Pruning the Overgrowth of Government Contracting Preferences

*By George R. La Noue**

The policy of creating preferences for businesses owned at least fifty-one percent by members of "minority" groups is now more than three decades old. In 1977, Congressman Parren Mitchell, the head of the Congressional Black Caucus, inserted into the Public Works Employment Act an amendment guaranteeing that at least ten percent of the funding of all contracts under this program be awarded to minorities ("blacks, Hispanics, Asians, Native Americans, Eskimos and Aleuts"). In *Fullilove v. Klutznick*,[1] the Supreme Court, in a ruling without a clear standard of review, decided that the expenditure program was constitutional. After the Court's response to these federal racial preferences, copycat programs spread to a variety of federal agencies and to many state and local governments where the political climate was favorable.

In *City of Richmond v. Croson*,[2] however, the Supreme Court became suspicious of the racial politics underlying these local contracting programs and decided that the standard of review for a racial classification was strict scrutiny requiring a judicial finding that a compelling interest existed and that the use of race was narrowly tailored.

Later, in *Adarand v. Pena*,[3] the Court ruled that the same standard exists for federal as well as state and local programs. With few exceptions, however, most preferential contracting programs have survived. Not many cases opposing the preference programs were brought, and many that were begun were underfinanced or underlawyered. Due to the imbalance of resources, these lawsuits can be difficult to pursue against government entities.

Recently, the Obama Administration has used the regulatory process to increase significantly the number of beneficiaries in various preferential programs. Women-owned businesses were added to the Small Business Administration "8(a)" set-aside program. In transportation-related programs, the definition of an "economically disadvantaged" person, which is based on the net worth of owners (excluding the value of the business and principal residence), was raised from $750,000 to $1.3 million. Thus, the Obama Administration has expanded the preferences for "disadvantaged businesses" to include literally millionaire owners. Because of the Uniform Certification practice, where a firm can simultaneously become certified in various preferential programs, that new definition of economic disadvantage will be adopted by many state and local preferential programs as well.

Given the entrenched nature of preferential contracting programs, what is the prospect of any suit against them being successful? It will depend on the level to which the government extends the preferences.

Federal preferences are the most difficult to challenge, but history demonstrates that success is not impossible.

In *Rothe v. Department of Defense*,[4] the plaintiffs were able to convince a unanimous Federal Court of Appeals that the ten-percent price preference for minorities bidding on Department of Defense (DOD) contracts had no compelling interest, either because the information Congress relied on was out-of–date, or because state and local disparity studies that the Department of Justice placed in the record were not reliable since they did not control for the capacity of minority and non-minority businesses. The Department of Justice (DOJ) chose not to risk an appeal to the Supreme Court.

In *Western States Paving v. Washington State Department of Transportation*,[5] the Ninth Circuit held that, while Congress had a compelling interest to establish a national Disadvantaged Business Program (DBE), local recipients of federal transportation funds had to make a finding of discrimination in their marketplaces in administering their programs to meet the "narrowly tailored" requirement. Further, those findings had to take into account DBE and non-DBE capacity and qualifications, and there needed to be a finding of discrimination against each major group benefitting from the preferences.

Again, the federal government decided not to appeal and simply instructed recipients in other circuits that they need not follow *Western States.* That strategy has been successful, and other courts have declined to follow the ruling in that case. Within the Ninth Circuit, however, each state and many local governments have commissioned disparity studies, with mixed results. After receiving the study results, some states (Idaho, Montana, and Nevada) moved to an entirely race-neutral system and no longer set DBE goals on individual contracts, and most other states significantly reduced their race-conscious goals. Other governments have been forced to exclude particular groups from their preferential programs. For example, based on its study, the California Department of Transportation (Caltrans) no longer permits construction firms owned by Hispanics or Asian Pacific American males to be used to meet DBE goals. Logically, that should reduce the state's overall goal. Some local governments and airports in the Ninth Circuit, not wishing to bear the cost of a disparity study, have moved to race-neutral programs.

So what pending attempts to prune these preferential programs appear promising? The Pacific Legal Foundation, on behalf of the Associated General Contractors (AGC) of San Diego, has sued Caltrans to void what is left of its DBE program. Although the trial judge did not substantially engage the issues in the case and ruled against the plaintiff from the bench, the case will be appealed.

Two substantial and novel questions will be raised. The first is whether, in setting goals on a transportation contract using a mixture of state and federal funding—a commonplace practice—the DBE goals can be set on the state portion. Since California's Proposition 209 forbids the use of racial, ethnic, and gender preferences where state funds are involved, Caltrans'

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assertion that it would be bureaucratically inconvenient to separate federal and state funding streams may not suffice as a compelling interest. Some other states—Arizona, Louisiana, Michigan, Nebraska, and Washington State—have Prop 209-like provisions in their state constitutions, though most states lack such provisions Furthermore, since the federal regulations do not require that DBE goals be set on state dollars, a ruling in California on this issue might have a ripple effect in many parts of the country.

The second issue, involving the determination of which persons are eligible for preferences, would strike at the heart of many federal, state, and local preferential programs. To maintain the image that these programs are narrowly tailored, in theory not every firm owned by a minority or women is eligible for preferences. The key to participation is the ability of firms to become certified as a DBE or MWBE, which means that the owner must affirm that he or she is "economically disadvantaged" and "socially disadvantaged." The threshold for defining "economic disadvantage" varies by the federal, state, or local program involved, but the definition of "social disadvantage" is almost everywhere the same. All of these programs begin with the "presumption" that all minority persons or women are socially disadvantaged, but then the certification process requires the certification applicant's signature affirming that he or she has "been subjected to racial or ethnic prejudice or cultural bias within American society because of their identities as members of groups without regard to their individual qualities."

