

**Office of
The City Attorney
City of San Diego**

**MEMORANDUM
MS 59**

(619) 236-6220

DATE: February 19, 2010

TO: Rules, Open Government and Intergovernmental Relations Committee

FROM: City Attorney

SUBJECT: Rules Committee Agenda for February 24, 2010, Item 1: Local Jobs Ordinance

The Rules, Open Government and Intergovernmental Relations Committee [Rules Committee], has docketed as Item 1 for its February 24, 2010 hearing, "Proposed Amendments to the Municipal Code: Local Jobs Ordinance." In connection with this docket item, we have attached our prior Report to the Rules Committee dated October 22, 2009, entitled "Small and Local Business Preference Program: Draft Ordinance, Revisions to Council Policy 100-10, and Related Legal Issues" [RC-2009-26].¹

In our October 22, 2009 Report, we included an analysis of local hiring requirements. See RC-2009-26, pp. 5-6. We determined that such requirements are problematic under the U.S. Constitution's Privilege and Immunities Clause (U.S. Const., Art. IV § 2.cl.1), which prohibits a state or local agency from discriminating between residents and non-residents without a "substantial reason" for doing so. Specifically, the City must show that non-residents "constitut[e] a particular source of evil at which [local workforce requirements] are aimed." *United Bldg. and Const. Trades Council of Camden County and Vicinity v. Mayor and Council of City of Camden*, 465 U.S. 208, 222 (1984).

If the Rules Committee wishes to pursue an ordinance imposing local workforce requirements, we recommend that it first build a factual record justifying disparate treatment between local and non-local workers sufficient to withstand constitutional challenge under the *Camden* case. We note that the *Camden* case does not address veteran workforce requirements. We can perform further research and analysis of this issue at your request.

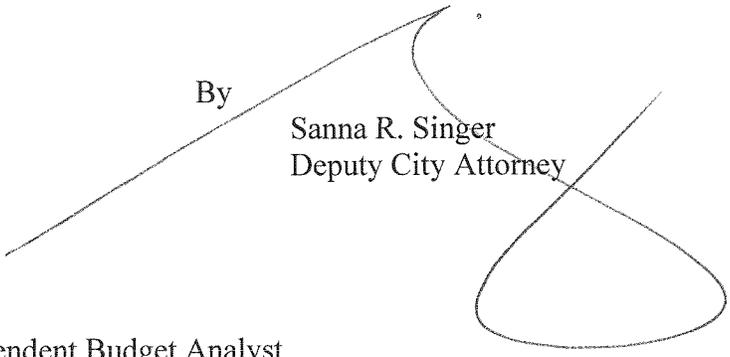
¹ For purposes of economy, we have not included the exhibits to RC-2009-26.

Our office stands ready to provide further guidance and answer any additional legal questions that you may have.

JAN I. GOLDSMITH, City Attorney

By

Sanna R. Singer
Deputy City Attorney

A large, handwritten signature in black ink, appearing to be 'Sanna R. Singer', is written over the typed name and extends upwards and to the left, crossing the word 'By'.

SRS:ar

Attachment

cc: Jerry Sanders, Mayor
Andrea Tevlin, Independent Budget Analyst

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October 22, 2009

REPORT TO THE COMMITTEE ON RULES, OPEN GOVERNMENT AND
INTERGOVERNMENTAL RELATIONS

SMALL AND LOCAL BUSINESS PREFERENCE PROGRAM: DRAFT ORDINANCE,
REVISIONS TO COUNCIL POLICY 100-10, AND RELATED LEGAL ISSUES

INTRODUCTION

At the May 27, 2009 hearing of the City Council's Rules, Open Government and Intergovernmental Relations Committee [Committee], the City Attorney presented a report on the City's legal options for implementing a small or local business preference program for City contracts. The Committee requested that the Equal Opportunity Contracting [EOC] Department and City Attorney return to the Committee with a proposed program and draft ordinance, which were to include some of the legal options presented.

Specifically, the Committee requested that the program include a small and local business bid preference for construction contracts up to \$1 million and mandatory subcontractor participation requirements for all construction contracts. At its September 2, 2009 hearing, the Committee also requested that EOC and the City Attorney bring forward proposed revisions to Council Policy 100-10, which would extend a small and local business preference to goods, services, and consultant contracts.

