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**REPORT TO THE COMMITTEE ON RULES, FINANCE
AND INTERGOVERNMENTAL RELATIONS**

LEGAL OPTIONS FOR SMALL OR LOCAL BUSINESS PREFERENCE PROGRAMS

INTRODUCTION

At the March 4, 2009, hearing of the City Council's Rules, Open Government and Intergovernmental Relations Committee [Committee], the Committee requested that the City Attorney analyze the City's legal options for implementing a small or local business preference program. Specifically, the Committee asked the City Attorney whether such a program would require an amendment to the City Charter or whether it could be achieved through alternative means, for example, by clarifying or expanding the meaning of the phrase "lowest responsible and reliable bidder" via ordinance. The Committee asked the City Attorney to analyze the City's options for a small or local business preference program both in the construction context and in the context of goods, services and consultant contracts. Our analysis follows:

QUESTIONS PRESENTED

1. Whether the City may implement a small or local business preference program for construction contracts?
2. Whether the City may implement a small or local business preference program for goods, services, and consultant contracts?

BRIEF ANSWERS

1. The City may implement a small or local business bid preference for construction contracts either by a vote of the electorate amending the "lowest responsible and reliable" requirements of Charter section 94 or by an ordinance amending the Municipal Code to provide for such a preference for construction contracts within certain dollar amounts. A third option would be to adopt an ordinance redefining the term "lowest responsible and reliable bidder" in the Municipal Code. However, this third option is legally problematic. A fourth option is to include a small or local business subcontractor requirement in bid specifications, provided the City can show that such a requirement furthers a legitimate governmental interest and is not arbitrary or capricious.

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2. The City may implement a small or local business bid preference in goods, services or consulting contracts. The City may also include a small or local business subcontractor requirement in bid specifications, provided the City can show that such a requirement furthers a legitimate governmental interest and is not arbitrary or capricious.

DISCUSSION

At the March 4, 2009, hearing of the Committee, the Mayor's Office and Equal Opportunity Contracting [EOC] Director presented a status report on the City's EOC program. The report included an overview of the City's current outreach and mentoring programs, statistical updates, as well as proposed strategies for enhancing diversity in City contracts. One proposal was to adopt a small or local business preference program, similar to programs utilized by the State of California, San Francisco, Oakland, Los Angeles or San Jose. Although still in preliminary planning stages, such a program might include bid preferences, mandatory subcontracting goals, or other benefits for small and local businesses such as financial or technical assistance. The Committee requested that the Mayor's Office and EOC Director solicit input from the contracting community and other stakeholders regarding various aspects of the program.

In addition, the Committee asked this Office to revisit our Report to the Natural Resources and Culture Committee dated April 28, 2003 [RC-2003-12]. In our 2003 report, the City Attorney had opined that in order to implement a small business preference program for construction contracts, the City would have to: (1) amend the Charter section 94 requirement that public works contracts be awarded to the "lowest responsible and reliable bidder," (2) adopt an ordinance limiting the program to contracts under certain dollar amounts consistent with the Charter, or (3) adopt an ordinance redefining "responsibility."¹ [RC-2003-12, pp. 8-11]. The 2003 report did not address the application of a small or local business preference to goods, services, or consultant contracts.

After reviewing current case law and comparing the charter provisions of other municipalities utilizing small or local business preference programs, we conclude that the City has the same options available to it as those set forth in the 2003 report. In addition, the City may be able to immediately implement: (1) a small or local business subcontracting requirement for construction contracts, and (2) either a small or local bid preference or subcontracting requirement for goods, services, and consultant contracts.

I. Construction

In the construction context, we must first consider whether a small or local business preference would be inconsistent with the City Charter. San Diego is a charter city, which means

¹ In the 2003 report, we recommended against this option, noting that redefining "responsibility" to include aspects other than those permitted by case law might not be legally defensible. RC -2003-12, pp. 10-11. We will discuss this option in further detail at pp. 6-7 below.

