

Date of Hearing: July 3, 2012

ASSEMBLY COMMITTEE ON JOBS, ECONOMIC DEVELOPMENT AND THE
ECONOMY

V. Manuel Pérez, Chair

SB 1510 (Wright) – As Amended: June 12, 2012

SENATE VOTE: 37-0

SUBJECT: Department of General Services: small business contracts

SUMMARY: Tightens the bidder requirements for demonstrating that a small business or microbusiness will serve a commercially useful function (CUF) in carrying out a state contract. By meeting the CUF requirements, a bidder may claim a 5% bid preference on competitive state contract awards.

Specifically, this bill expands the CUF requirements to include demonstrating that the small business or microbusiness has responsibility for:

- 1) Its own accounts receivable, and that the accounts receivable of the certified small business or microbusiness are not directly or indirectly controlled by the prime contractor, supplier, or wholesaler.
- 2) Negotiating price, determining quality and quantity, ordering, installing, if applicable, and making payment for the products, inventories, materials, and supplies required for the contract.

EXISTING LAW:

- 1) Designates The Department of General Services (DGS) as the administrator of the state Small Business Procurement and Contract Act (Small Business Act), including, but not limited to, a small business certification process and a 5% preference program for bids made by certified small business and microbusinesses.
- 2) Establishes a 25% small business participation goal for contracts financed with the proceeds of the infrastructure-related bond acts of 2006. Through Governor Executive Order, a 25% annual small business procurement participation goal is set for all state contracts made by state entities under the authority of the Governor.
- 3) Establishes a 5% preference for bids made by certified small business and microbusinesses for the award of state procurement contracts. A single bid preference is limited to \$50,000. Non-small businesses must subcontract at least 25% of their contracts with small business to qualify for the small business bidder's preference.
- 4) Requires, as a condition for receiving the preference, that the small business or microbusiness perform a commercially useful function (CUF) in executing the state contract.
- 5) Specifies that information in the bid package demonstrate that the small business or microbusiness does all of the following:

- a) Is responsible for the execution of a distinct element of the work of the contract.
 - b) Carries out its obligation by actually performing, managing, or supervising the work involved.
 - c) Performs work that is normal for its business services and functions.
- 6) Applies civil penalties for any person who knowingly and fraudulently represents that a CUF is being performed in order to obtain or retain a bid preference or a state contract.
 - 7) Defines a small business as independently owned, not dominant in its field of operation, domiciled in California, employing 100 or fewer employees, and earning \$14 million or less in average annual gross revenues for the three previous years.
 - 8) Defines a microbusiness as a small business which, together with its affiliates, has an average annual gross receipts of \$2.5 million or less over the previous three years, or is a manufacturer with fewer than 25 employers.

FISCAL EFFECT: The measure was referred from the Senate Committee on Appropriations to the Senate Floor pursuant to 28.8.

COMMENTS:

- 1) **Bill Purpose:** According to the author, "SB 1510 will codify and strengthen existing laws pertaining to small businesses bidding on state work in order to stop the practice of using sham small businesses to get state contracts.

SB 1510 seeks to strengthen these existing policies by providing DGS with clearly defined language to identify phony small businesses. Right now, DGS' ability to enforce compliance is hindered, due to the very broad definitions of compliance requirements. The current statute sets a very low threshold, thereby allowing CSBs/DVBEs with little or no employees or inventory to compete against CSBs/DVBEs who do hire their own employees.

SB 1510 will clarify that the small business: Must be responsible for negotiating price, determining quality and quantity and pay for the material itself. SB 1510 will provide a clear set of rules so that legitimate small and disabled veteran businesses can fairly compete for state business."

- 2) **Small Business Preferences:** The Small Business Act, administered through DGS, was implemented more than 30 years ago to increase the participation of small business within the state's procurement process. In 1989, a disabled veteran owned business enterprise (DVBE) component and a 3% annual procurement participation goal was added to SBA. While existing law has no annual small business goal, since 2001 there have been four Executive Orders (EOs) specifying a 25% annual goal for small business participation in state procurement.

In order to assist state government entities in reaching the small business and DVBE participation goals, contracting entities are provided a number of specific tools, including bid

preferences, a streamlined procurement method, and designation of small business procurement liaisons at every agency. SB 1510 proposes to tighten the requirements for claiming the small business and microbusiness bid preference.

Certified small business and microbusiness bidders and other bidders that commit to using certified small business and microbusiness subcontractors are eligible for a 5% bid preference where the solicitations are made either on the basis of lowest responsible dollar bid, or on the basis of highest score, considering factors in addition to price. DVBE bidder and firms that commit to using DVBEs may also receive a bid preference of between 1% and 5%. There are programmatic limits to the overall value of these preferences with a single bid preference limited to \$50,000 and the combination of all preferences not exceeding \$100,000 (many DVBEs are also certified small businesses allowing for two preferences).