We have included below an overview of the draft Small and Local Business Ordinance and proposed Council Policy 100-10, which include the Committee's recommendations. In addition, we have provided legal analysis on related inquiries by the Committee, including: (1) whether and to what extent the City may include a local workforce component in the proposed program; (2) whether and to what extent the City can adjust bonding and insurance requirements on City contracts; and (3) whether and to what extent the City can utilize the results of the California Department of Transportation's [CALTRANS] disparity study for implementing an alternative, race and gender-conscious contracting program.

QUESTIONS PRESENTED

1. Are the proposed Small and Local Business Ordinance and revisions to Council Policy 100-10 legally permissible?
2. May the City include a local workforce requirement in the proposed program?

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3. May the City adjust bonding and insurance requirements for City contracts?

4. May the City utilize the results of the CALTRANS disparity study to implement a race and gender-conscious alternative to the proposed small and local business program?

BRIEF ANSWERS

1. Yes. The proposed Small and Local Business Ordinance and revisions to Council Policy 100-10 provide preferences for small and local businesses that are permissible under the City Charter, and both state and federal law.

2. Probably not. A local workforce requirement is legally problematic under the federal Privileges and Immunities Clause. However, if the City Council wishes to pursue this option, the City would first need to establish a factual basis for concluding that non-resident workers constitute a particular "source of evil" to be remedied.

3. Yes. The City may adjust its existing performance bond requirements and its standard insurance requirements for City contracts. However, we strongly recommend that staff carefully evaluate the risk of non-performance, the cost of substituting a new contract if necessary, and also consult with Risk Management before making any such adjustment. The City may not adjust existing bid bond requirements without Council action or payment bond requirements for construction contracts.

4. No. The City may not use the results of the CALTRANS disparity study to implement a race and gender-conscious program. The legality of such a program is currently under review by the California Supreme Court. Even if the Court upholds this type of program, the City would need to conduct a disparity study that is specific to the City of San Diego.

DISCUSSION

The City has a number of legal options for implementing a small or local business preference program. The options vary depending on the nature of the contract at issue. Accordingly, the draft ordinance and Council Policy revisions discussed below include different preference mechanisms for construction, goods and services, and consultant contracts.

I. Small and Local Business Ordinance: Construction Contracts

Per the Committee's request, we have drafted a Small and Local Business Ordinance for construction contracts, attached hereto as **Exhibit A**. The ordinance would amend San Diego Municipal Code [SDMC] sections 22.3601 through 22.3616, which currently set forth the components of the Minor Construction Program [MPC]. Established in 2002, the MPC requires "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. SDMC §§ 22.3610(a), 22.3611(a). The proposed changes would increase the cap for minor public works to \$500,000, add a small and local business bid preference for major public works projects under

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\$1,000,000, and impose mandatory subcontractor participation requirements for small and local businesses on all public works contracts.¹

A. Sheltered Competition and Bid Preferences

The proposed Small and Local Business Ordinance would raise the caps for minor public works to \$500,000 and create a two-tiered sheltered competition program: (1) contracts valued at \$250,000 to \$500,000 would be bid out to a closed universe of Small Local Business Enterprises [SLBEs] and Emerging Local Business Enterprises [ELBEs],² and (2) contracts valued under \$250,000 would be bid out to a closed universe of ELBEs.

In addition, the ordinance would establish bid preferences for SLBEs and ELBEs bidding on major public works contracts over \$500,000 but under \$1 million. Contracts in this category would be subject to a bid preference in the way of: (1) 5 percent discount off the bid price for SLBEs and ELBEs bidding as prime contractors, and (2) a discount off the bid price equal to the percentage of SLBE or ELBE subcontractor participation not to exceed 5 percent of the total bid price.

As discussed in our Report to the Rules Committee dated May 20, 2009, entitled "Legal Options for Small or Local Business Preference Programs" [RC-2009-9], these proposals are legally permissible. The City Charter requires the award of a construction contract to the "lowest responsible and reliable bidder" only if the contract exceeds a sum established by the Council by ordinance. San Diego Charter § 94; *see also* RC-2009-9, pp. 3-6. Therefore, Council has authority to set caps under which sheltered competition procedures or bid preferences³ may be used.

¹ It is important to note that the proposed ordinance would only affect construction contracts funded by the City. State and federally-funded contracts may be subject to alternative programs and subcontracting requirements, depending on the funding agency.