The certification form does not distinguish between identified discrimination that might have led to a business handicap or "societal discrimination," which the Supreme Court has ruled is not a basis for a preferential program. It does not require that the discrimination be relatively recent, be continuing, or have occurred in the jurisdiction involved. In short, the certification process does not create a narrowly-tailored program by screening out appropriate from inappropriate beneficiaries.

In *Western States*, the Ninth Circuit was unconvinced that these individual attestations provided appropriate evidence of discrimination because "they do not provide any evidence of discrimination within the Washington transportation contracting industry." Now, in *AGC, San Diego v. Caltrans*, the Ninth Circuit will be given a chance to review the "social disadvantage" definition in the certification process. A judicial requirement that governments verify that an applicant actually has suffered recent and relevant discrimination, just as the government now checks to see that the economic statements on the certification form are accurate, would have a dramatic impact on the future of DBE and MWBE programs.

There are other pruning approaches. In all circuits, it is clear that a state or local preferential program must be supported by a finding of discrimination in the industry involved. Most often, this requires a disparity study. While about 200 such studies have been completed, there are a number of state and local preferential programs that exist without any studies. Moreover, the study must be reasonably recent. The U.S. Commission on Civil Rights believed that five years was the reasonable limit.[6] The federal court of appeals in the *Rothe* case declined to adopt that limit but did agree that much of the evidence the government relied upon was "stale."

Moreover, there are a number of cases, including *Croson,* that stand for the proposition that programs must have justification for the preferences for each major group receiving them. For example, the recent decision by the Fourth Circuit in *Rowe v. North Carolina Department of Transportation* stripped women, Hispanics, and Asians from the state's MWBE program because of lack of evidence in the state disparity study to support their inclusion.[7] Yet because of the politics involved, many jurisdictions do not restrict their preferences to the groups and industries where their studies found a disparity. These programs are highly vulnerable.

Also, there is the question of the validity of the disparity study involved and its findings. *Croson* requires that such a study compare contracting awards that qualified, willing, and able MWBE firms garner with similar non-MWBE firms to determine whether statistically significant disparities create an inference of discrimination. Obviously, if MWBEs are smaller, younger, or in less skilled specialties, differences in contracting awards cannot be attributed solely to discrimination.

The disparity study industry is controlled by a handful of firms. Some of the largest, NERA and Mason Tillman, for example, make no examination of the relative qualifications of MWBEs and non-MWBEs and treat ability or capacity cursorily. Such studies are vulnerable, particularly if the list of "available" firms the consultants used to create their disparity ratios can be acquired. Such lists will show that firms of vastly different characteristics were considered by the consultants as equally available. As the federal circuit court noted in *Rothe*, a microbrewery and Budweiser are in the same business, but it would not be expected that they would have the same sales volume. Most important, the circuit court found that it was not enough to establish a threshold of being able to bid on one contract to determine availability because that measure fails to account for "the relative capacity of businesses to bid *on more than one contract at a time.*"[8]

Another area where additional clarification would contribute to the purpose of the law in creating a level playing field is in goal setting. Assuming for the sake of argument that a DBE or MWBE goal is based on a compelling interest, there are important narrow tailoring issues about the goal-setting process and ultimate result. Typically, a government will set an annual aspirational goal and then higher or lower goals on individual contracts. While the annual goals usually compare the number of minority- and women-owned firms to other firms, they often ignore differences in the qualifications, willingness, and ability of firms in each group and thus are not narrowly tailored. Specific contract goal-setting is even more problematic. Often the availability of non-DBEs or non-MWBEs is ignored altogether, and a goal will be set if at least three DBEs or MWBEs are believed to be available. This type of goal-setting in effect can create a subcontracting quota and thus does not form a level playing field.

Finally, while some may hope for a homerun judicial decision eliminating all preferential contracting programs, it is likely that some courts will be more receptive to a series of decisions that will make such programs actually remedy discrimination where it exists and terminate programs that are merely reflections of racial and gender politics.

Endnotes

1 448 U.S. 448 (1980).

2 488 U.S. 469 (1989).

3 515 U.S. 200 (1995).

4 545 F.3d 1023 (2008) (*Rothe VII*).

5 407 F.3d 983 (2005).

6 U.S. Comm'n on Civil Rights, Disparity Studies as Evidence of Discrimination in Federal Contracting (2006).

7 See also *Croson*, 488 U.S. at 506: *Western States*, 407 F.3d at 1002-3; Monterey Mechanical Co. v. Wilson,125 F.3d 702 (9th Cir. 1997); Builders Ass'n of Greater Chi. v. County of Cook, 256 F.3d 642 (7th Cir. 2001); Associated Gen. Contractors of Ohio v. Drabik, 214 F.3d 730 (6th Cir. 2000); O'Donnell Constr. Co. v. District of Columbia, 963 F.2d 420 (D.C. Cir. 1992), in support of the principle that separate findings of discrimination must be made for each group.

8 *Rothe VII*, 545 F.3d at 1044 (emphasis in the original).