



Employment and Contracts – City of San Carlos

INTRODUCTION

In early 2003, San Carlos citizens raised concerns about the City Council’s decision to contract the position of Public Works Director/City Engineer formerly held by a long-term employee, Parviz Mokhtari, who had retired with full pension benefits. His company, Mokhtari Engineering, Inc. was awarded the contract to perform the job of Public Works Director/City Engineer. Subsequently, two additional projects totaling \$475,000 were awarded to that same company, with no competitive process in one case, and a highly questionable process in the other.

Citizens, as well as the local newspapers, believe such arrangements encourage cronyism, create situations that promote conflicts of interest, raise questions of appropriate spending and expose the city to considerable financial risk. They allow highly paid former city employees to take advantage of the public retirement system and create situations that significantly weaken public trust.^{1 2 3}

The Grand Jury found the City of San Carlos (City) believes the concerns are overblown and lack credibility. The City denies it has done anything illegal or improper and suggests the motives behind the complaints lack integrity. A *San Mateo County Times* article dated October 9, 2003 noted one City Council Member

¹ A January 14, 2004 editorial in the *San Mateo County Times* characterized this arrangement as “an egregious breach of ethics” that “raises serious questions about the council’s competence and, more importantly, its collective thinking on what’s right and wrong.”

² On November 5, 2003, the *San Francisco Chronicle* reported that State Senator Jackie Speier strongly criticized arrangements in which retired state employees returned to work while collecting state retirement benefits, a situation not unlike the San Carlos Public Works Director/City Engineer. She was quoted as saying that they are “rife with cronyism” and stated “they retire on Friday, they come back on Monday, and, guess what? Their salary increases by 50%.”

³ A February 10, 2004 editorial in the *San Mateo County Times* stated, “Time and again, San Carlos City Council members have danced around the obvious—that awarding major construction contracts to an employee’s engineering firm is a blatant conflict of interest. ...San Carlos must reverse this practice of letting a city employee get city contracts especially when that employee oversees administration of the contracts.

referred to those raising concerns as “nitpickers.” The Grand Jury determined the City believes the initial public concern can be attributed to an overly enthusiastic reporter, to the uninformed and confused, to political rivalry, and to disgruntled citizens dissatisfied with how requests made to the city were handled.

The City Ordinance Code defines the Public Works Director/City Engineer as a position of employment.⁴ The City chose to disregard the ordinance code and enter into a contract with Mokhtari Engineering, Inc. By taking this action, the City also ignored potential liability under federal as well as state tax laws which prohibit employers from avoiding withholding requirements by labeling employees as “independent contractors,” and state pension guidelines that prohibit retirees who are collecting public pensions from working as public employees over a certain number of hours.

The City did not advertise the availability of this contract position or provide any competitive process before entering into the contract with Mokhtari Engineering, Inc. to act as the Public Works Director/City Engineer at an initial annual rate of \$192,000. The contract for oversight of the Downtown Improvement project, worth \$300,000, was awarded to Mokhtari Engineering, Inc., without soliciting proposals from any other firms. The Industrial Road project, worth \$175,000, was awarded to Mokhtari Engineering, Inc., through a purported competitive process in which Mokhtari Engineering, Inc. acting as Public Works Director/City Engineer helped to prepare the Request For Proposal documents, and helped to select which companies should be asked to submit proposals. Other smaller contracts were also awarded to Mokhtari Engineering, Inc. without a competitive process.

The City claims that money was saved by its decisions and that no competitive bid process for the contracts in question was needed. Savings reported by the City were supported with flawed analyses and by comparisons to estimates of costs prepared by Mokhtari Engineering, Inc. for its own work.

After coming to the conclusion that the City was unable to answer questions adequately or alleviate concerns, and that an official, independent investigation of the matter was necessary, a citizen filed a complaint with the San Mateo County Civil Grand Jury.

The Grand Jury reviewed the complaint and initiated an investigation of the following issue:

Does the City of San Carlos have a fair, impartial contracting process, free from bias, without conflicts of interest and undue liability exposure?