² The proposed ordinance defines SLBE as a Small Business Enterprise (based on certain dollar thresholds to be set by the City Manager) that is also a Local Business Enterprise. An ELBE is an Emerging Business Enterprise (based on certain dollar thresholds to be set by the City Manager, which are approximately half of those for a Small Business Enterprise) that is also a Local Business Enterprise. A Local Business Enterprise is a business that has a principle place of business and substantial employee presence in the City or County of San Diego, and which has been in operation for twelve consecutive months. Proposed SDMC § 22.3603.

³ Preferences based on business size or locality are subject to a constitutional "rational basis" review and are generally permissible. *See Associated General Contractors of California, Inc. v. City and County of San Francisco*, 813 F.2d 922, 944-45 (9th Cir. 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) (finding that a local business preference did not violate the federal Equal Protection Clause; 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); RC-2009-9, pp.4-5. *See, also, Big Country Foods, Inc. v. Board of Education of the Anchorage School District*, 952 F.2d 1173, 1177-78 (9th Cir. 1992) (upholding 7 percent preference for in-state milk producers against dormant commerce clause challenge). However, preferences may not be based on race or gender. The California Constitution states: "The state shall not discriminate against, or grant preferential treatment to, any individual or group on the basis of

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B. Mandatory Subcontractor Participation

The proposed Small and Local Business Ordinance also would impose a mandatory subcontracting requirement for SLBEs and ELBEs on all major and minor public works contracts. Contractors would either have to reach the mandatory subcontractor requirements, or demonstrate good faith efforts to do so, in order to be responsive to a request for bid.

Mandatory subcontractor participation requirements are legally permissible provided that they further a legitimate government interest and are not “arbitrary, capricious, or lacking in evidentiary support.” *Associated Builders and Contractors, Inc. v. San Francisco Airports Commission*, 21 Cal. 4th 352, 361 (1999); *see also M&B Construction v. Yuba County Water Authority*, 68 Cal. App. 4th 1353, 1361 (1999); *see also RC-2009-9*, pp. 7-9.

It is important to note that we are not aware of a case specifically holding that mandatory subcontractor requirements for small and local businesses are permissible bid requirements. However, the case law generally affords government agencies discretion in crafting bid specifications. *See, e.g., Associated Builders and Contractors*, 21 Cal. 4th at 366-369. In addition, other jurisdictions have been successful in imposing such requirements,⁴ and we have not found legal authority specifically prohibiting this approach.

In order to best insulate subcontractor requirements from legal challenge, we recommend that the City Council state why a preference for small and local business would further legitimate governmental interests, for example, promoting diversity, growing small businesses, and stimulating the local economy. We have incorporated draft declarations, for Council’s consideration, in the draft Small and Local Business Ordinance (Exhibit A).

II. Council Policy 100-10: Goods, Services, and Consultant Contracts

We also attached, as **Exhibit B**, proposed revisions to existing Council Policy 100-10. Council Policy 100-10 currently permits the Purchasing Agent to apply a local vendor preference to goods and services contracts. Specifically, it provides for a discretionary bid discount for local vendors in an amount equal to the amount of sales tax returned to the City. The policy states 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

race, sex, color, ethnicity, or national origin in the operation of public employment, public education, or public contracting.” Cal. Const. art. I, § 31(a).

⁴ For example, the City of San Francisco currently imposes a local business subcontractor participation requirement for all public works contracts regardless of dollar amount. The City of Oakland imposes a small and local business subcontractor participation requirement for all construction contracts over \$100,000.

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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. (emphasis added).

At its September 2, 2009 hearing, the Committee requested revisions to Council Policy 100-10 that would: (1) increase the bid discount for goods and services contracts; and (2) make imposition of the bid discount mandatory rather than discretionary. We have drafted revisions, which provide for a 2 percent bid discount for SLBEs and ELBEs bidding or proposing as primes and a voluntary subcontractor requirement of 20% for SLBEs and ELBEs. We have also extended the Council Policy to encompass consultant contracts. Finally, in response to Committee input, we have included provisions requiring that Requests for Bid [RFBs] and Requests for Proposals [RFPs] include the bidder's or proposer's commitment to diversity as an evaluation criterion.