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that it has the power to govern its own “municipal affairs.” Cal. Const. Art. XI, § 5. The City’s power to govern its municipal affairs is subject only to the explicit limitations and restrictions contained in its charter and the state and federal constitutions. However, “a charter city may not act in conflict with its charter,” and “any act that is violative of or not in compliance with the charter is void.” *Domar Electric, Inc. v. City of Los Angeles*, 9 Cal.4th 161, 171 (1994). Generally, courts have considered municipal contracting to be a municipal affair. *See, e.g., id.* at 170-171 (holding that “the expenditure of city funds on a city’s public works project is a municipal affair”). Therefore, a charter city has discretion to develop its own contracting rules and procedures for its municipal affairs as long as they do not conflict with the city’s charter.

A. Charter Requirement: “Lowest Responsible and Reliable Bidder”

Our City Charter includes specific provisions governing the advertising and award of public works contracts. Charter section 94 provides, in relevant part:

In the construction, reconstruction or repair of public buildings, streets, utilities and other public works, when the expenditure therefore *shall exceed the sum established by ordinance of the City Council*,² the same shall be done by written contract, except as otherwise provided in this Charter, and the Council, on the recommendation of the Manager or the head of the Department in charge if not under the Manager’s jurisdiction, shall let the same to *the lowest responsible and reliable bidder*, not less than ten days after advertising for one day in the official newspaper of the City for sealed proposals for the work contemplated. (Emphasis added.)

Courts generally have interpreted a requirement to award to the “lowest responsible and reliable bidder” – or similar terms³ – to mean that a local agency must award to the lowest responsible bidder meeting advertised specifications. The agency has no discretion to consider subjective factors, such as relative quality, in making an award. *See, e.g., Associated Builders and Contractors, Inc. v. San Francisco Airports Commission*, 21 Cal.4th 352, 366 (1999); *City of Inglewood- L.A. County Civic Center Authority v. Superior Court*, 7 Cal.3d 861, 867-68 (1972).

² The monetary threshold for award to the “lowest responsible and reliable” bidder has changed over time. When first adopted in 1931, Section 94 required all contracts over \$1,000 to be let to the “lowest responsible and reliable bidder.” The dollar threshold was increased to \$2,500 in 1953, and to a “sum established by ordinance” in 1977. RC-2003-12, p. 9.

³ In the *City of Inglewood*, the court was interpreting an analogous state statute, which requires that construction projects over a certain dollar amount be awarded to the “lowest responsible bidder.” *City of Inglewood*, 7 Cal.3d at 864. The California Supreme Court has interpreted the state statute requiring award to the “lowest responsible bidder” as having the same legal effect as San Francisco’s charter requiring award to the “lowest reliable and responsible bidder.” *Associated Builders and Contractors, Inc. v. San Francisco Airports Commission*, 21 Cal.4th 352, 365 (1999). Due to the similarity between the San Francisco and San Diego charter language, a court would likely interpret San Diego’s charter requirement in the same manner.

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However, courts have had differing views on the flexibility of the phrase “responsible and reliable” – or like phrases. The Ninth Circuit has adopted a narrow view of the phrase, interpreting it to pertain only to the bidder’s fitness and ability to perform the work advertised. *Associated General Contractors of California, Inc. v. City and County of San Francisco*, 813 F.2d 922, 925-26 (1987), *overruled in part on separate grounds by Associated General Contractors of California, Inc. v. Coalition for Economic Equality*, 950 F. 2d 1401, 1414 (1991). In *Associated General Contractors*, a contractors’ association challenged a San Francisco ordinance, which gave bid preferences to Minority-owned Business Enterprises [MBEs], Women-owned Business Enterprises [WBEs], and Locally-owned Business Enterprises [LBEs]. The contractors’ association claimed that the ordinance conflicted with San Francisco’s charter and also violated the federal equal protection clause. *Id.* at 924.⁴