⁴ San Carlos City Ordinance Code Sec 2.44.040(E)

The Grand Jury interviewed and reviewed public documents written by citizens, City officials and staff, and individuals with agencies and companies involved in the contract process with the City. The Grand Jury also reviewed documents from the California Fair Political Practices Commission, the Internal Revenue Service, the Public Employee Retirement System and various legal references.

The Grand Jury concludes that the City's failure to use a fair competitive process and the City's use of independent contractors for employee positions are not only deceptive, but have the appearance of impropriety, regardless of whether or not these actions may be legally valid.⁵ These actions have seriously undermined the public trust in the City.

The detailed recommendations in this report provide guidance for the City to restore the public trust and reduce liability exposure. In summary, the City must:

- Review and establish processes to assure a fair, impartial selection of contractors.
- Avoid entering into any contracts that may have even the appearance of conflict of interest.
- Establish procedures to assure employees and contractors comply with conflict of interest and disclosure laws.
- Establish procedures to avoid undue exposure to employment related liabilities.
- Maintain and make more readily available to the public, information that forms the basis of its decisions.

The following sections report specifically on the issues investigated and their respective conclusions and recommendations.

Section One: Contractor Selection Process

Section Two: Conflict of Interest and Other Legal Issues

Section Three: Decision-Making and Liability Risks

⁵ It should be noted that in 2000-2001, the Grand Jury investigated the City Council's reassignment of elected City Clerk duties to an appointed position created by the City Council in order to effectively circumvent the requirement that the City Clerk be an elective position. In 2001-2002 the Grand Jury found that the City, "... acted by subterfuge and legislative sleight of hand ..." to resolve the problem.

SECTION 1 - CONTRACTOR SELECTION PROCESS

Background:

To obtain professional services, a city may send a Request for Proposal (RFP) to firms that may be qualified to provide those services. An RFP typically includes the following:

1. A description of the nature of goods or services the city is seeking to obtain
2. The factors by which the proposals will be evaluated in weighted order, as well as the bases upon which disqualification may take place
3. The name and contact telephone number of the person designated to respond to questions
4. Information about where and when interested parties may obtain copies of the project plan
5. Procedures for submission, including response requirements, minimum content and filing deadlines
6. A statement regarding the protection of confidential information
7. Requests for information regarding:
 - a. the principals of the firm and their experience and qualifications
 - b. the experience and qualifications of the individuals available to be assigned to the project
 - c. the firm's previous relevant work, current availability, its strength and stability (bond capacity) and why it can be expected to provide service in a safe manner free from liability
 - d. its proposed work plan and schedule
 - e. fees that will be charged

In granting a contract for professional services, a city is not required to use a competitive bid process or, if a competitive bid process is used, it is not required to accept the proposal that has the lowest cost.

Findings:

After September 1, 2001, when Parviz Mokhtari retired and his firm began providing Public Works Director/City Engineer services under contract, the following contracts were granted to Mokhtari Engineering, Inc.:

SERVICE	INITIAL DATE OF CONTRACT	AMOUNT	AWARD PROCESS
Public Works Director	September 1, 2001	\$196,800/year (current rate)	Non Competitive
Downtown Improvement Project	May 13, 2002	\$300,000	Non Competitive
Industrial Road Project	June 23, 2003	\$175,000	Request For Proposal
NPDES (Sewer billing)	April 16, 2003	\$11,350/year	Non Competitive
SCOOT (Downtown Shuttle)	September 1, 2001	\$77.00/hour	Non Competitive

San Carlos City Ordinance 3.12.260 (B) sets the following conditions relative to developing, assessing and awarding contracts using an RFP:

- Requests for proposals shall state evaluation factors.
- In conducting discussions, there shall be no disclosure of the identity of any firm submitting a proposal or of any information derived from proposals submitted by them.
- Offers shall be accorded equal treatment with respect to any opportunity for discussions and revisions of proposals, and such revisions may be permitted after submissions and prior to award for the purpose of obtaining best and final offers.
- An award shall be made to the responsible firm whose proposal is determined in writing to be the most advantageous to the City, taking into consideration price and evaluation factors set forth in the request for proposals. **No other factors or criteria shall be used in the evaluations.** (Emphasis added).
- Upon receipt of any department services, the department head shall be responsible for making a careful check of the quality, conditions and quantity of the services received.

