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LEGAL CHALLENGES TO IN-STATE CONTRACTING PREFERENCES

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This report discusses possible legal constraints to in-state contracting and hiring preferences. OLR Report 2012-R-0433 describes Connecticut's in-state preference laws.

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SUMMARY

In-state contracting and hiring preferences are most often challenged as violations of the U.S. Constitution's (1) Privileges and Immunities (P&I), (2) Commerce, and (3) Equal Protection clauses. In general, courts have upheld, against such challenges, carefully-designed preferential purchase laws that advance legitimate state interests. However, laws that establish hiring preferences or quotas for public works projects have generally been struck down as violations of the P&I Clause.

The P&I Clause applies only to individuals, and not corporations, and thus is most commonly a factor in cases involving hiring preferences or quotas for workers, rather than for contract awards to companies. States often avoid Commerce Clause challenges to in-state preference laws by asserting the "market participant exception," under which certain contracting practices (including in-state preferences) may be upheld if

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the government establishes that it is acting as a market participant (like any private business or consumer) and not as a regulator. (The clause only applies to market regulation.) In-state preference laws survive Equal Protection challenges if they (1) advance a legitimate state interest and (2) are rationally related to the achievement of that interest.

PRIVILEGES AND IMMUNITIES CLAUSE

The P&I Clause (Article IV, Section 2) provides that “[t]he Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the Several States.” In *Toomer v.Witsell*, 334 U.S. 385 (1948), the U. S. Supreme Court held that the clause “was designed to ensure to a citizen of state A who ventures into State B the same privileges which the citizens of State B enjoys.”

A notable aspect of the P&I Clause is that it applies only to individuals, and not corporations. Thus, somebody using the P&I Clause to challenge a purchasing preference must demonstrate an individual harm separate and apart from the harm suffered by the corporation. For example, in *Smith Setzer v. South Carolina Procurement Review Panel,* 20 F.3d 1311 (1994), the company’s majority shareholder attempted to assert a P&I claim against South Carolina's preferential purchase law based on the personal economic harm it had caused him. However, the court held that he lacked standing to assert this claim, ruling that any personal economic harm he suffered derived from the corporation’s.

Because of this, the P&I clause is most commonly a factor in cases involving hiring preferences or quotas for workers, rather than for contract awards to companies.

Standard of Review

In *Toomer*, the Court enumerated a three-part test for evaluating P&I challenges. Under that test, a court must: (1) determine whether the policy at issue burdens a right protected by the P&I Clause; (2) consider whether the state has a “substantial reason” for the discriminatory practice; and (3) evaluate whether the practice bears a substantial relationship to the state's objectives. Even if a policy burdens a P&I-protected right, it can still survive if it is supported by a substantial reason and bears a substantial relationship to the state's objectives.

With respect to in-state preferences, the Supreme Court in *Toomer* said that nonresidents must be shown to “constitute a peculiar source of the evil at which the statute is aimed, [and there must be] a reasonable relationship between the danger represented by [nonresidents], as a class, and the…discrimination practiced upon them."

Hiring Preferences

In *United Building and Construction Trades Council v. Camden,* 465 U.S. 208 (1984), the Supreme Court struck down a Camden, NJ ordinance that required 40% of the workforce on a city-funded construction project to reside in the city. It ruled that pursuit of a common calling is one of the fundamental privileges protected by the P&I Clause:

> A determination of whether a privilege is “fundamental” for purposes of [the P&I] Clause does not depend on whether the employees of private contractors and subcontractors engaged in public works projects can or cannot be said to be “working for the city.” The opportunity to seek employment with such private employers is “sufficiently basic to the livelihood of the Nation,” as to fall within the purview of the Privileges and Immunities Clause even though the contractors and subcontractors are themselves engaged in projects funded in whole or part by the city (internal citations omitted).