San Francisco’s charter language was similar to San Diego’s in that it required public works contracts over a certain dollar amount to be awarded to the “lowest reliable and responsible bidder.” *Id.* Citing *City of Inglewood*, the court held that “that term ‘responsible’ has reference to the quality, fitness and capacity of the low bidder to satisfactorily perform the work.” *Id.* at 925. The court went on to find that this definition of “responsibility” was limited to the bidder’s fitness and ability to perform the work advertised. It did not include factors unrelated to the ability to perform, such as whether the low bidder was a particular type of business or had demonstrated “social responsibility,” as the lower court had improperly found:

[T]he district court here removed all connection between ‘responsibility’ and volitional action. A contractor is deemed responsible not because of how it conducts its business but because of what it is: [a] firm that qualifies as an MBE, WBE or LBE is conclusively deemed responsible; a firm that does not is conclusively deemed irresponsible. By holding that ‘the concept of responsibility is sufficiently flexible to embody other legitimate municipal concerns such as the remedying of past discrimination,’ [citation omitted] the district court transformed a limitation on the city’s power into a broad authorization for preferring some contractors over others on the basis of innate characteristics. . . . We doubt even [a court permitting a more expansive definition of ‘responsibility’] would have gone that far.

⁴ The court found that, in addition to conflicting with the San Francisco charter, the MBE preference violated the federal equal protection clause because it was a race-based classification that could not withstand strict scrutiny analysis. *Associated General Contractors*, 813 F.2d at 938. Although the court did not find the WBE preference to be facially invalid, it noted that the WBE preference was subject to heightened scrutiny as a gender-based classification and therefore “troubling” in light of equal protection principles. *Id.* at 941-42. The court did not find an equal protection violation in the case of the LBE preference. Applying a rational basis analysis, the court found that San Francisco had articulated legitimate reasons for the preference - i.e., to offset the cost of doing business in the city and to stimulate the local economy. *Id.* at 944-945.

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Id. at 926-27. Ultimately, the court rejected a more expansive definition of “responsibility,” and found that the bid preference for MBEs, WBEs and LBEs violated San Francisco’s charter because it permitted award to other than the lowest bidder capable of performing the work. *Id.* at 927.

Under *Associated General Contractors*, a program that gives preference to small or local businesses, such as permitting a discount of a certain percentage on bid price, would violate our City Charter by permitting award to other than the lowest bidder capable of performing the work. This would be an impermissible end run around the Charter section 94 requirement to award to the lowest responsible bidder.

B. Options for Small or Local Preference Program

1. Amend the Charter

If the City wishes to implement a program that gives a bid preference to small or local businesses for construction contracts, one option would be for City voters to approve an amendment to Charter section 94 to permit such a program. For example, San Francisco’s charter now expressly permits a ten percent bid preference for local businesses and suppliers. San Francisco Charter section A7.204 provides:

The Board of Supervisors shall have full power and authority to enact all necessary ordinances to carry out the terms of this section and may by ordinance provide that any contract for any public work or improvement or for the purchase of materials which are to be manufactured, fabricated or assembled for any public work or improvement, a preference in price not to exceed 10 percent shall be allowed in favor of such materials as are to be manufactured, fabricated or assembled within the City and County of San Francisco. . . . When any ordinance shall so provide any officer, board or commission letting any contract may in determining the lowest responsible bidder for the doing or performing of any public work or improvement add to said bid or sub-bid an amount sufficient not exceeding 10 percent in order to give preference to materials manufactured, fabricated or assembled within the City and County of San Francisco.

San Diego could adopt a similar approach. Depending on the type of program Council wishes to pursue, this Office can assist with drafting proposed Charter language to harmonize the “lowest responsible and reliable” requirement with a small or local business preference.

2. Limit Bid Preference to Contracts of Certain Dollar Amounts

The City also could choose to limit a small or local business preference to construction contracts under a certain dollar amount. Under Charter section 94, only contracts that “exceed

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the sum established by ordinance of the City Council” must be awarded to the lowest responsible bidder. Therefore, the City Council could adopt an ordinance specifically creating a small or local business preference program for construction contracts within certain dollar amounts.