The City's department heads, including the Public Works Director/City Engineer, typically prepare RFP's for services to be provided in areas over which they have responsibility, and assist the City Manager to assess proposals and make decisions as to the award of the contract.

The Industrial Road contract was unique in that it was awarded through an RFP process only after concerns were raised by citizens about the lack of consideration given to other contractors. The process was not in accordance with City ordinances and did not follow usual practices.

- The RFP did not include evaluation factors.
- The Public Works Director/City Engineer submitted a proposal on behalf of his own company and assisted in:
 - Preparing the project for which management services were needed
 - Preparing the RFP
 - Determining the firms to be solicited for service
- The City Manager assumed responsibilities usually carried out by the Public Works Director/City Engineer with respect to addressing technical questions from possible contractors about the project and the RFP.

In a letter appearing in the *San Mateo County Times* on January 12, 2004, Council Member and former Mayor Tom Davids wrote “On the Industrial Road Project, when the City learned that Mokhtari Engineering planned to submit a proposal for the inspection work, Brian Kangas Foulk was hired to develop the Request for Proposal.” The Grand Jury established that Brian Kangas Foulk did not have any involvement in the preparation of the RFP for the oversight contract.

The Grand Jury further determined that the City was not aware of its own written procedures for reviewing and awarding contracts, and that no uniform practices in this regard are followed.

The City Manager recruited a person through the City/County Association of Governments (C/CAG) to independently review and evaluate the proposals for the project and recommend a selection. The City is a member of C/CAG, and a member of the San Carlos City Council chaired the C/CAG board at that time. C/CAG’s director chose an individual to perform the review who had a professional relationship with Mr. Mokhtari when both had served together in the past on C/CAG and professional organization committees.

The reviewer believed his task was to affirm the City’s decision to award the contract to Mokhtari Engineering, Inc. No one in the City provided the reviewer any information or guidance to direct his task or to define the scope of his review. He sought no such advice. His review was performed without a copy of the RFP, without a copy of the project documents, without knowledge of the City’s past practices, guidelines or relevant codes, and without the City’s input concerning the criteria that should be used for assessment. The reviewer was free to decide on his own how he would review and assess the proposals. No attempt was made by the reviewer to contact those firms who submitted proposals for the purpose of clarification.

The reviewer was inconsistent in applying the criteria used in evaluating the proposals. The reviewer downgraded the proposal of a firm pre-qualified by the City because key personnel had not worked on a previous City project. The reviewer downgraded two proposals because they specified a requirement for use of City office space, computers, office equipment and miscellaneous supplies despite the fact that the RFP stated “the city will provide a desk and a computer.”

The reviewer included in his evaluation of the proposals a personal assessment of the validity of public concerns about the possible conflict of interest related to Mokhtari Engineering Inc.’s submission of a proposal. In a letter written to the City Manager dated March 10, 2003, the reviewer justified his positive evaluation of the Mokhtari Engineering, Inc. proposal as follows: “On the surface, it would appear that Mr. Mokhtari may not be entirely objective and working to the benefit of San Carlos, (something I can not deduce from the submitted proposal). However, when all is said and done, Mr. Mokhtari should be much more considerate of cost increases because of his city position and the fact that his personal contract for employment could be adjusted or terminated if it is suspect that he is taking advantage of the situation. . . . There is no gain for Mr. Mokhtari to shortchange the City of San Carlos. His unique position of wearing “two hats” makes him much aware of scrutiny than any of the other prospective firms vying for the project. Conflict of interest is not an issue with this work. It is only a minor perception problem that, when analyzed, is not a problem at all.”

The reviewer recommended the City offer the contract to Mokhtari Engineering, Inc. and the City Manager made such a request to the City Council. The Council delayed voting on the contract because concerns of fairness were raised by one of the firms that was not selected. A meeting of the City Manager, the complainant, and the reviewer was held to review the assessment process and to provide information to the complainant about why his firm was not recommended. In a memo prepared for the meeting dated April 8, 2003, the reviewer stated that he completed a second, more-in depth review of the proposals as requested. He included in the memo the more detailed scoring chart he used to score each proposal a second time. Using this new process, he noted, Mokhtari Engineering, Inc. came out on top again, validating his original thinking. He further noted that he carried out the second review, like the first, “without influence or bias of any kind.” While the reviewer’s memo stated that the second review was requested by the City Manager, the Grand Jury received contrary information in interviews.

