Constitutional Issues Relating to "Buy Local" and Local Hiring and Contractor Preferences

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Barbara R. Gadbois, Gibbs, Giden, Locher, Turner & Senet
Theodore L. Senet, Gibbs, Giden, Locher, Turner & Senet
Kristi J. Smith, Supervising Deputy City Attorney, Riverside

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By

Barbara R. Gadbois, Esq., LEED AP, Partner, Gibbs, Giden, Locher, Turner & Senet, LLP and Kristi J. Smith, Esq., Supervising Deputy City Attorney, Office of the City Attorney, City of Riverside

I. INTRODUCTION

In recent years, city council members and local taxpayers look to legal counsel for analysis of methods for increasing participation of local businesses and local workers on city public works projects. This paper sets forth analysis of the basic legal requirements and constraints relating to potential options to fulfill this stated goal.

II. CONSTITUTIONAL ISSUES RELATING TO BUY LOCAL CONTRACTOR PURCHASING PREFERENCES.

A. Introduction

To determine the constitutionality of a local purchasing preference law (See attached **Exhibit A** for an example ordinance), three clauses of the U.S. Constitution must be considered: the Commerce Clause, the Privileges and Immunities Clause, and the Equal Protection Clause. As discussed herein, when a local government acts as "market participant" expending its own funds to purchase goods and services, a local purchasing preference will be valid under the Commerce Clause. Likewise, when a local purchasing preference does (1) not burden a fundamental privilege protected by the Privileges and Immunities Clause; or (2) if it does burden a fundamental privilege, but there is a "substantial reason" for discrimination against citizens of another state, then the preference will not violate the Privileges and Immunities Clause. Finally, since non-local vendors are not a suspect classification, to survive an Equal Protection Clause challenge, a preference law need only demonstrate that the classification (e.g., local vs. non-local businesses) is rationally related to a legitimate governmental purpose, such as encouraging local industry.

B. The Commerce Clause

Constitutional challenges against local purchasing preferences arise primarily from the Commerce Clause (Article I, Section 8 of the U.S. Constitution). The "dormant" or "negative" Commerce Clause affects local purchasing preferences in that it prohibits state and local governments from taking actions that burden interstate commerce. *See*, *e.g.*, *Healy v. Beer Institute, Inc.* (1989) 491 U.S. 324, fn. 1. There is, however, a well-recognized exception to the dormant Commerce Clause for "market participants," that was established by the Supreme Court in *Hughes v. Alexandria Scrap Corp.* (1976) 426 U.S. 794. In *Hughes*, a Maryland program offered money to scrap processors who removed abandoned cars or "hulks" from state roads. Stricter documentation requirements were imposed on out-of-state processors than on in-state processors. *Id*. at 797-801. Finding that Maryland entered the hulk market as a purchaser, not a regulator, the Court held that the state needed no independent justification for its action. *Id*. at 809. "Nothing in the purposes animating the Commerce Clause prohibits a State, in the absence of congressional action, from participating in the market and exercising the right to favor its own citizens over others." *Id.* at 810. This "market participant exception" means that when a state or local government acts in the market like a business or customer, rather than a regulator, the government may favor certain customers or suppliers. The government must be expending its own funds in order to be considered a market participant rather than a regulator. *White v. Massachusetts Council of Construction Employers, Inc.* (1983) 460 U.S. 204, 214.

The State of California's Buy American Act (Cal. Govt Code §§ 4300-4305) (the "Act") was found to be unconstitutional by the California Court of Appeal in *Bethlehem Steel Corp. v. Board of Commissioners of the Dept of Water & Power of the City of Los Angeles* (1969) 276 Cal.App.2d 221. The Act requires that contracts for construction or for the purchase of materials for public use be awarded only to those who agree to use or supply materials manufactured in the United States. *Id*. at 223-224. The Court found that the Act unconstitutionally encroached on exclusive power of the federal government. The next year, the California Attorney General concluded that the California Preference Law (Cal. Govt Code §§ 4330-4334) was similarly unconstitutional because it "affects foreign commerce as much as did the…Act." 53 Ops.Cal.Atty.Gen. 72, 73 (1970).