As discussed in our 2003 report, Council took this approach when it created the Minor Construction Program [MCP] in 2002. [RC 2003-12, p. 9]. The MCP, codified at San Diego Municipal Code [SDMC] sections 22.3601 *et seq.*, permits “minor public works,” i.e., construction contracts valued at \$250,000 and under, to be bid out to a closed universe of small and emerging businesses who are participants of the program. As with the MCP, Council could pass an ordinance creating a small or local business preference program for contracts under a certain dollar threshold. For example, Council could enact a program for construction contracts greater than \$250,000 (the cap for minor public works contracts) but less than \$1,000,000 (the threshold for Council approval of major public works contracts).

At least two other cities have taken this approach in order to ensure consistency between their respective charters and a small or local business preference. Los Angeles, whose charter provides that contracts over a dollar amount set by ordinance be awarded to the “lowest responsive and responsible bidder” (Los Angeles City Charter section 371(a) and (e)(1)), has limited its small and local business bid preference to material and supply contracts for less than \$100,000.⁵ San Jose, whose charter requires that public works contracts over \$100,000 be awarded to the “lowest responsible bidder” (San Jose City Charter section 1217), has limited its program to public works contracts under \$100,000 and other, non-public works contracts.

If Council wishes to pursue this option, this Office can assist with drafting an ordinance that would be consistent with both the Charter and applicable provisions of the Municipal Code.

3. Redefine “Responsible and Reliable” Via Ordinance

Another option, discussed briefly in our 2003 report, is for Council to pass an ordinance redefining the term “responsible and reliable bidder” to include factors such as compliance with a small or local business preference program. Currently, the Municipal Code defines the term “responsible” as “a bidder’s quality, fitness, and capacity to perform the particular requirements of the proposed work.” SDMC § 22.3003. This definition closely tracks the definition of “responsibility” set forth in *City of Inglewood* and *Associated General Contractors*, discussed above. If Council wishes to enact a more expansive definition of “responsibility,” it could do so by ordinance.

As mentioned in our 2003 report, the City of Sacramento took this approach by defining “lowest responsible bidder” in its municipal code to include re-calculation after compliance with a small business preference. Sacramento City Code section 2.36.020. However, according to the

⁵ Interestingly, the Los Angeles City Charter expressly permits a bid preference for California or Los Angeles County firms. Los Angeles City Charter section 371(a). However, it does not expressly permit a small business bid preference, which may explain why Los Angeles capped its program at \$100,000.

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City of Sacramento's website, Sacramento only applies a small business bid preference to goods and services contracts. Construction contracts are not subject to a bid preference, but do appear to be subject to a small business subcontracting requirement.

Although this is an option, an ordinance adopting a more expansive definition of "responsibility" is vulnerable to a legal challenge on the ground that it conflicts with the Ninth Circuit's holding in *Associated General Contractors*. As discussed above, the court in that case limited the meaning of "responsibility" to factors pertaining to a bidder's ability to perform the work advertised. An ordinance purporting to expand the definition of "responsibility" beyond such factors could be struck down as inconsistent with the plain language of our City Charter.

4. Include Subcontractor Requirement in Bid Specifications

Instead of imposing a bid preference in the form of a percentage discount for small or local businesses, the City could opt to include a small or local business subcontracting requirement in City construction contracts. Although we are not aware of a case directly addressing this approach, courts generally afford local agencies broad discretion in crafting bid specifications. See, e.g. *San Francisco Airports Commission*, 21 Cal. 4th at 366; *M&B Construction v. Yuba County Water Authority*, 68 Cal. App. 4th 1353, 1361 (1999).