As discussed in our May 2009 report and follow-up Report to the Rules Committee of September 14, 2009, entitled "Equal Opportunity Contracting: Existing Legal Options" [RC-2009-22], 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. Therefore, the City may impose a bid preference for small and local vendors or consultants without a Charter or Municipal Code change.

In addition, the City can impose a mandatory SLBE and ELBE subcontractor requirement provided that the subcontractor requirement furthers a legitimate governmental interest and is not arbitrary or capricious. *M&B Construction*, 68 Cal. App. 4th at 1361. We included draft declarations regarding the purpose of a small and local business preference for goods, services, and consultant contracts for Council's consideration in the proposed revisions to Council Policy 100-10 (Exhibit B).

III. Local Workforce Requirements

At the Committee's September 16, 2009 hearing, Councilmember Falconer asked whether the City also may require, as a component of a small and local business program, that contractors employ a local workforce. Programs that require contractors to employ a local workforce, also known as "local hire" programs, may be legally problematic under the Privileges and Immunities Clause of the federal constitution, which prohibits a state from discriminating between its residents and non-residents without a "substantial reason" for doing so. U.S. Const., Art. IV § 2.cl.1; *United Bldg. and Const. Trades Council of Camden County and Vicinity v. Mayor and Council of City of Camden*, 465 U.S. 208, 222 (1984).

In *Camden*, the U.S. Supreme Court analyzed a Camden, New Jersey, ordinance requiring that 40% of employees working on city construction projects be Camden residents. *Id.* at 210. The Court found that the ordinance implicated the Privileges and Immunities Clause because the opportunity for non-residents to seek employment from private contractors was a basic privilege protected by the federal constitution. As such, the Court held, the City of Camden had to demonstrate a "substantial reason" for requiring a local workforce; specifically, the city

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had to show that non-residents “constituted a particular source of evil at which the statute was aimed.” *Id.* at 222, citing *Toomer v. Witsell*, 334 U.S. 385, 398 (1948).

If Council wishes to pursue a local workforce requirement, we recommend that Council first build a factual record as to why non-resident workers constitute “a particular source of evil” that needs to be remedied in San Diego. Further, we note that in order to qualify as “local” under the draft Small and Local Business Ordinance, a business must have its principle place of business and a significant employee presence in San Diego County. Although local *workforce* requirements may be difficult to justify, courts have generally upheld local *business* preferences as constitutional. *See, e.g. Big County Foods, Inc. v. Board of Education of the Anchorage School District*, 952 F.2d 1173, 1177-78 (9th Cir. 1992)(upholding Anchorage school district program providing 7 per cent preference to in-state milk producers because school district was acting as a “market-participant”).

IV. Bonding and Insurance

At the May 27, 2009 hearing, the Committee also asked the City Attorney to provide an overview of the City’s legal options for adjusting the City’s standard bonding and insurance requirements. The legal requirements for bonding and insurance requirements are as follows:

A. Legal Requirements for Bonding

The City requires various types of bonds from contractors to protect the City’s financial interests from risks inherent in public contracting. While bonding requirements are generally discretionary for goods, services, and consultants, certain types of bonds are mandatory for construction contracts pursuant to state or local law. There are three basic types of contract bonds: (1) bid bonds, (2) performance bonds, and (3) payment bonds. We discuss each type of bond, in turn, below:

1. Bid Bonds

A bid bond is a surety required from bidders on public works contracts to ensure the successful bidder executes the contract under the terms of its bid. *See* San Diego Charter § 94. If the successful bidder fails to execute the contract, the amount of the bid bond is forfeited to the agency letting the public works contract. Cal. Pub. Cont. Code § 20172.

The City Charter expressly requires bid bonds for construction contracts. San Diego City Charter section 94 states: “Each bidder shall furnish with his bid such security or deposit insuring the execution of the contract by him as shall be specified by the Council or as provided by general law.” As a charter city, the City may exercise authority over municipal affairs free from the constraints imposed by most general laws of the State. However, general law controls even a

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municipal affair where the City Charter adopts the general law by express provision. *Becker v. Council of City of Albany*, 47 Cal. App. 2d 702, 704, 707 (1941); 45 Cal. Jur. 3d *Municipalities* § 184 (2008). Since Council has not specified any other bid bond requirement, the language in Charter section 94 – “or as provided by general law” – expressly adopts general law governing bid bonds.