In *Reeves, Inc. v. Stake* (1980) 447 U.S. 429, the Supreme Court held that a policy of the South Dakota Cement Commission was constitutional. Due to a cement shortage, the State Cement Commission enacted a policy that required a state cement plant that had previously produced cement for in-state residents and out-of-state buyers to now confine its sales only to in-state residents. *Id*. at 429. This policy caused an out-of-state buyer to drastically cut its distribution. *Id*. at 432-433. The Court found that South Dakota "unquestionably" fit the definition of a market participant and that the resident preference program was valid. *Id*. at 440.

In *Big Country Foods, Inc. v. Board of Education of the Anchorage School District, Anchorage, Alaska* (1992) 952 F.2d 1173, the Ninth Circuit held that a policy that gave a 7% bidding preference to in-state milk harvesters was valid under the market participant exception to the dormant Commerce Clause.

C. The Privileges and Immunities Clause

The Privileges and Immunities Clause, in the 14th Amendment to the U.S. Constitution, comes into play with respect to local purchasing preferences, although it is somewhat more applicable to local hiring preferences. The Privileges and Immunities Clause prevents states and local governments from discriminating against citizens of other states. This Clause only protects individuals, however, not corporations. *Western and Southern Life Ins. Co. v. State Bd. of Equalization of California* (1981) 451 U.S. 648, 656. Therefore, since local purchasing preferences affect corporations that sell goods, not individuals that sell goods, this Clause is less likely to provide a substantial basis for a challenge to a local purchasing preference law.

Notwithstanding this applicability issue, in order to overcome a Privileges and Immunities Clause challenge, a local purchasing preference must (1) not burden a fundamental privilege protected by the Clause; or (2) if it does burden a fundamental privilege, there must be "substantial reason" for discrimination against citizens of another state. *United Bldg. & Construction Trades Council of Camden County & Vicinity v. Mayor and Council of the City of Camden* (1984) 465 U.S. 208, 222. Moreover, "[a]s part of any justification offered for the discriminatory law, nonresidents must somehow be shown to 'constitute a peculiar source of the evil at which the statute is aimed.'" *Id*. (quoting *Toomer v. Witsell* (1948) 334

U.S. 385, 396). The Court noted, however, that "[e]very inquiry under the Privileges and Immunities Clause 'must ... be conducted with due regard for the principle that the states should have considerable leeway in analyzing local evils and in prescribing appropriate cures.' [citation] This caution is particularly appropriate when a government body is merely setting conditions on the expenditure of funds it controls." *United Bldg., supra,* 465 U.S. at 222-223.

In 1989, the California Attorney General determined that a county policy that gave a 5% preference to local vendors did not violate the Privileges and Immunities Clause under certain circumstances. The contract had to be for supplies that were either (1) not subject to the requirement that preference be given to the lowest responsible bidder (Cal. Govt Code § 25482), or (2) in a general law county that employs a purchasing agent. In making this finding of constitutionality, the Attorney General noted several important factors. First, the county was expending its own funds. Second, neither "the opportunity to be employed by or to contract with the government is…a fundamental interest explicitly or implicitly guaranteed by the Constitution." 72 Ops.Cal.Atty.Gen. 86 (1989). Therefore, the Equal Protection Clause of the 14th Amendment required only that there be a rational relationship between the classification and a legitimate government purpose. *Id*. The Attorney General found that the classification of vendors inside and outside the county was "rationally related to the legitimate governmental purpose of economic development." *Id*.

D. The Equal Protection Clause

The Equal Protection Clause of the 14th Amendment has also been used to attack local purchasing preferences. Under the Equal Protection Clause, no state may "deny to any person within its jurisdiction the equal protection of the laws." U.S. Const. amend. XIV, Sec. 1. An equal protection analysis only requires strict scrutiny of a legislative classification when the classification impinges on certain fundamental rights or operates to the peculiar disadvantage of a suspect class; otherwise, a rational relationship test is used. 13 Cal.Jur.3d Constitutional Law § 366. This test asks "whether the classification is rationally related to a legitimate governmental purpose." *Id*. Regarding government contracts, the Supreme Court has stated that "like private individuals and businesses, the government enjoys the unrestricted power to produce its own supplies, to determine with whom it will deal, and to fix the terms and

conditions upon which it will make needed purchases." *Perkins v. Lukens Steel Co.* (1940) 310 U.S. 113, 127. This principle appears to leave little room for an equal protection challenge where no suspect class is involved. Since non-local vendors are not a suspect class, the Equal Protection Clause does not present a likely obstacle to local purchasing preference laws. If the preference reflects a legitimate interest of the local governments, such as encouraging local industry or enhancing the local tax base, the preference should be valid.

