



STATE OF CALIFORNIA
FAIR POLITICAL PRACTICES COMMISSION
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November 23, 2021

Matthew Zucca
1721 Robin Whipple Way
Belmont, California 94002

Re: Your Request for Advice
Our File No. A-21-107

Dear Mr. Zucca:

This letter responds to your request for advice regarding Government Code Section 1090, et seq.¹ Please note that we are only providing advice under Section 1090, not under other general conflict of interest prohibitions such as common law conflict of interest.

Also, note that we are not a finder of fact when rendering advice (*In re Oglesby* (1975) 1 FPPC Ops. 71), and any advice we provide assumes your facts are complete and accurate. If this is not the case or if the facts underlying these decisions should change, you should contact us for additional advice.

We are required to forward your request regarding Section 1090 and all pertinent facts relating to the request to the Attorney General's Office and the Alameda County District Attorney's Office, which we have done. (Section 1097.1(c)(3).) We did not receive a written response from either entity. (Section 1097.1(c)(4).) We are also required to advise you that, for purposes of Section 1090, the following advice "is not admissible in a criminal proceeding against any individual other than the requestor." (See Section 1097.1(c)(5).)

QUESTION

Would Section 1090 prohibit you, as the incoming Assistant Director of Public Works for the City of Hayward, or the City of Hayward itself, from reviewing and evaluating proposals by EKI Environment & Water ("EKI"), given that you are a former EKI employee, a current stockholder and creditor of EKI, and a participant in EKI's defined contribution plan?

CONCLUSION

Section 1090 would prohibit you, as Assistant Director of Public Works, from making or participating in the making of any contract between the City and EKI. However, as long as you

¹ All statutory references are to the Government Code, unless otherwise indicated.

disqualify yourself from all participation and play no role whatsoever in the contracting process, the City may contract with EKI.²

FACTS AS PRESENTED BY REQUESTER

In October of 2018, you left EKI Environment & Water (“EKI”), an engineering firm, after approximately 20 years of employment. During this time, you acquired EKI common stock separate from the ESOP. Upon separating from EKI, you entered into an agreement with EKI for the repurchase of your shares of EKI’s common stock. Under the terms of the Repurchase Agreement, EKI agreed to purchase 8,700 shares of your common stock for a total price of \$41,934.00. This purchase is payable in the form of a promissory note payable over sixty months at an annual interest rate of six percent, with the last payment occurring on October 5, 2023. Payments on this promissory note are \$810.70 per month, or \$9,728.40 per year.

Separate from the Repurchase Agreement, during your period of employment with EKI, you also vested in EKI’s employee stock ownership plan (“ESOP”), whose assets consists of both EKI stock and cash. The EKI ESOP is intended to qualify as an Employee Stock Ownership Plan as defined in Section 4975(e)(7) of the Internal Revenue Code.³ As of the end of the 2019 plan year (the most recent plan year),⁴ you own 32,418 shares of EKI stock as part of your ESOP account, valued at \$175,531.90, as well as \$4,112.11 in cash. EKI estimates that your balance of EKI stock accounts for approximately 1.8% of the total number of shares of stock in the ESOP. Beginning in plan year 2020, EKI ceased issuing dividends on stock. However, beginning in November 2023, EKI is obligated under the ESOP to begin making distributions to you from the ESOP account. These distributions must be completed within five years, at which point they will exceed five percent of your annual income. You plan to transfer these disbursements from the ESOP into a separate, tax-advantaged retirement account.

You are now being considered for a position as the Assistant Director of Public Works for the City of Hayward (“City”). The City has historically done business with EKI and anticipates that it will do further business with EKI in the future. You indicate that the Assistant Director of Public Works would be “expected to, at a minimum, manage EKI’s work efforts as part of the position’s duties.” In the job bulletin for the position you provided, the essential duties of the Assistant Director include “evaluating, negotiating, and recommending professional services agreements and construction contracts [...],” as well as “selecting and supervising professional, technical, and administrative personnel.”

² We note that the Political Reform Act also prohibits an official from taking part in any decision if it is reasonably foreseeable the decision will have a material financial effect on economic interests enumerated by the Act. However, to the extent that you disqualify yourself from all participation and play no role whatsoever in the contracting process, the Act is not implicated, and we do not address it further.

³ An employee stock ownership plan is a qualified contribution plan under Section 401(a) of the Internal Revenue Code designed to invest primarily in qualifying employer securities.

⁴ At the time of your request for advice, information had not yet been released for plan year 2020, but no material changes were anticipated.

ANALYSIS

Government Code Section 1090 provides that “[m]embers of the Legislature, state, county, district, judicial district, and city officers or employees shall not be financially interested in any contract made by them in their official capacity, or by any body or board of which they are members.” (Gov. Code Section 1090(a).)

