issue bonds, including some tax-exempt, expressly "for the purpose of financing a portion of the costs required to construct . . . a privately-owned hotel" ²⁰ Proceeds of the bonds were loaned to a private developer, who entered into a design-build-operate-lease agreement with the city for a convention center hotel. During the lease term, possession of all improvements on the premises would remain with the tenant developer, but would revert to the city at expiration of the lease.²¹

The *San Antonio* hotel project was challenged as a public work, based on its being partially funded through bonds issued by a local government corporation, and thus subject to Texas' prevailing wage law. The wage law applied "only to the construction of a public work . . . paid for in whole or in part from public funds" ²² The court held that the funds from bonds raised for hotel construction by a local government corporation were not "public funds," mainly because the government did not remain liable for repayment to bondholders if the corporation defaulted²³, and no funds from the state or city were used to secure or pay the bonds.²⁴ Because no public funds (as the court interpreted the term) were used in this project, it was not a "public work"; thus, the prevailing wage law did not apply.²⁵

¹⁹ 224 S.W.3d 738 (Tex. App. 2007).

²⁰ *Id.* at 741 (quoting Ordinance No. 100685).

²¹ *Id.*

²² *Id.* at 746 (quoting Tex. Gov't Code Ann. § 2258.002 (Vernon 2000)).

²³ *Id.* at 747.

²⁴ *Id.* at 749.

²⁵ *Id.* at 751.

However, the dissent in this case would have viewed the arrangement in question as one that *did* involve public funding; thus the project was, in its view, a public work and subject to the prevailing wage law. The dissent strongly criticized the majority's definition of public funding as "very restrictive,"²⁶ and the majority's holding as against public policy in Texas.²⁷ In the dissent's opinion, the arrangement between the city and developer was a P3, the hotel project *was* publicly funded, and the city was merely seeking to avoid the reach of the prevailing wage statute through an artfully crafted contract.²⁸

In a similar case in Pennsylvania, the court came to the opposite conclusion from that of the *San Antonio* majority. In *Lycoming County Nursing Home Assoc., Inc. v. Commw. of Pa., Dep't of Labor & Indus., Prevailing Wage Appeal Board*, county commissioners set up a non-profit corporation to build and operate a project, in this case a nursing facility.²⁹ The county authorized the issuance of bonds, loaned the proceeds to the newly established corporation to develop the facility, and the corporation contracted with a developer to construct the facility. The court held that the project was a public work for purposes of the prevailing wage law³⁰, because the project was paid for, at least in part, with public funds.³¹

The primary rationale for the *Lycoming* court's determination that public funds *were* used in the project at issue was that the county remained liable on the bonds if the non-profit

²⁶ *Id.* at 752.

²⁷ *Id.* at 751.

²⁸ *Id.* (The hotel project as "a prime example of a public-private venture" wherein, "[t]hrough artfully crafted project documents, the City [sought] to avoid application of the prevailing rate statute . . . on publicly-funded public projects.").

²⁹ 627 A.2d 238 (Pa. Commw. Ct. 1993).

³⁰ 43 P.S. § 165-3.

³¹ *Lycoming* at 243.

corporation defaulted.³² In *San Antonio*, however, no political subdivision of the state would have been liable for default.³³

The take-home message from *Lycoming* and *San Antonio* is that P3 agreements must be carefully drafted, with an eye to the legal ramifications of the funding structure selected; and even then, the definition of what makes a work "public" may be open to interpretation and subject to skilful advocacy.

P3s and Competitive Bidding Laws

In the United States, public contracts are generally subject to the competitive bidding process as a matter of public policy. This is considered the best way to serve the public interest, if for no other reason than to save the taxpayer money by securing construction services at the lowest possible cost. With the growth of P3s, however, local governments are more likely to apply alternative approaches for procurement, which in turn face criticism, and challenges in court.

In *American Recycling Company*, for example, the county procurement code allowed for an exception to the standard competitive bidding process, such that at the county's discretion, a contract could be entered into by a competitive proposal method.³⁴ In the proposal method, the contract would be awarded to the offeror whose proposal was most advantageous to the county, and not necessarily the one who presented the lowest bid price.³⁵ The developer in *American Recycling* submitted a proposal to the county for a design-build-operate project, was awarded the position of lowest proposal, but then was not awarded the contract. The developer sued the

³² *Id.*

³³ *San Antonio* at 749.

³⁴ *American Recycling Co. v. County of Manatee*, 963 F. Supp. 1572 (M.D. Fla. 1997).

³⁵ *Id.* at 1574.

county for breach of contract and on due process claims, challenging the county's discretionary procurement method. The court upheld the method, and stated that no contract existed where, as in this case, the code specifically distinguished between an award of a bid and award of a contract; "by accepting the bid, the . . . county, as a matter of law, is not accepting the bidder's offer."³⁶

One of the criticisms of procurement methods that differ from the competitive bidding process, such as competitive proposals or single-source procurement³⁷ that are frequently used in P3 arrangements, is that they give too much discretion to the government entity.³⁸ Where price is not a controlling factor, there is concern that the government is less accountable for its decisions, more open to favoritism or corruption in the award of "discretionary" contracts.³⁹ The benefit of such alternative procurement methods, however, is that they permit the execution of a single contract for multiple phases of the design-build process, rather than requiring a series of competitively bid contracts, thus shortening the procurement process.⁴⁰ Additionally, design and construction can proceed concurrently, which shortens project duration.⁴¹ And importantly, discretionary contract awards allow the government to consider other factors than price, such as the experience and expertise of the various design-build team members and how they relate to each other, all of which is crucial in putting together a productive and efficient design-build team, and one that will best serve the needs of the public.

³⁶ *Id.* at 1582.

³⁷ *See, e.g., Sloan v. Greenville County*, 590 S.E.2d 338, 343 (S.C. Ct. App. 2003).

³⁸ *Id.* at 344 ("Critics espouse that design-build vests too much discretion with the governing body regarding when and to whom public contracts are awarded.").

³⁹ *Id.*

⁴⁰ *Id.* at 343.

⁴¹ *Id.*

Conclusion

With many states experiencing infrastructure deficits, P3s are one tool governments may use to create public infrastructure projects. They are attractive in that they allow for streamlining of the procurement process by bringing together all facets of a project into one team; they shift construction and financial risks to the private sector, while allowing the public to maintain control of the project; and, in some cases, they may be structured to avoid the liabilities that could arise from purely public works. Criticisms of P3s include that they may allow public entities to avoid regulations specifically imposed on public works as a matter of public policy, such as prevailing wage laws; and that discretionary or single-procurement contract awards may leave government bodies open to corruption and favoritism, leading to increased costs to the taxpayer. These arguments appear to be based on policy or politics, rather than legal defects. It appears that the trend toward more P3 projects nationwide continues. More than half the states now have P3-enabling legislation, and P3s are being considered as the structure for a greater variety of infrastructure projects.⁴²

⁴² Deloitte at 7.