E. Local Preference Case Study – City of Riverside

In 1976, the City of Riverside amended their then existing Purchasing Resolution to add a provision to award a contract to a local bidder who was not the lowest bidder if the local bidder's quote does not exceed one percent of the sales taxable portion of the lowest bid or when it can be demonstrated that the cost of dealing with the lower out-of-town bidder would exceed the local bid. (Resolution No. 12867)

In 1991, when the City of Riverside revised and revamped its Purchasing Resolution, they carried over the one percent sales tax provision but clarified it was for the purchase of goods. Eleven years later, desiring to award more contracts to local bidders, the City retained the services of John Husing, Ph.D., of Economics & Politics, Inc. ("Husing") to analyze the economics and viability of establishing a five percent (5%) local preference.

Husing's study found, among other things, that: a) purchasing products from local vendors allows for the money paid to circulate through the local economy longer, thereby stimulating the local economy as opposed to purchases made outside the City which money would only serve to stimulate other economies; b) every new dollar entering into the City creates from 1.97 to 2.61 times more total economic activity and household income before it "leaks" away to other geographic areas; c) local vendors would tend to use other local vendors, thus multiplying and continuing to expand the local economy; d) the Inland Empire is not as mature a region as Los Angeles and Orange Counties, and by increasing the local preference it would help increase that maturity in the area, draw and return more businesses including professional services, and expand the local economy; and e) giving local vendors a five percent (5%)

preference would be a modest way in which to stimulate and expand the City's economy.

Based on that study, the City amended its Purchasing Resolution (Resolution No. 20363) to establish a preference for the procurement of goods from a local vendor, define a qualified local vendor and to award a contract to a local vendor provided the difference between the local responsible bidder and the lowest responsible bidder does not exceed five percent (5%) of the lowest responsible bidder. To qualify as a local vendor, the bidder must certify at the time of bid the following:

a) it has fixed facilities with employees located within the City limits;

b) it has a business street address (Post Office box or residential address shall not suffice to establish a local presence);

c) all sales tax returns for the goods purchased must be reported to the State through a business within the geographic boundaries of the City and the City will receive one percent (1%) of the sales tax of the goods purchased; and

d) it has a City business license.

The current Purchasing Resolution No. 21182, adopted in June 2006, carried over the provisions of Resolution No. 20363 and the City currently has a five percent (5%) preference.

III. CONSTITUTIONAL ISSUES RELATING TO LOCAL HIRE PROGRAMS.

A. Mandatory Local Participation.

1. Legal Requirements for Mandatory Local Participation

a. Requirements for Use on *Private* Development

With the goal of increasing employment opportunities for residents, cities and counties nationwide have established programs to encourage and, in some cases, to require private developers of construction projects to hire locally for skilled and unskilled labor. For example, the City of Pasadena recently adopted an ordinance (See attached **Exhibit B**)

mandating that private developers who receive city financial assistance, in the form of grants financing, revenue sharing, provision for the sale of city property at less than market rate, fee waivers or other forms of financial assistance, to enter into a local hire agreement establishing a minimum percentage of construction-related payroll or equivalent that must be accomplished with resident employee hours either during construction or as part of on-going, non-temporary employment following completion of the project. Pasadena's local hire program is voluntary for private development not receiving city financial assistance; however, participating developers receive a partial rebate of the city's construction tax. Unlike private developers, who are free to negotiate the terms and price of construction contracts, the requirement for the city to award construction contracts to the lowest responsive bidder, makes use of local programs difficult. City council members and taxpayers may not appreciate that competitive bidding rules make it difficult to require a mandatory number of local firms or workers and make it difficult to predict the results of such well-intentioned programs.

b. Requirements for Use on *Public* Works

Local hiring ordinances mandating use of local contractors and workers on public works projects have historically been faced with constitutional scrutiny at the federal and state level.

(1) Commerce Clause – Not an Issue if Only City Funds Used

The Commerce Clause, Article I, § 8, cl. 3 of the United States Constitution prevents state and local governments from interfering with Congress's power to regulate commerce among the states. In *White v. Massachusetts Council of Const. Employers, Inc*., 460 U.S. 204 (1983), the mayor of Boston issued an executive order requiring all projects funded in whole or in part by city funds to be performed by a work force at least half of which were city residents. The Supreme Court held that when a state or local government expends only its own funds for a public project, the city acted as a market participant and was not subject to the restraints of the Commerce Clause. Thus, local participation programs can rarely be used when federal or state funds are involved in project funding.