The *Camden* case set a precedent for in-state preferences with respect to project workforces, as governments often have difficulty showing that nonresidents are the peculiar source of the evil (e.g., high unemployment rates) at which the statutes are aimed. For instance, in recent years, the U.S. District Court in Massachusetts, citing *Camden*, enjoined at least three municipalities (Worcester, Fall River, and Quincy) from enforcing resident hiring preferences for municipal projects, holding that they violated the plaintiffs’ rights under the P&I clause (*Utility Contractors Association of New England v. Worcester*, 236 F.Supp.2d 313 (2002); *Utility Contractors Association of New England v. Fall River* No. 10-10994-RWZ, 2011 (D. Mass. Oct. 4, 2011); *Merit Construction Alliance v. Quincy* No. 12-10458-RWZ, 2012 (D. Mass. April 18, 2012)).

Contracting Preferences

Corporations’ inability to assert a P&I claim makes this clause less of a factor in challenges to purchasing preferences. As *Smith Setzer* shows, individual plaintiffs often have difficulty demonstrating a harm separate and distinct from the one suffered by the corporation.

However, in at least one case, a judge ruled against an in-state contracting preference because of a P&I clause violation. In *McCrossan v. Rahn,* 96 F.Supp.2d 1238 (2000), a federal district court held that New Mexico's preferential purchase law violated the P&I clause because it affected the plaintiff's ability to own a business.

To qualify for New Mexico's in-state preference, a company had to, among other things, have a majority of its shares owned by one or more New Mexico citizens. The court held that this burdened the plaintiff's rights under the P&I Clause by discriminating against him on the basis of state citizenship, preventing him from competing equally with New Mexicans. As the court wrote in the opinion, "what is protected here is the right to own shares, in a meaningful manner, by providing standing to a shareholder whom a statute targets on the basis of state citizenship."

After finding the violation of a P&I-protected right, the court then determined that the residence requirement was not closely or substantially related to the statute's purpose. It thus severed this requirement from the rest of the statute.

COMMERCE CLAUSE

Market Participant Exception

The Commerce Clause (Article I, Section 8) grants the federal government the power to regulate commerce among the states. It has also been held to mean the converse, that states cannot pass laws that improperly burden or discriminate against interstate commerce (i.e., the "negative" or "dormant" commerce clause).

However, case law has established what's known as the market participant exception to the Commerce Clause. Under this exception, certain contracting practices (including in-state preferences) may be upheld if the government establishes that it is acting as a market participant (like any private business or consumer) and not as a regulator. (The clause only applies to market regulation.)

According to the Supreme Court:

> [n]othing 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…Impact on out-of-state

> residents figures in the equation only after it is decided that the city is regulating the market, rather than participating in it, for only in the former case need it be determined whether any burden on interstate commerce is permitted by the Commerce Clause (*Hughes v. Alexandria Scrap Corp.,* 426 U. S. 794 (1976)).

The exception allows governments to use preferences for their own purchases that would otherwise violate the Commerce Clause if it imposed them on private businesses. For example, in 1992 the Supreme Court struck down, based on the Commerce Clause, an Oklahoma statute that required utilities using coal-fired power plants to purchase 10% of their coal from Oklahoma coal mines. However, it noted that imposing the requirement on a state-owned utility would be permissible under the market participant exception (*Wyoming v. Oklahoma,* 502 U.S. 437 (1992)).

Similarly, the Court ruled in favor of the City of Boston in a case that challenged, under the Commerce Clause, a city hiring quota. In *White v. Massachusetts Council of Construction Employers, Inc.,* 460 U.S. 204 (1983), the Court held that an executive order requiring that at least 50% of all jobs on construction projects funded in whole or in part by city funds be filled by bona fide city residents did not violate the Commerce Clause; the executive order was an example of the market participant exception. (Unlike in *Camden*, the plaintiffs in this case did not raise a P&I challenge.)

Limits to the Exception

The market participant exception does not cover all in-state preferences. For example, in *South-Central Timber Development, Inc. v. Wunnicke*, 467 U.S. 82 (1984), the Supreme Court struck down an Alaska law under which the state sold reduced-price timber from state-owned forests only on the condition that buyers agreed to process the timber at an Alaska facility before exporting it. The Court held that, because the state was not a participant in the downstream processing market, the law was an example of market regulation, not market participation: "although the State may be a participant in the timber market, it is using its leverage in that market to exert a regulatory effect in the processing market, in which it is not a participant."