Under Section 1090, “the prohibited act is the making of a contract in which the official has a financial interest.” (*People v. Honig* (1996) 48 Cal.App.4th 289, 333.) A contract that violates Section 1090 is void. (*Thomson v. Call* (1985) 38 Cal.3d 633, 646.) Section 1090 is concerned with financial interests, other than remote or non-interests, that prevent public officials from exercising absolute loyalty and undivided allegiance in furthering the best interests of their agencies. (*Stigall v. Taft* (1962) 58 Cal.2d 565, 569.) The analysis of a financial interest under Section 1090 is separate and distinct from that applied under the Political Reform Act.

If you were to assume the Assistant Director of Public Works position for the City of Hayward, the prohibitions of Section 1090 would apply to you as a City officer. In addition, you indicated that the City intends to “utilize EKI’s service,” as the City has done in the past. Thus, the City’s decisions at issue, concerning proposals to the City by EKI, involve a contract for services between the City and EKI.

The determinative issue is whether you, as Assistant Director of Public Works, would be making or participating in contracts between the City and EKI in which you have a prohibitory financial interest.

Section 1090 casts a wide net to capture those officials who participate in any way in the making of the contract. (*See People v. Sobel* (2d DCA 1974) 40 Cal.App.3d 1046, 1052.) Therefore, for purposes of Section 1090, participating in making a contract is defined broadly as any act involving preliminary discussions, negotiations, compromises, reasoning, planning, drawing plans and specifications, and solicitations for bids. (*Millbrae Assn. for Residential Survival v. City of Millbrae* (1968) 262 Cal.App.2d 222, 237; see also *Stigall*, 58 Cal.2d at 569.)

When an employee of an agency, as opposed to a board member, has a financial conflict the employee’s agency may enter into the contract as long as the employee plays no role whatsoever in the contracting process. Therefore, if the employee plays no role whatsoever in the contracting process (either because such participation is outside the scope of the employee’s duties or because the employee disqualifies themselves from all such participation), the employee’s agency is not prohibited from contracting with the employee or the business entity in which the employee is interested. (*See* 80 Ops.Cal.Atty.Gen. 41 (1997); *Burns* Advice Letter, A-14-060.)

You indicate that the City anticipates soliciting, receiving, and considering proposals from EKI in the future, and that the Assistant Director of Public Works would be “expected to, at a minimum, manage EKI’s work efforts as part of the position’s duties.” Moreover, the essential duties of the Assistant Director, according to the job bulletin you provided, include “evaluating, negotiating, and recommending professional services agreements and construction contracts [...]” Therefore, if selected as Assistant Director of Public Works, you would be making or participating in making professional services contracts between the City and EKI if you engaged in these duties.

Moreover, under Section 1090, “the prohibited act is the making of a contract in which the official has a financial interest.” (*Honig, supra*, 48 Cal.App.4th at p. 333.) While Section 1090 does not specifically define the term “financial interest,” case law and Attorney General Opinions state that prohibited financial interests may be indirect as well as direct, and may involve financial losses, or the possibility of losses, as well as the prospect of pecuniary gain. “However devious and winding the chain may be which connects the officer with the forbidden contract, if it can be followed and the connection made, the contract is void.” (*People v. Deysher* (1934) 2 Cal.2d 141, 146.) You have identified four distinct possible financial interests,⁵ which we discuss in turn.

Repurchase agreement: First, under your stock repurchase agreement with EKI, you hold a promissory note payable by EKI over sixty months at an annual interest rate of six percent. Under this promissory note, EKI must pay you \$810.70 per month, or \$9,728.40 per year, until October 5, 2023. You are therefore a creditor of EKI. Courts have found that “a creditor-debtor relationship constitutes a prohibited financial interest under section 1090.” (*People v. Watson*, 15 Cal. App. 3d 28, 33; see also *Collins* Advice Letter, No. A-21-118 [just like a official has a financial interest in a contract that involves their current employer because they have an interest in the overall financial success of the company (84 Ops.Cal.Atty.Gen. 158, 161-162 (2001), an official would also have an interest in the continued financial success of their former company that intends to pay out the official’s equity stake over a ten-year period].) You indicate that it is possible, in the event of a conflict of interest, that you could renegotiate the repurchase agreement or delay or extend the repayment period. However, delaying or extending the repayment period does not dissolve the interest, and absent other hypothetical changes, the promissory note under the repurchase agreement between you and EKI constitutes a financial interest for purposes of Section 1090.

Ownership of EKI stock in ESOP: Second, you own 32,418 shares of EKI stock as part of your ESOP account, valued at \$175,531.90, as well as \$4,112.11 in cash, as of the end of the 2019 plan year (the most recent plan year). EKI estimated that your balance of EKI stock accounts for approximately 1.8% of the total number of shares of stock in the ESOP. While Section 1090 does not define the term “financial interest,” we have previously advised that “it appears that the Legislature considers stock ownership in a corporation with whom a public agency is contracting to be a type of financial interest that raises issues under Section 1090.” (*Peters* Advice Letter, C-14-036.) Therefore, unless the noninterest exception discussed below applies, your ownership of EKI stock constitutes a prohibitory financial interest for purposes of Section 1090.