(2) Privileges and Immunities Clause – Must Have a "Substantial Reason" for the Program and

the Program Must be Narrowly Tailored to Address Underlying Reason

The Privileges and Immunities Clause, Article IV, § 2, of the United States Constitution prevents a state from discriminating against out-of-state citizens. In *United Building and Constructions Trades Council of Camden County and Vicinity v. Mayor and Council of the City of Camden*, 465 U.S. 208 (1984), the Supreme Court extended the privileges and immunity protection to municipal residency classifications. Thus, there must be a "substantial reason" for discrimination against citizens of another state when awarding local public contracts. Nonresidents must be the cause of a "particular evil" and the local hire law must bear a close relationship/be narrowly tailored to address the particular evil. The Supreme Court held that Camden's ordinance requiring 40% of employees of contractor and subcontractors to be city residents, was subject to the strictures of the Privileges and Immunity clause and the ordinance discriminated against nonresidents but it was impossible to evaluate the city's justification for the local hire program to determine if there was a "substantial reason" for the program.

In *Hicklin v. Orbeck*, 437 U.S. 518 (1978), the Supreme Court analyzed a constitutional challenge to the "Alaska Hire" law, which was an extremely broad local hire law. The Supreme Court held that the Alaska Hire law violated the Privileges and Immunities Clause because it found that Alaska's unemployment was not caused by non-resident jobseekers, but rather by lack of education, lack of training, or geographic remoteness. Moreover, even if non-residents could be shown to be "a peculiar source of the evil" at which the Alaska Hire law was aimed, the statute would still be invalid because the hiring preference was given to all Alaskans, not just unemployed Alaskans. The Supreme Court noted that the means by which Alaska discriminates against non-residents "must be more closely tailored to aid the unemployed the [Alaska Hire law] is intended to benefit." *Id*. at 528. The Alaska Hire law was also overly broad in terms of what businesses fell within its scope, and effectively attempted to mandate that all businesses that benefit in any manner from Alaska's development of oil and gas bias their employment practices in favor of Alaska residents.

Thus, in order withstand strict scrutiny analysis any local hire or local business contracting program that mandates a specified percentage of local participation, must be

supported by a study supporting the substantial reason for the program and a nexus showing the program is narrowly tailored to correct the underlying reason for the program. See the San Francisco program (attached as **Exhibit C**) discussed below for the information that must be included in a disparity study to support a local participation program and note that the San Francisco program has not been tested by the courts.

(3) Privileges and Immunities Clause – Must Have a "Substantial Reason" for the Program and the Program Must be Narrowly Tailored to Address Underlying Reason

The California Constitution, Article XI, § 10 (b) provides that, a city or county, including any chartered city or chartered county, or public district, may not require that its employees be residents of such city, county, or district; except that [after employment] such employees may be required to reside within a reasonable and specific distance of their place of employment or other designated location. In *Cooperrider v. San Francisco Civil Service Commission*, 97 Cal.App.3d 495 (1979), the Court of Appeal held the city's one-year residency requirement for city job applicants was unconstitutional because it violated Article XI, § 10 (b), which protects the right to migrate, resettle, find a new job and start a new life and violated the right to seek public employment without discrimination under the equal protection clause Article IV, § 16. Since two fundamental rights were at issue, the court applied a strict scrutiny test, requiring that the city demonstrate a compelling state interest was advanced by the policy and that no less intrusive means could achieve the same result. The city offered evidence only as to its attempts to use city funds to prevent unemployment among the impoverished residents of the city and its affirmative action policy, but was not able to establish that there was a rational relationship, let alone a compelling interest, between those objectives and the one-year residency requirement. In light of this case, durational residency requirements are typically minimal, 2 weeks to 3 months when part of a local participation program, if duration of residency is addressed at all.

(4) Local Hire Requirement Cannot Restrain Freedom of Association or Require Unfair Labor Practices

In *O'Hare Truck Service, Inc. v. City of Northlake*, 518 U.S. 712 (1996) a towing firm sued after it was dropped from the city's list of available contractors when it

refused to contribute to the city mayor's reelection campaign. The Supreme Court held that First Amendment protections afforded to public employees against being discharged for refusing to support a political party or candidates also extended to independent contractors.