In a memo to the City Council, May 2, 2003 recommending the Industrial Road contract with Mokhtari Engineering, the City Manager stated: “It is possible, of course, for a different firm to win a contract as the process is done in an open and impartial manner. However, I do note that Mokhtari Engineering, Inc. is given certain advantages when it bids for a Construction Management contract using plans and specifications the development of which they have overseen. This does not give them an unfair advantage but it does give them a level of intimacy with the documents that allows them to be more precise in their proposals. That, coupled

with the outstanding inspectors they proposed to hire for these two projects, did make it difficult for others.”

Conclusions:

When the City uses a competitive process it should be transparent and free of improprieties.

The procedure used to select Mokhtari Engineering, Inc. to provide construction management services for the Industrial Road project:

- Lacked objectivity.
- Failed to meet expected and reasonable professional standards.
- Did not treat professionally those firms that submitted proposals.

The lack of a truly competitive RFP selection process and the appearance of a conflict of interest discourage firms from submitting proposals, impairs the City’s ability to obtain cost information, and damages the City’s reputation.

The shallowness of the RFP process leads reasonable people to conclude that the City had selected Mokhtari Engineering, Inc. before initiating any “competitive” process.

Recommendations:

To provide a fair and impartial process in the selection of its contractors, the City Council should, by September 1, 2004:

1. Review best practices in other cities and agencies and establish a well-defined and detailed professional Request for Proposal process.
2. Revise City Ordinances to reflect best practices.
3. Establish a process in the event an outside review is desirable or necessary that will:
 - assure independence of the reviewer;
 - assure the reviewer is properly qualified;
 - define the scope and criteria of the review;
 - provide the reviewer all necessary information needed to conduct a thorough and impartial review.

4. Immediately establish a policy to review criteria and evaluation methods used by staff when making recommendations.

SECTION 2 - CONFLICT OF INTEREST AND OTHER LEGAL ISSUES

Background:

The Political Reform Act as contained in Government Code Section 81000 et seq. states: “Public officials, whether elected or appointed, should perform their duties in an impartial manner, free from bias caused by their own financial interests or the financial interests of persons who have supported them.” “Public officials,” include contractors that act as consultants to the agency. (Government Code Section 82048)

The Political Reform Act prevents conflicts of interest in two ways -- disclosure and disqualification. To avoid conflicts of interest, assets and income of public officials that might be materially affected by their official actions should be disclosed and, in appropriate circumstances, the officials should be disqualified from acting. (Government Code Section 81002(c))

Government Code Section 1090 codifies the common law prohibition and the general policy of the state against public officials having a personal interest in contracts they make in their official capacities. An Opinion of the California Attorney General citing facts similar to those existing in San Carlos concluded, “. . . employees of a county may not contract with their County Board of Supervisors to provide the county, as independent contractors in the future, those public services they are presently performing as county employees.”⁶

Any violation of the City’s Conflict of Interest Code is deemed to be a violation of the California Political Reform Act and constitutes a misdemeanor.

The City Conflict of Interest Code requires the Public Works Director/City Engineer to file a financial disclosure on Fair Political Practices Commission Form 700. The Public Works Director/City Engineer must report investments in a business entity in which he had a 10% or greater interest and those valued at \$2,000 or more owned during the reporting period and which are located, doing business, planning to do business, or have done business during the previous two years in San Carlos. The Public Works Director/City Engineer also must report the source and amount of gross income received if the amount totals \$500 or more and was received from any source which is located, doing business, planning to do business, or which has done business during the previous two years in the City.

⁶ 66 Ops. Cal Atty. Gen.156 (1983)

The purpose of financial disclosure is to alert public officials to personal interests that might be affected while they are performing their official duties, i.e., making governmental decisions. Disclosure also helps to inform the public about potential conflicts of interest.