The California Public Contract Code requires that a bid bond shall be in an amount equal to at least 10 percent of the amount bid for all public works contracts over \$5,000. Cal. Pub. Cont. Code §§ 20162, 20171. A reduction of bid bond requirements below these minimums would violate state law, and is therefore not permissible under the City Charter unless Council chooses to specify an alternative percentage by ordinance.

2. Payment Bonds

Payment bonds are required by state law from general contractors to cover amounts that are not paid to a subcontractor due to a general contractor’s default. *See Black’s Law Dictionary*, p. 189 (8th ed. 2004); Cal. Civ. Code § 3247. The purpose of the payment bond law is to provide a statutory remedy for subcontractors in the event of default by the general contractor on a public works project. This is because the usual remedy of mechanic’s liens cannot be used against public entities. *California Electric Supply Co. v. United Pacific Life Ins.*, 227 Cal. App. 2d 138, 144 (1964); *Walt Rankin & Associates v. City of Murrieta*, 84 Cal. App. 4th 605, 625-626 (2000).

State law requires all general contractors awarded a public works contract over \$25,000 to file a payment bond with the public entity letting the contract. Cal. Civ. Code § 3247(a). This requirement applies to “every original contractor to whom is awarded a contract by a public entity.” Cal. Civ. Code § 3247(a). Under state law, the payment bond must be for 100 percent of the total amount payable under the contract. Cal. Civ. Code § 3248(a).

Although older cases provide that payment bond requirements do not apply to a charter city when a contract is purely a “municipal affair” (*see, e.g., Loop Lumber Company v. Van Loben Sels*, 173 Cal. 228, 234-235 (1916); *Williams v. Vallejo*, 36 Cal. App. 133, 140-141(1918)), we strongly recommend against removing or reducing state payment bond requirements. More recent cases have held that, in the event a public agency fails to comply with state statutes requiring bonds for the protection of subcontractors, the public agency is directly liable to the subcontractor. *See, e.g., Azusa Western, Inc. v. City of West Covina*, 45 Cal. App. 3d 259, 262-264 (1975) (holding City liable for failure to comply with state law release bond requirements). If payment bonds are later held to be a matter of statewide concern, and the City has failed to enforce state law

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requirements, the City may be directly liable to subcontractors for missed payments by the general contractor.

3. Performance Bonds

A performance bond is “[a] third party’s agreement to guarantee the completion of a construction contract upon the default of the general contractor.” Black’s Law Dictionary, p. 1174 (8th ed. 2004). Performance bonds protect the City’s financial interests by ensuring that a project is completed at no additional cost to the City in the event a contractor or developer is unable to finish a project.

The City Charter expressly requires performance bonds for construction contracts over \$100,000. City Charter section 94 states that, “For [public works] contracts exceeding \$100,000.00, the Council shall require each contractor to insure the faithful performance of his contract by delivering to the City a surety bond in an amount specified by the Council” Although Council has not formally specified an amount for performance bonds, the City currently requires performance bonds covering 100 percent of the total contract amount for most construction contracts.

There is no legal requirement for performance bonds for goods, services, and consultant contracts. However, the City regularly requires performance bonds for goods and services contracts and sometimes consultant contracts, which vary from a small percentage to 100 percent of the contract price depending on the nature of the contract.

Performance bonds provide the City with an expedited method for recovering against a non-performing contractor, short of having to file a breach of contract action. Therefore, we recommend that City staff consider the risk of non-performance and ease of replacing the contractor before adjusting performance bond requirements.

In conclusion, the City must include a bid bond requirement in the amount of 10 percent of the contract price for all construction projects over \$5,000 unless Council specifies an alternative percentage by ordinance. In addition, we strongly advise requiring payment bonds on construction contracts in the amount of 100 percent of the contract price. Performance bonds are required for construction projects over \$100,000 and are discretionary for goods, services, and consultant contracts. We recommend that City staff consider the risk of non-performance and the ease of replacement before removing or reducing performance bond requirements.

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B. Insurance

In addition to requiring contractors to file bonds, the City also typically requires contractors to provide insurance to protect the City from contracting risks. The Charter and the Municipal Code do not set forth specific insurance requirements. However, the Municipal Code authorizes the City to “require vendors and contractors to provide insurance and surety bonds for *contracts* and *public works contracts*.” San Diego Municipal Code § 22.3007. (Emphasis in original to indicate defined terms.) Standard insurance requirements are currently set by the Risk Management Department, and incorporated into contracts by the Purchasing and Contracting Department. We advise that City staff consult with Risk Management prior to removing or reducing insurance requirements on City contracts.