Based on the ruling in the *O'Hare* case, many attorneys recommend that a local hire program include exceptions for union contractors who are already bound by collective bargaining agreements or project labor agreements or date of last employment arises from the terms of the collective bargaining agreement to which contractor and subcontractors are signatories.

29 USC 158(b) provides that it shall be an unfair labor practice for a labor organization or its agents: (1) to restrain or coerce (A) employees in the exercise of the rights guaranteed in section 157 of this title [Section 157 grants employees the right to organize, engage in concerted activities, etc.] . . . (2) to cause or attempt to cause an employer to discriminate against an employee in violation of subsection (a)(3) of this section [Section 158(a)(3) makes it an unfair labor practice for an employer to discriminate . . . in regard to hire or tenure of employment or any term or condition of employment to encourage or discourage membership in any labor organization . . .]

Generally, it is a violation of Section 8(b) of the National Labor Relations Act (28 U.S.C. 158(b)) for a union to engage in a systematic and continuous pattern of making referrals in violation of the terms of a collective bargaining agreement without a legitimate purpose. *See*, *National Labor Relations Board v. International Association of Bridge, Structural and Ornamental Iron Workers, Local 433*, 600 F.2d 770, 777 (9th Cir. 1979), *see also*, *Laborers and Hod Carriers Local No. 341*, 564 F.2d 834, 839-40 (9th Cir. 1977).

Although we have not found a case directly on point, the requirement to abide by a local hiring ordinance may provide a legitimate purpose and thus no unfair labor practice. Although criminal liability may arise from an unfair labor practice, generally, criminal liability attaches only when there is an unfair labor practice that results in physical injury.

(5) Mandatory Local Business Participation Requirement May Violate Charter

Requirement to Award to Lowest Bidder Unless Exceptions Apply

In *Associated General Contractors v. City and County of San Francisco*, 813 F.2d 922 (1987), the Ninth Circuit evaluated the city ordinance, as it existed at the time, giving local firms a 5% bidding preference for contracts put out to bid and found that the ordinance was invalid because it conflicted with the city charter requirement that the contract be let to the lowest reliable and responsible bidder and did not fall within any of the charter exceptions to competitive bidding. The Ninth Circuit rejected the argument that determination of a bidder's responsibility includes the determination that a bidder is "socially responsible" and able to comply with a local hire requirement.

Thus, it is unlikely that a public entity can mandate use of local businesses or local workers at specified levels without modifying a charter that requires award to the lowest responsibility bidder, or unless there is an existing charter exception for award to other than the low bidder (such as a reciprocal preference similar to Public Contract Code Section 6107).

(6) Local Participation Program May Not Violate Equal Protection Clause If Supported by a Substantial Reason and the Program is Narrowly Tailored

In *Associated General Contractors v. City and County of San Francisco*, 813 F.2d 922 (1987), the Ninth Circuit also held that the 5% preference to local firms did not violate the equal protection clause by promoting local businesses at the expense of nonresident competitors because "the city may rationally allocate its own funds to ameliorate disadvantages suffered by local businesses, particularly where the city itself creates some of the disadvantages". The Ninth Circuit noted that two of the ordinance's findings are relevant to this issue: 1) local businesses are at a competitive disadvantage with businesses from other areas because of the higher administrative costs of doing business in the city (e.g. higher taxes, higher rents, higher wages and benefits for labor, higher insurance rates, etc.; and 2) the public interest would best be served by encouraging businesses to locate and remain in San Francisco through the provision of a minimal preference. The court found that the preferences given local businesses were "relatively slight" as the local businesses got only a 5% preference, there were no goals,

quotas or set-asides. The preference applied only to those transactions where the city itself was a party. Moreover, the definition of a local business was rather broad; foreign businesses can become local businesses by acquiring fixed offices or distribution points within the city and paying their permit and license fees from a city address. Thus, any business willing to share some of the burdens of a San Francisco location (higher rents, wages, insurance etc.) can enjoy the benefits of the preference.