Government Code Section 87100 states, “No public official at any level of state or local government shall make, participate in making or in any way attempt to use his official position to influence a governmental decision in which he knows or has reason to know he has a financial interest.”

- “Influences” means: contacts, appears before, or otherwise attempts to influence any member, officer, or employee of the City, or acts on behalf of the City for the purpose of influencing that decision;
- “Participate” includes negotiations and advice by way of research, investigations, or preparation of reports or analyses for the City Manager or members of the City Council; and
- “Public Official” includes any consultant under contract serving in a staff capacity and making governmental decisions.⁷

Findings:

Discussions between Mr. Mokhtari and the City to continue providing his services as Public Works Director/City Engineer as a consultant under contract with Mokhtari Engineering, Inc. occurred prior to his retirement as an employee. The contract was reviewed by the San Carlos City Attorney July 31, 2001 and signed by Mr. Mokhtari and the City Manager August 29, 2001. Mr. Mokhtari officially retired from the City August 31, 2001.

The Fair Political Practices Commission Form 700 filed by the Public Works Director/City Engineer for the time period of January 1, 2002 – December 31, 2002, states that he had “no reportable interests” to disclose. The Public Work Director/City Engineer failed to disclose significant income from his company, Mokhtari Engineering, Inc., despite the fact that it received payments for services as Public Works Director and from various engineering contracts from the City during the reporting period.

Minutes of the May 12, 2003 City Council meeting indicate that Mr. Mokhtari assisted in the preparation of the actual Request for Proposal document and assisted in determining which firms would be asked to submit proposals. Mr. Mokhtari (as

⁷ California Code of Regulations section 18701(a)(2)(B).

Mokhtari Engineering, Inc.) was both encouraged and allowed by the City to submit a proposal to provide these services.

Even before the May 12, 2003 meeting, citizens challenged the process that resulted in the selection of Mokhtari Engineering, Inc. on the grounds that there was an inherent conflict of interest. A memo dated May 2, 2003 from the City Manager to the City Council states, "Staff explained there was no conflict because Mokhtari Engineering, Inc. which is responsible for the design and quality of the project, could not shed its responsibility for construction management. The firm awarded that contract would be working for Mokhtari Engineering, Inc. meaning that the only question was whether Mokhtari Engineering, Inc. would do the work with its own employees or with a third party." The letter further stated, ". . . the City Attorney also reviewed the law, indicating there was not a conflict."

The Grand Jury attempted to determine the basis of this advice given by the City Attorney and requested a waiver of the attorney client privilege be sought from the City Council for this purpose. Even though the City Attorney's advice was referred to in a public meeting as specific support for the City's actions, the City Council refused to waive the privilege.

Conclusions:

Questions exist about the legality of the City Public Works Director/City Engineer, when still an employee of the City, discussing and finalizing an arrangement with City officials to provide, as a contractor, the same services he provided as an employee.

Questions exist about the legality of the City Public Works Director/City Engineer participating as a contracted Public Official in the awarding of contracts to his own firm.

The City Public Works Director/City Engineer economically benefited from the contracts for the Downtown Improvement, Industrial Road, and other projects awarded to Mokhtari Engineering, Inc.

The refusal to allow the Grand Jury to obtain information from the City Attorney regarding advice that the City Council and the City publicly referred to as justification for their actions in public meetings and documents is inappropriate.

Recommendations:

- 5.0 The City Council of San Carlos should:
 - 5.1 Not allow public officials to participate in the decision making process to award contracts to their own companies.
 - 5.2 Not contract with individuals or entities that have financial conflicts of interest in the contract.
 - 5.3 Review each Fair Political Practices Commission Form 700 to assure complete and accurate financial disclosure as required.

- 6.0 The San Mateo County District Attorney should:
 - 6.1 Determine whether criminal or civil enforcement action should be taken against Parviz Mokhtari, Mokhtari Engineering, Inc. or the City of San Carlos, regarding conflict of interests or financial disclosure and
 - 6.2 Take appropriate action to directly or by referral to the Fair Political Practices Commission to enforce the law.