IV. CALTRANS Disparity Study

At the Committee’s May 27, 2009 hearing, Councilmember Frye asked whether, in lieu of a small or local business program, the City could utilize the results of the CALTRANS disparity study to implement a race or gender-conscious program. We advise against this approach for the following reasons:

First, California courts still have not resolved whether the results of a disparity study will support a race or gender-conscious program against constitutional challenge. As discussed above, the California Constitution prohibits preferences based on race or gender in public contracting. Proposition 209, codified in the California Constitution, states: “The state shall not discriminate against, or grant preferential treatment to, any individual or group on the basis of race, sex, color, ethnicity, or national origin in the operation of public employment, public education, or public contracting.” Cal. Const. art. I, § 31(a).

A case pending before the California Supreme Court, *Coral Construction, Inc. v. City and County of San Francisco*, 149 Cal. App. 4th 1218 (2007), review granted August 22, 2007, suggests that federal equal protection principles may trump Proposition 209 in cases of severe intentional discrimination. In *Coral*, the City of San Francisco used the results of its disparity study to support a race and gender-conscious contracting program. The appellate court held that, as a matter of law, evidence of severe and intentional discrimination could support a race and gender-conscious program under federal law notwithstanding Proposition 209. *Id.* at 1246-50. However, *Coral* is currently under review by the California Supreme Court.

Second, even if *Coral* is upheld, the City of San Diego would need to conduct its own, particularized disparity study in order to support a race or gender-based program. Federal law requires that a race or gender-based program survive “strict scrutiny” review, meaning that the program is: (1) necessary to serve a compelling state interest; and (2) narrowly tailored to address that interest. *City of Richmond v. J.A. Croson Company*, 488 U.S. 469, 496-97, 507 (1989). As such, a program may not be based on a broad-based disparity study. *See, e.g.*,

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Fullilove v. Klutznick, 448 U.S. 448, 504-05 (1980) (generalized findings of discrimination in the national or statewide marketplace did not establish a “compelling state interest” in a program targeting the Richmond construction industry). Rather, race and gender-based programs must be based on particularized findings of discrimination in the specific location and industries that the program targets. *Id.*⁵

The CALTRANS study, which was issued in June 2007, examines contracts awarded throughout the state in each of the CALTRANS Districts. CALTRANS District 11 includes all of San Diego County and Imperial County, not just the City of San Diego. Since the CALTRANS study was a state-wide study, with only limited data specific to the San Diego market, a court is not likely to find it sufficiently particularized to support a race or gender-based program for the City of San Diego.

If the City wishes to pursue a race or gender-conscious program to remedy discrimination in the City of San Diego, we recommend that the City first commission a disparity study specific to the San Diego marketplace to assess whether and to what extent such discrimination exists. We also recommend following the Supreme Court’s progress in the *Coral* case. Our Office stands ready to provide updates on the *Coral* case as requested.

CONCLUSION

The proposed Small and Local Business Ordinance and revisions to Council Policy 100-10 provide legally permissible mechanisms for promoting diversity in construction, goods, services, and consultant contracts. We would not recommend including a local workforce requirement unless and until Council has made factual findings regarding why non-resident workers present a particular “source of evil” to be remedied. The City may consider adjusting performance bond requirements and insurance requirements. However, adjustments, if any, should only be made after careful evaluation of the associated risks and consultation with Risk Management. The City’s bid bond requirement for construction contracts may be adjusted by ordinance, but payment bond requirements are required by state law and may not be modified.

⁵ For a complete discussion of the *Coral*, *Crosen* and *Fullilove* decisions, see City Att’y MOL No. 07-13 (Sept. 10, 2007), entitled “Overview of Law Concerning Equal Opportunity in Contracting: Existing Programs and Recommendations.”

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The City may not use the results of the CALTRANS disparity study as a basis for an alternative, race or gender-based program because, even if such a program were permissible, the study does not include findings specific to the City of San Diego.

Respectfully submitted,

By

Sanna R. Singer
Deputy City Attorney

SRS:amt
Attachments
RC-2009-26