(7) City and County of San Francisco Ordinance

Prior to the enactment of the San Francisco Local Hiring Policy for Construction (Policy), San Francisco required contractors "to make a good faith effort" to hire qualified individuals who are residents of the City and County of San Francisco to comprise not less than 50% of each contractor's total construction workforce, measured in labor work hours, and to give special preference to minorities, women, and economically disadvantaged individuals. A 2010 study by Chinese for Affirmative Action and Brightline Defense Project found that, since 2003, the average local hire figures on city-funded construction was less than 25% and actually dipped below 20% for 2009.

On December 14, 2010, the San Francisco Board of Supervisors passed an ordinance establishing the San Francisco Local Hiring Policy for Construction, in order "to advance the city's workforce and community development goals, removing obstacles that may have historically limited the full employment of local residents on the wide array of opportunities created by public works projects, curbing spiraling unemployment, population decline, and reduction in the number of local businesses located in the city, eroding property values, and depleting San Francisco's tax base." The San Francisco Policy requires contractors and their subcontractors performing public works projects for the City and County of San Francisco worth $400,000 or more to hire local San Francisco residents and extends to projects at sites located up to 70 miles beyond the jurisdictional limits of San Francisco. The San Francisco program requires an initial local hiring requirement with a mandatory participation level of 20% of all project work hours within each trade performed by local residents, with no less that 10% to be performed by disadvantaged workers. Subject to periodic review, the mandatory

participation level increases annually over 7 years at increments of 5%, up to a mandatory participation level of 50%, with no less than one-half to be performed by disadvantaged workers. The San Francisco program authorizes the negotiation of reciprocity agreements with other local jurisdictions that maintain local hiring programs. The San Francisco Program exempts: 1) Projects using federal or state funds if application of the Policy would violate federal or state law, or would be inconsistent with the terms or conditions of a grant or contract with an agency of the United States or the State of California; 2) Project work hours performed by residents of states other than California (to prevent a challenge based on the Privileges and Immunity Clause of the U.S. Constitution); and 3) Projects where the local hire program conflicts with an existing Project Labor Agreement or collective bargaining agreement (to prevent a challenge based on the *O'Hare* decision).

While it is understandable for San Francisco to want to increase local jobs, favoring local workers can negatively impact neighboring cities that are also experiencing high unemployment levels. According to the December 2010 figures by the California Employment Development Department, six of the nine Bay Area Counties have higher unemployment rates than, San Francisco which was at 9.2%. While local hiring goals are laudable, such goals should not be accomplished by introducing new obstacles for the regional workforce; the Bay Area is a mobile and economically interdependent region and it does not benefit from pitting neighboring communities against each other. A similar analysis applies to the Los Angeles basin.

B. Local Participation Goals with Good Faith Efforts.

Because of the legal limitations and practical difficulty of implementing mandatory programs set forth above most local subcontractor and hiring ordinances relating to public works projects require bidders to document a "good faith" effort to meet the local participation goal, but do not require that bidders meet the goal in order to receive award of the contract.

1. <u>California Supreme Court Review of a Targeted Outreach Program</u>

In the 1980's, the City of Los Angeles City Council adopted a policy to ensure that minority (MBE) and women-owned (WBE) businesses have the maximum

opportunity to participate in the performance of contracts and subcontracts. The Los Angeles program examined the adequacy of bidders' good faith in conducting subcontractor outreach efforts to obtain MBE, WBE and other business enterprises (OBE) utilizing 10 factors including selecting specific work items for subcontracting, advertising, good faith negotiations, etc. Although the city established a percentage "goal" for MBE and WBE participation, the program made clear that failure to meet the stated goal would not disqualify a bidder. Only bidders who failed to document good faith efforts to obtain MBE/WBE/OBE subcontractor participation would be disqualified.

The California Supreme Court case of *Domar Electric, Inc. v. City of Los Angeles*, 9 Cal.4th 161 (1995) expressly held that a Los Angeles City charter provision requiring award of contracts to the "lowest and best regular responsible bidder" did not bar the city from requiring bidders to comply with a subcontractor outreach program that involved no bid preferences, set-asides or quotas. The Court reviewed provisions of the LA City Charter that expressly stated that "bidders may be required to submit with their proposals detailed specifications of any item to be furnished, together with guarantees as to efficiency, performance … and other appropriate factors" and that a local bidder preference may be allowed if provided for by ordinance. Since these charter provisions neither expressly authorize or forbid the city from adopting a subcontractor outreach requirement, the Court indicated that the validity of the program must be ascertained with reference to the purposes of competitive bidding, which are "to guard against favoritism, improvidence, extravagance, fraud and corruption to prevent waste of public funds; and to obtain the best economic result for the public". The Court found no conflict between the city's outreach program and the purposes of competitive bidding, which necessarily imply equal opportunities to all. The Court discussed that despite the lack of empirical evidence it was not unreasonable for the city to conclude that in the absence of mandated outreach, prime contractors will tend to seek out familiar subcontractors and therefore their bids may or may not reflect as low a price had reasonable outreach efforts been made.