SECTION 3 – DECISION-MAKING AND LIABILITY RISKS

Background:

The management of the City reviewed services to determine if there were ways in which services could be provided at less cost. The City determined it could save money by contracting top-level management services traditionally performed by employees. A number of City services are provided in this manner. The City's Public Works Director/City Engineer and the Assistant City Manager/Finance Director services are two such independent contractors. The City recognizes the risks involved in these arrangements, but believes that cost savings justify taking these risks.

City employees are covered by Social Security and California Public Employees Retirement System (CalPERS). The City must pay its share of contributions for both for each of its employees. If an individual providing services for the City is classified as an independent contractor, and is determined by the Internal Revenue Service (IRS) to be an employee the City may be liable for all required contributions that were not withheld, reported and paid. The IRS has a 20 Factor Test to assist employers to determine whether an individual is providing services as an employee or as a contractor (Appendix 1). The State of California follows these determinations

regarding employment taxes. Any entity may request a determination of worker status for purposes of Federal employment taxes and income tax withholding by completing a Form SS8 provided by the IRS.

An individual who is providing services as an independent contractor or working for someone else may later assert that he or she is really an employee of the City and demand retroactive benefits, including but not limited to CalPERS service credit. If the individual were to be successful, the City would owe arrears contributions along with interest and penalties to the IRS, the state and CalPERS.

San Carlos City Ordinance 2.44.040(E) explicitly provides that the Public Works Director shall be an “employee.”

Findings:

On September 1, 2001, the City entered into a personal service contract with the Public Works Director/City Engineer’s firm, Mokhtari Engineering, Inc. for Parviz Mokhtari to provide the services of Public Works Director/City Engineer. Mr. Mokhtari had worked as an employee for the City for 20 years in that capacity. The job description incorporated in the contract was unchanged from that used when Mr. Mokhtari was an employee. The Grand Jury found the City believed the contract would save money and serve the personal interests of Mr. Mokhtari, while retaining a valuable resource. The City would no longer pay employment taxes or retirement contributions and Mr. Mokhtari would receive his retainer, and his retirement benefits. The City expected full-time services. The Grand Jury requested the City provide details of the savings calculations made at the time the initial contract was negotiated. None were provided by the City.

The “new” Public Works Director/City Engineer, as a contractor was provided, at no cost to his firm, the same staff, office, access to facilities, supplies and equipment he had when he was an employee. The City claims that it discounts the retainer to pay for these benefits. The Grand Jury requested the details related to the discount at the time the contract was negotiated and replaced. None were provided by the City.

At the time the contract was awarded, no one else was considered by the City to provide these services. The City Council awarded the contract without going through a hiring, bidding or RFP process.

When Mr. Mokhtari retired with full medical and dental benefits from the City, his salary was \$152,000. The City agreed to pay Mokhtari Engineering, Inc. a retainer for the same services for the first year of \$192,000. The agreement was revised increasing the fees by 2.5% to \$196,800 and was approved by the City Council September 16, 2002.

The replacement agreement was changed in a number of significant ways. The Grand Jury found that City management was unaware of any differences between the documents and believed any changes in the document must be mistakes . The City Council would not waive its attorney client privilege to allow the City Attorney to provide information to clarify these matters.

Eventually, at the request of City Council members, two years after the contract was first written, the City Manager prepared a memo (September 17, 2003) addressing the details of the savings that resulted from contracting the Public Works position. The analysis reflected a savings of \$31,866 per year. While the City reduced the duties of the Public Works Director/City Engineer the costs of providing services that would not be provided in the newly created part time position were not included in the analysis. The Grand Jury found that the analysis was misleading and flawed in a number of other significant areas. The Grand Jury requested the City provide details of how some of the Public Works Director/City Engineer's duties were reassigned and to whom. None were provided.

The City did not provide the Grand Jury any evidence that it used the common law or the 20 Factor Test when it entered into or renewed its contract agreements with Mokhtari Engineering, Inc. to provide Public Works/City Engineer services. Nor has the City provided evidence that it analyzes, define or monitors the present working relationship between the City and its contracted Public Works Director/City Engineer. The City has not requested a determination of employment status from the IRS for this position.