For example, in *San Francisco Airports Commission*, the California Supreme Court addressed whether the San Francisco Airports Commission could include the provisions of a "pre-hire" agreement⁶ in the bid specifications for an airport renovation project. Two contractors' associations challenged inclusion of the pre-hire agreement in the bid specifications, asserting that such an inclusion violated competitive bidding laws. *Id.* at 358-59. Specifically, the contractors' associations claimed that the pre-hire agreement circumvented San Francisco's charter requirement that projects be awarded to the lowest responsible bidder because it favored contractors pre-disposed to using union workers. *Id.* at 366.

The *San Francisco Airports Commission* court disagreed, finding that competitive bidding laws were intended to guard against favoritism and corruption for the benefit of the taxpayers rather than the bidders, and "should be so construed and administered as to accomplish such purposes fairly and reasonably with sole reference to the public interest." *Id.* at 365, citing 10 McQuillin, *Municipal Corporations* (3d rev. ed. 1990) § 29.29, p.375. Therefore, local agencies could set bid specifications that included factors other than price:

A responsible bid thus is one that responds to all proper bid specifications, and in setting such, the public agency must be accorded considerable latitude... [citation omitted]. By necessary implication, therefore, the

⁶ A "pre-hire" agreement, in this context, is an agreement between a public agency and a labor union setting forth the terms under which labor may be employed for a particular project. For example, the agreement in the *San Francisco Airports Commission* case required that the contractors selected for the project pay union wages in exchange for a "no-strike" pledge and other concessions from the union. 21 Cal.4th at 358-59.

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direct cost of the project need not be the agency's sole consideration in setting bid specifications.

Id. at 366.

The court went on to find that the public policy behind competitive bidding laws was not “unfettered competition,” but rather creating an equal opportunity for all bidders to compete. Since any contractor could comply with the pre-hire specifications, the court reasoned, no one was excluded from bidding on the project. *Id.* at 366-69. Moreover, local agencies have discretion to impose specifications furthering legitimate governmental interests so long as they are not “arbitrary, capricious, or lacking in evidentiary support.” *Id.* at 374-75. In San Francisco's case, it had submitted substantial evidence showing that the pre-hire specifications could help ensure the timeliness of the project and keep overall costs down by avoiding labor disputes. Therefore, the court found the specifications did not violate competitive bidding laws. *Id.*

The court reached a similar conclusion in *M & B Construction, supra*, 68 Cal. App. 4th at 1361-62. In that case, the court held that a local agency had discretion to require, in the bid specifications for a pipeline project, that all bidders have a “class A” general engineering license. The court reasoned that, based on an engineer's recommendations, the agency had “made a pre-bid determination that the public would be better served in terms of quality and economy by letting the project only to licensees with the most appropriate experience . . .” *Id.* at 1361.

Such a determination, the court ultimately concluded, was not subject to reversal unless it was “arbitrary, capricious or entirely lacking in evidentiary support . . . contrary to established public policy or unlawful or procedurally unfair . . .” *Id.* at 1361, citing *Mike Moore's 24-Hour Towing v. City of San Diego*, 45 Cal. App. 4th 1294, 1303 (1996). Importantly, the court noted the distinction between local agencies' discretion to set bid specifications and their inability to award to other than the lowest responsible bidder when all bid specifications had been met. 68 Cal. App. 4th at 1361.

Consistent with *San Francisco Airports Commission* and *M & B Construction*, the City of San Diego could decide to include a small or local business subcontracting requirement in construction projects without a Charter amendment or ordinance. Indeed, the City currently imposes a mandatory subcontracting requirement for construction projects over \$100,000 pursuant to the Subcontractor Outreach Program [SCOPE].⁷ In addition to, or in place of SCOPE, the City could mandate that a certain portion of City construction projects be subcontracted to small or local businesses.

⁷ The SCOPE program requires that all bidders meet a certain overall subcontracting goal on City construction projects, but does not require that the subcontractors be of a certain business type. SCOPE also includes voluntary goals for Disadvantaged Business Enterprises [DBEs], Disabled Veteran Business Enterprises [DVBES], MBEs, WBEs, and Other Business Enterprises [OBEs]; however, there is no penalty for failure to meet voluntary goals. The SCOPE program that is currently in place has not been legally challenged to date.