2. <u>Discussion</u>

A local contractor/worker outreach program with non-mandatory goals and mandatory good faith efforts would likely be subject to the same level of review as the MBE/WBE program examined by the *Domar* court and should be structured in a similar manner in order to withstand a potential legal challenge. In fact, the majority of local participation programs implemented by California local agencies use a good faith effort model. These programs are often initially well received because they establish a public policy for use of local firms and workers. The results of the programs, however, are often criticized because it is difficult to structure a good faith effort program and achieve significant levels of local participation. Some critics view good faith efforts as meaningless and push for mandatory programs.

Programs which require review of bidders' documentation of good faith efforts can also complicate the bidding and contract award process and may provide new grounds for disappointed bidders to protest proposed contracts.

C. Bonus/Incentive Payments for Local Participation.

In light of the shortcomings of good faith effort outreach programs, charter cities may wish to explore the use of incentives, such as a line item allowance in the bid and contract, which can be used to fund bonus/incentive payments based on documented levels of actual local participation achieved throughout the duration of the project discussed in the next section.

1. California Constitutional Prohibition on Gift of Public Funds

Article XVI, Section 6 of the California Constitution prohibits the legislature from making or authorizing the making of any gift of public money or thing to an individual or corporation. California Government Code Section 82028(a) defines "gift" as "any payment that confers a personal benefit on the recipient, to the extent that consideration of equal or greater value is not received…." The gift prohibited by the Constitution includes voluntary transfers of personal property without consideration, as well as "all appropriations of public money for which there is no authority or enforceable claim, even if there is a moral or equitable obligation." 58 Cal. Jur. 3d State of California § 91.

To determine whether an appropriation of public funds is a "gift," the primary question is whether the funds are to be used for a public purpose or a private purpose; if the funds will be used for a public purpose, the appropriation is not a gift. 45 Cal. Jur. 3d Municipalities § 172. "The benefits to the state from an expenditure for a public purpose is in the nature of a consideration; therefore, the funds expended are not a gift, even though private persons are benefitted from them." *Id*. What constitutes a public purpose is generally left to the discretion of the legislature, and courts will not disturb such a determination if it has a reasonable basis. *Sturgeon v. County of Los Angeles* (2008) 167 Cal.App.4th 630, 638-639 (*review denied*).

2. Charter City Exemption

The California Constitutional prohibition on gifts of public funds, however, does not apply to charter cities. *Mullins v. Henderson* (1946) 75 Cal.App.2d 117, 129; *Sturgeon*, 167 Cal.App.4th at 637; 45 Cal. Jur. 3d Municipalities § 172.

3. Payments for a Public Purpose are Not Gifts

A local contractor/local hire program that gave a bonus to the contractor or its key personnel at project closeout based on local participation levels on the project would likely not be viewed as a gift of public funds because the bonus payment would be for a public purpose, even though the contractor/individual would also benefit. "A mere incidental benefit to an individual does not convert a public purpose into a private purpose, within the meaning of the rule." 45 Cal. Jur. 3d Municipalities § 172. The rationale for a local hiring program is to use taxpayer dollars that are invested into public projects in the city while also increasing the economic strength of the city by providing city residents with an opportunity to be employed on those projects. This rationale would likely be determined to be a public purpose. Rewarding a contractor at the end of such a project with a bonus for actually using local hires on the project serves that public purpose by encouraging the contractor to look locally for new hires whenever possible. The fact that the contractor also benefits is a consequential advantage to the program, but not its purpose. The city's concern is the public—the local residents, and in turn, the entire city economy—that stands to gain from a local hiring program.

Examples of expenditures that have been deemed public purposes by the courts include: providing inhabitants of a municipality with utility services; public housing projects for low-income families; and a joint study by two municipalities of common sewage problems. *County of Riverside v. Whitlock* (1972) 22 Cal.App.2d 863; *Housing Authority of City of Los Angeles v. Shoecraft* (1953) 116 Cal.App.2d 813; *City of Oakland v. Williams* (1940) 15 Cal.2d 542.