If the IRS were determining employment status of the Public Works Director/City Engineer, it would consider the following:

The present Public Works Director/City Engineer:

- Performs his services personally, on City premises and is required to “report” to the City Manager
- Performs the exact same services he did when he was an employee
- Directs, supervises and evaluates the work of city employees
- Is required to train, motivate, and discipline employees
- Is an integral part of City management
- Appears before the City Council, and committees as a representative of the City
- Works for the City full-time and does not make his services available to the public
- Directs the work of other consultants on behalf of the City

The City:

- Defines the Public Works Director as a management employee in its Ordinance Code.
- Represents Parviz Mokhtari as the City's Public Works Director/City Engineer on business cards and the City's website without any reference to Mokhtari Engineering, Inc.
- Provides the Public Works Director/City Engineer office staff, use of equipment, and supplies
- Has entered into an ongoing contractual relationship with the Public Works Director/City Engineer

During the investigation, it came to the Grand Jury's attention that Mokhtari Engineering, Inc. had never registered to do business in San Carlos as required by city ordinance. The Grand Jury was advised that a business registration has been subsequently obtained and the required fees paid.

In January 2002, the City assisted in the development of a Joint Powers Agency (JPA) and then entered into a contract with that JPA to provide the services of Financial Director. The City's Finance Director, a regular full-time employee, took a leave of absence from the City. He was immediately hired by the JPA to fill the contracted Finance Director position, performing the same services he performed as a City employee. The City is the only client of the JPA. Management of the JPA reports it has attempted to add other clients but has been unsuccessful.

Various attorneys indicated to the City in October and November of 2002 that by contracting with the JPA for services the City could incur liability for Social Security and/or CalPERS obligations, if the JPA's workers were determined for the purposes of those systems, to be employee(s) of the City and otherwise covered by Social Security and or eligible to enroll in CalPERS.

When it established its relationship with the JPA, the attorneys warned the City Council that it must take the following steps to minimize the risk of employment related liabilities:

- Carefully construct and monitor agreements and related employment arrangements to maximize the possibility JPA employees will be found to be JPA employees, and not employees of the City
- Use the criteria found in the IRS 20 Factor Test and the model provided by the Regional Government Services agreement with Bay Area Water Transit Authority to write agreements and to guide staff performance
- Ensure that employee practices and services described within the agreements are scrupulously followed, and
- Consider how extremely important it is that employees of the JPA work for more than one client.

If the IRS were determining employment status of the Finance Director, it would consider the following:

The City Finance Director:

- Is identified by ordinance as an “management employee”
- Is on un-paid leave of absence from the City
- Represents the City before the public and negotiates on its behalf
- Primarily performs work only for the City
- Is an integral member of the City’s management team;
- Is directed by City ordinance to report to the City Manager;
- Recruits, trains, plans, assigns, supervises and evaluates the work of City personnel;
- Has authority to develop policies, procedures and rules for the efficient operation of the Finance Department.

Conclusions:

The City’s liability exposure can be reduced considerably if the City structures and monitors the working relationships under its independent contractual agreements in conformity with the 20 Factors Test.

The City is substantially exposed to a potential liability for employment taxes and other employment related costs by the manner in which it contracts for its services.

The analysis of savings by contracting for Director of Public Works is flawed and does not accurately reflect the financial effect of the decision to contract these services.

The City does not maintain adequate records to document its decisions.

The City does not make available to the public sufficient information used in making decisions.

The City does not have procedures to assure that all businesses are properly registered. Revenue is lost as a result.

The City exercised the attorney client privilege to obstruct access to information required for a thorough Grand Jury investigation.

Recommendations:

- 7.0 The City of San Carlos should by September 1, 2004:
 - 7.1 Review all existing independent contractor agreements with regard to the IRS 20 Factor Test and determine whether the contract should be terminated or amended to reduce liability exposure to the City. Obtain an employment status determination from the IRS for current and future independent contractors, including the Public Works Director and Finance Director.
 - 7.2 Include provisions in all independent contractor professional service contracts to transfer or indemnify the City from any potential employment related liability.
 - 7.3 Direct the City Manager and staff of the City of San Carlos to review the best practices in other communities and implement those that will assure that business registration fees and related penalties (if any) are paid.