The Court has also held that certain tax policies do not qualify for the market participant exception. One such case involved an Ohio tax credit for ethanol sold (as a component of gasohol) by fuel dealers, but only for (1) Ohio-produced ethanol and (2) ethanol produced in states that give tax credits to Ohio-produced ethanol. The Supreme Court struck down this law as a Commerce Clause violation. In rejecting Ohio's claim to the market participant exception, the Court held that the issue was not Ohio’s purchase or sale of ethanol, but its assessment and computation of taxes, which is a “primeval government activity” (*New Energy Co. of Indiana. v. Limbach*, 486 U.S. 269 (1988)).

EQUAL PROTECTION CLAUSE

The Equal Protection Clause (14th Amendment, Section 1) prohibits states from denying any person within their jurisdiction the equal protection of the laws. The standard of review for equal protection cases depends on the type of distinction that a law or policy makes. Distinctions based “suspect classifications” (e.g., race or religion) or that involve fundamental rights are subject to strict scrutiny. To survive strict scrutiny, a law must (1) serve a compelling state interest and (2) be narrowly tailored to that interest.

However, non residency is not a suspect classification for equal protection purposes. Thus, a state scheme that discriminates against nonresidents is instead subject to the rational relationship standard; a state only needs to prove a (1) legitimate (rather than compelling) purpose and (2) rational connection between (and not a narrow tailoring of) the law and the achievement of that purpose.

Because of the more relaxed standard of review, preference laws are less susceptible to equal protection challenges. For instance, in *Smith Setzer* (the South Carolina case described above), the Fourth Circuit Court of Appeals rejected the plaintiff’s equal protection challenge to South Carolina’s preferential purchase law. It held that (1) the state had a legitimate interest in directing the benefits generated, by state purchases, to the state’s citizens and (2) the statute’s rationality was at least debatable, meaning it satisfied the rational relationship test.

Similarly, in *McCrossan v. Rahn* (the New Mexico case described above), although the court ruled against the state on the P&I Clause, it held that the contracting preference did not violate the Equal Protection Clause.

Successful Equal Protection Challenges

Although in-state preferences are evaluated on the rational relationship standard, we did find some cases where a court held that a preference failed this standard. For example, in *Metropolitan Life Insurance v. Ward* 470 U.S. 869 (1985), the Supreme Court struck down an Alabama law that taxed out-of-state insurance companies at a higher rate than domestic insurance companies. The Court held that the law had a purely discriminatory purpose, unsupported by any legitimate state interest:

> Alabama's aim to promote domestic industry is purely and completely discriminatory, designed only to favor domestic industry within the State, no matter what the cost to foreign corporations also seeking to do business there. Alabama's purpose…constitutes the very sort of parochial discrimination that the Equal Protection Clause was intended to prevent.

In another case, a federal district court in Arkansas struck down the state's preference law on equal protection grounds. It held that there was no evidence to show that the preference served the state's and local governments' fiscal interests or was likely to do so in the future (*Rayco Construction Company v. Vorsanger,* 397 F.Supp. 1105 (1975)).

We also found a case where a court struck down an Arizona in-state preference law for lack of a rational relationship to a legitimate state interest. While the case was brought under Arizona's state constitution, the court's analysis parallels the analysis under the federal Equal Protection Clause.

Under the Arizona statute, any vendor qualified for the preference if it paid at least $200 in taxes on real or personal property in Arizona for at least two consecutive years. The state supreme court held that this law had no rational relationship to its stated purpose. According to the court, "a tax payment of $400 is so insignificant in proportion to the amount of the potential preference conferred on even a modest size public work job that any reasonable relationship between the statute and furtherance of the legislative purpose…has been destroyed" (*Big D Construction Corp. v. Court of Appeals for the State of Arizona, Division One* 789 P.2d 1061 (Ariz. 1990)).

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