One case that is particularly analogous to paying bonuses for using local contractors/hires is *Sturgeon v. County of Los Angeles* (2008) 167 Cal.App.4th 630. In *Sturgeon*, the plaintiff challenged the validity of benefits provided by the County to superior court judges. The challenge was based in part on the argument that the benefits were an unconstitutional gift of public funds. The court of appeal held that the benefits given to the judges were not gifts of public funds. The court noted that most earlier California cases had found that a public employer's provision of benefits to its employees, "including bonuses for work already performed," serve public, not private purposes. *Id*. at 638. In *Sturgeon*, the court found that the benefits to judges helped with recruitment and retention of judges, and therefore the benefits were not gifts under the meaning of Article XVI, Section 6 of the Constitution.

A bonus paid to a contractor for using local contractors/hires helps a city's economy by incentivizing that contractor to look to city residents first when subcontracting and job openings arise on a project, which benefits a city and its residents. Therefore an incentive bonus for local hires should not be viewed as a gift of public funds, because it is an expenditure for a public purpose—the contractor is giving consideration (utilizing city residents) for the payment of public funds (the bonus).

IV. SUMMARY

A. Mandatory Local Participation.

In order to survive a challenge under the U.S. Constitution Commerce, Privileges and Immunity and Equal Protection clauses, a mandated "preference" (as opposed to a "goal") for local participation on a city public works project:

1) Requires project funding from city funds only (no federal, state or grant funding);

2) Requires a "substantial reason" for the local preference, e.g., nonresidents must be the cause or a particular "evil" (such as similar preferences legislated by other states or municipalities, or a disparity study that shows local contractors or workers are not getting their expected share of city public work contracts);

3) Must be narrowly tailored to address the particular evil or address the local disadvantage;

4) Must indicate that the program does not apply if it violates federal or state law or a grant so as to jeopardize funding for the project;

5) Local residence requirement cannot impair California Constitutional right to resettle and find a job (Article XI §10(b))

6) Must not conflict with charter provisions requiring award to low bidders; and

7) With respect to local hiring, cannot restrain freedom of association or require unfair trade practices, (i.e., should either provide exceptions for union hall hiring practices, however disparate treatment could raise equal protection challenges by non-union contractors) or the city should attempt to obtain union cooperation *before bidding* a project with a local participation program or use only with negotiated contracts.

B. Local Participation Goals with Good Faith Efforts.

Legal requirements for a program that requires bidders to undertake good faith efforts to meet a goal for local firm/resident participation on a city project include (See **Exhibit D** for

sample):

1) Establishes a goal for local participation, but does *not* require bidders to meet the goal,

2) Requires *all* bidders, including local firms, to undertake subcontractor/supplier and worker outreach,

3) Requires bidders to undertake outreach to *all* qualified subcontractors, suppliers and workers including, but not limited to, local firms and individuals, and

4) Compliance with any charter or ordinance requirements for approval by the city council.

C. Bonus/Incentive Payments for Local Participation.

The California constitutional prohibition against gifts of public funds does not apply to charter cities unless there is specific language in their charters prohibiting such use of funds. The test for whether payments of public funds are a gift is whether the funds are used for a public purpose, regardless of whether a private person also benefits from the expenditure. Incentive payments tied to the level of participation local firms and workers on a city project reasonably appear to advance a public purpose of improving the lives of city residents, improving the revenue of local businesses and improving the overall local economy; therefore a bonus paid to a firm or individual to serve that public purpose would likely not be considered a gift waste of public funds.

V. FURTHER CONSIDERATIONS

A. Determine the scope and nature of the local participation program

B. Gather statistics from federal, state and local entities regarding labor statistics, sales tax revenues, etc. to support need for program even if a mandatory

participation level program is *not* used to support the program as consistent with the basic policies of competitive bidding

C. Adopt a resolution, ordinance or similar legislative action on the public benefit, specifically addressing the fact that there will be no gift of public funds if an incentive/bonus payment is part of the program.

D. Consider methods of measuring results

E. Consider incorporating a sunset date and reporting requirements for projects where no incentive provided as well as projects with local business/hire program, and review to determine whether program/bonus increased use of locals