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However, in order to withstand legal challenge, the City will need to show that a mandatory subcontracting goal for small or local business furthers a legitimate government interest and is not arbitrary or capricious. In order to accomplish this, we would recommend that the City make findings – either through studies, testimony, or otherwise – that a small or local business subcontracting requirement would further a legitimate government interest, such as increasing participation in City contracts or stimulating the local economy.

II. Goods, Services, and Consultants

The Charter section 94 requirement to award to the “lowest responsible and reliable bidder” extends only to public works projects over a dollar amount determined by ordinance. The standards for selecting goods, services and consultant contracts permit greater discretion to award contracts based on factors other than price and fitness to perform the work advertised. The Municipal Code provides that goods and services contracts be awarded to the “low acceptable bid that best meets City requirements.” SDMC § 22.3026(a)(2). Although the standard for selecting consultants is not expressly addressed in the Municipal Code, Council Policy 300-07 provides that the City shall select the “highest qualified” consultant after consideration of relevant selection criteria. Therefore, the City may apply a small or local business bid preference to goods, services or consultant contracts without a Charter amendment or Municipal Code change.

In fact, the City currently has a “local vendor preference” for goods and services contracts. Council Policy 100-10, enacted in 1984, provides that:

The City shall purchase materials, supplies and services from businesses within the City of San Diego when it is legal and economical to do so. All or any portion of the City Sales Tax returned to the City shall be considered in the evaluation of bids. In the event of tie bids, San Diego vendors will be given preference.

Council Policy 100-10 does not address small business preferences, bid preferences in the form of fixed percentages, or consultant contracts. If the Council wishes to pursue a more comprehensive small or local business program for goods, services or consultant contracts, we can assist with updating Council Policy 100-10 to reflect appropriate programmatic changes.

In addition, for the same reasons discussed above applicable to construction contracts, the City could include a small or local business subcontractor requirement in specifications for goods, services, or consultant contracts, so long as such a requirement furthers a legitimate governmental interest and is not arbitrary or capricious. *M&B Construction*, 68 Cal. App. 4th at 1361.

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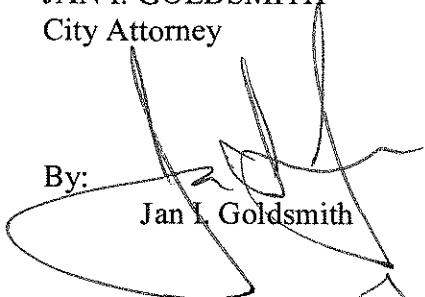
CONCLUSION

A small or local business bid preference for construction contracts may be implemented either by: (1) a vote of the electorate amending the “lowest responsible and reliable” requirements of Charter section 94 to provide for such a program; or (2) by an ordinance amending the Municipal Code to establish such a preference for construction contracts up to an express dollar amount. A third option would be to adopt an ordinance redefining the term “lowest responsible and reliable bidder” in the Municipal Code. However, this third option is legally problematic. A fourth option is to include a small or local business subcontractor requirement in bid specifications, provided the City can show that the subcontractor requirement furthers a legitimate governmental interest and is not arbitrary or capricious.

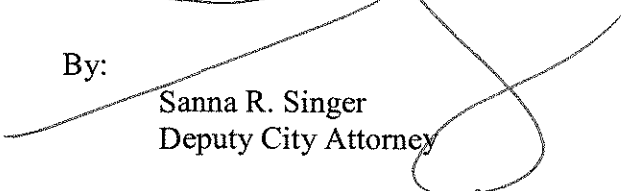
Goods, services, and consulting contracts are not subject to the “lowest responsible and reliable bidder” restrictions of Charter section 94. Therefore, the City Council may adopt a small or local business bid preference program for these types of contracts. As with construction, the City may include a small or local business subcontractor requirement in goods, services, or consultant contracts, provided the City can show that the subcontractor requirement furthers a legitimate governmental interest and is not arbitrary or capricious.

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