Future ESOP distributions: Third, you have an interest in EKI’s ESOP, a defined contribution plan intended to qualify under federal Internal Revenue Code Section 4975(e)(7). Beginning in November 2023, EKI is obligated under the ESOP to begin making distributions to you from the ESOP account. These distributions must be completed within five years and will exceed five percent of your annual income. You have indicated that you intend to transfer these disbursements from the EKI ESOP into another tax-deferred retirement account, an action that would not result in taxable income. As noted in the *Peters* letter, however, for purposes of Section 1090, whether payments are technically “income” under tax law is not relevant. Rather, we have advised payments made for the benefit of an official are generally financial interests, regardless of

⁵ In your advice request, you identify six potential financial interests, one of which is the “overlap of repurchase agreement and ESOP disbursements,” and another is “ESOP stock valuation.” We have consolidated these potential interests with other relevant interests to avoid redundancy.

what form such payments take. (*Peters Advice Letter, supra.*) You have also indicated that during the 2023 calendar year, your ESOP distributions and promissory note payments will overlap. Namely, at some point in 2023, you will receive payments associated with both the repurchase agreement (promissory note) as well as two ESOP disbursements. Since the ESOP is a federally qualified retirement plan, you do not have the option to choose how and when to receive disbursements.

Section 1090 offers no guidance on whether an interest in a defined-contribution plan—such as an ESOP—and fixed payments under such a plan are a financial interest for purposes of Section 1090. We have previously advised that a 401(a)-qualified defined contribution plan and the payments made under such a plan are not financial interests for purposes of Section 1090 because payments made under the plan are defined, fixed benefits that, by law, cannot be altered by any contract. (*Mason Advice Letter (A-18-236)*; *See also, Peters Advice Letter, No. C-14-036 and Diaz Advice Letter (A-15-235).*) Therefore, consistent with our determination in previous advice letters, we find that neither your ESOP plan nor the payments made thereunder are financial interests for purposes of Section 1090.

ESOP dividends: You indicate that EKI has historically issued dividends on stock, with amounts varying depending on annual company profits. These dividends were issued in the form of cash contributions to each ESOP account. However, you have been informed that, starting in plan year 2020, EKI will no longer be issuing dividends on stock. That said, you note that it is possible that EKI could resume dividend payments in the future, the value of which may exceed five percent of your annual income. While this may be true, because this scenario is hypothetical, and EKI does not issue stock dividends at present, we need not analyze whether you have a financial interest in EKI stock dividends.

In summary, we find that, unless one of the statutory exceptions applies, as Assistant Director of Public Works, you would have a financial interest in contracts between EKI and the City. Specifically, the promissory note as part of the stock repurchase agreement, as well as your ownership of EKI stock, constitute financial interests under Section 1090, subject to the statutory exception discussed below.

The Legislature has created various statutory exceptions to Section 1090's prohibition where the financial interest involved is deemed a "remote interest" under Section 1091 or a "noninterest" under Section 1091.5.

Noninterest Exception

Under the noninterest exception, an official is not deemed to be financially interested in a contract made with a for-profit corporation when the official owns less than three percent of the shares of the corporation, provided that the total annual income to the official from dividends of the stock does not exceed five percent of the official's total annual income and *any other payments made to the official by the corporation* do not exceed five percent of the official's total annual income. (Section 1091.5(a)(1).) If a "noninterest" is present, the contract may be made without the officer's abstention.

Your ownership of EKI stock in the ESOP constitutes approximately 1.8% of total stock in all ESOP accounts—less than three percent. Moreover, EKI does not pay you dividends on this

stock. You do receive other payments from EKI under the promissory note, as part of the stock repurchase agreement. You anticipate that these repurchase agreement payments will not exceed five percent of your total annual income. However, starting in November 2023, you will receive distributions from your ESOP that will exceed 5% of your annual income, including at least two ESOP disbursements that will overlap with your repurchase agreement payments. Thus, the noninterest exception does not apply, because future payments made to you by EKI will exceed five percent of your total annual income.

Accordingly, you have a financial interest under Section 1090 in any proposal submitted to the City by EKI. However, as long as you disqualify yourself from all participation and play no role whatsoever in the contracting process,⁶ the City is not prohibited from contracting with EKI.

If you have other questions on this matter, please contact me at (916) 322-5660.

Sincerely,

Dave Bainbridge
General Counsel

By: Toren Lewis
Counsel, Legal Division

TAL:dkv

⁶ Note that a decision to modify, extend, or renegotiate a contract constitutes involvement in the making of a new contract under Section 1090. (See *City of Imperial Beach v. Bailey* (1980) 103 Cal.App.3d 191.)