- 8.0 The City of San Carlos should establish policies by September 1, 2004 to ensure that :
 - 8.1 Important analyses and other relevant documents used in the decision making process are made available for future reference in the event such reference is required.
 - 8.2 The City Manager carefully review all analyses presented to the City Council to assure they reflect the facts accurately and have not been prepared to support a predetermined conclusion.
 - 8.3 City Management and Staff, and the City Attorney carefully review contracts to assure that the provisions are those intended and there are no oversights or mistakes before they are approved by the City Council.
 - 8.4 Advice of legal counsel is made available to the public when reference to such advice is made in response to public questions about significant matters before the City Council and the release of such information would not violate existing laws.

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Attachment A

The IRS 20 Factors Analysis*

Determining the level of control you have over your workers is the key to resolving the issue of whether your workers are employees, for whom you have payroll tax obligations, or independent contractors, for whom you do not. When IRS auditors analyze this issue, they work through a list of 20 different factors before concluding whether a sufficient level of control is present to create an employer-employee relationship. You should go through this same exercise before you try to claim that someone who does work for you is an independent contractor and not your employee.

As you work through the list, keep in mind that the importance of each factor will vary depending on the type of work being done and the circumstances of your own particular case. Because this is a rather subjective analysis, your goal should be to honestly assess how great a risk you'll be taking if you plan to treat a worker as an independent contractor. In close cases, talk to your tax professional or request an IRS determination of the worker's status. That being said, here are the 20 factors:

- 1. Instructions.** Workers who must comply with your instructions as to when, where, and how they work are more likely to be employees than independent contractors.
- 2. Training.** The more training your workers receive from you, the more likely it is that they're employees. The underlying concept here is that independent contractors are supposed to know how to do their work and, thus, shouldn't require training from the purchasers of their services.
- 3. Integration.** The more important that your workers' services are to your business's success or continuation, the more likely it is that they're employees.
- 4. Services rendered personally.** Workers who must personally perform the services for which you're paying are more likely employees. In contrast, independent contractors usually have the right to substitute other people's services for their own in fulfilling their contracts.
- 5. Hiring assistants.** Workers who are not in charge of hiring, supervising, and paying their own assistants are more likely employees.
- 6. Continuing relationship.** Workers who perform work for you for significant periods of time or at recurring intervals are more likely employees.
- 7. Set hours of work.** Workers for whom you establish set hours of work are more likely employees. In contrast, independent contractors generally can set their own work hours.
- 8. Full time required.** Workers whom you require to work or be available full time are likely to be employees. In contrast, independent contractors generally can work whenever and for whomever they choose.
- 9. Work done on premises.** Workers who work at your premises or at a place you designate are more likely employees. In contrast, independent contractors usually have their own place of

business where they can do their work for you.

10. Order or sequence set. Workers for whom you set the order or sequence in which they perform their services are more likely employees.

11. Reports. Workers whom you require to submit regular reports are more likely employees.

12. Payment method. Workers whom you pay by the hour, week, or month are more likely employees. In contrast, independent contractors are usually paid by the job.

13. Expenses. Workers whose business and travel expenses you pay are more likely employees. In contrast, independent contractors are usually expected to cover their own overhead expenses.

14. Tools and materials. Workers whose tools, materials, and other equipment you furnish are more likely employees.

15. Investment. The greater your workers' investment in the facilities and equipment they use in performing their services, the more likely it is that they're independent contractors.

16. Profit or loss. The greater the risk that your workers can either make a profit or suffer a loss in rendering their services, the more likely it is that they're independent contractors.

17. Works for more than one person at a time. The more businesses for which your workers perform services at the same time, the more likely it is that they're independent contractors.

18. Services available to general public. Workers who hold their services out to the general public (for example, through business cards, advertisements, and other promotional items) are more likely independent contractors.

19. Right to fire. Workers whom you can fire at any time are more likely employees. In contrast, your right to terminate an independent contractor is generally limited by specific contractual terms.

20. Right to quit. Workers who can quit at any time without incurring any liability to you are more likely employees. In contrast, independent contractors generally can't walk away in the middle of a project without running the risk of being held financially accountable for their failure to complete the project.

* US Chamber of Commerce (uschamber.com/sb)