The purpose of these preferences is to help these targeted businesses to successfully compete with larger size firms and national chains for state contracts. In applying these preferences to a state contract, a bidder is required to demonstrate that the small business, microbusinesses or DVBE will perform a CUF in executing the contract. The CUF requirement is designed to prevent a bidder from using a business as a "pass through" or "front" for another business that would otherwise not qualify for the small business, microbusiness or DVBE bid preference. The CUF requirement applies to all state purchasing activities, including contracts for goods, services, informational technology and public works.

Current law requires a business to (1) be responsible for a distinct element of the contract; (2) actually perform, manage, or supervise contract related work; and (3) perform a task that is normal for its business, in order to be considered as serving a CUF.

A contractor or subcontractor is not considered performing a CUF if the contractor's or subcontractor's role is limited to that of an extra participant in a contract, through which funds are passed to other businesses, which actually perform the contract work. The contracting entity has the challenging task of making a CUF determination prior to awarding the contract, as the bid preference is likely to be a determining factor in a business obtaining the bid. Small business and DVBE advocacy groups, like those sponsoring SB 1510, believe that the CUF rules are being exploited in practice, resulting in state contracts being awarded to inappropriate bidders based on the use of small businesses that are simply "fronts" for other businesses.

SB 1510 adds to the CUF requirements by having the bidder also demonstrate that the small business and microbusiness is financially and administratively independent of the prime contractor, suppliers or wholesaler.

- 3) Proposed DGS Regulations: Existing law only applies the CUF requirement to small businesses and microbusinesses. Statute does not currently address the standards by which a DVBE is certified including requirements for material financial and administrative control. In 2011, DGS began a comprehensive update of its DVBE regulation to reflect a range of statutory changes between 2003 and 2010. In addition, DGS is proposing the inclusion of language substantially similar to the existing and proposed CUF provisions in SB 1510.

The Committee may wish to consider codifying DVBE CUF requirements to ensure that future regulatory changes are kept consistent with the CUF requirements for small business, microbusiness.

- 4) Historical Small Business Procurement Participation: Despite the longstanding existence of the Small Business Act, periodic statutory upgrades, and EOs, the state's success in achieving small business and DVBE participation goals in state procurement contracts has been inconsistent.

Since 2001, when the first EO set the 25% small business participation target, the state has met its goal only three times. In the most recent report on procurement, 2008-09, DGS reported that \$2.4 billion (26.8%) out of a total of \$8.96 billion of all state contracts to small businesses. This represents a \$2.0 billion increase in small business contracts from 2007-08. The state has only once achieved its 3% DVBE participation goal, that being in 2007-08 when \$190 million in contracts (3.04%) were awarded to bids that included DVBEs.

- 5) California's Small Business Economy: California's dominance in many economic areas is based, in part, on the significant role small businesses play in the state's \$1.9 trillion economy. Businesses with fewer than 100 employees comprise nearly 98% of all businesses, and are responsible for employing more than 37% of all workers in the state.

Among other advantages, small businesses are crucial to the state's international competitiveness and are an important means for dispersing the positive economic impacts of trade within the California economy. Small businesses have consistently functioned as economic engines. According to the Small Business Administration's Small Business Economy 2011, small businesses nationally outperformed large firms in net job creation nearly three out of four times from 1992 through 2010 when private-sector employment rose.

Small businesses have also played an important role in challenging economic times. During the nation's economic downturn from 1999 to 2003, microenterprises (businesses with fewer than five employees) created 318,183 new jobs or 77% of all employment growth, while larger businesses with more than 50 employees lost over 444,000 jobs.

During the most recent recession, however, small businesses have been especially hard hit. Equifax reported that bankruptcies in California rose by 81% in 2009, as compared to 44% nationally. This trend continued in 2010 where the Equifax report stated that while in general bankruptcies were down across the nation (26% decrease), small business bankruptcies in California accounted for almost 20% of all small business bankruptcies in the nation. In 2011, the metropolitan statistical areas (MSAs) in western states continued from the final quarter in 2010 to lead the nation in small business bankruptcies. The region, however, also experienced the most significant decrease in bankruptcy filings year over year from Q1 2011 to Q1 2012—more than a 40% decline in some MSAs.

- 6) Related Legislation: The following is a list of related legislation.
 - a) AB 31 (Price) Small Business Contract Preferences and Enforcement: This bill made several key changes to state procurement procedures including increasing the maximum contract threshold amount for awards to a small business and DVBE, under a specific

streamlined procurement process, from \$100,000 to \$250,000. Further, the bill required contractors that made contract commitments to include small business or DVBE participation to report the final percent of the contract actually paid to these entities. Status: The bill was signed by the Governor, Chapter 212, Statutes of 2009.

- b) *AB 926 (Ruskin) Loss Leader Notice Requirements*: This bill required certain advertising of state contracting opportunities to include a specified statement relating to an existing prohibition against the use of "loss leaders." Specifically, the bill requires every solicitation that appears in the California State Contracts Register including informational technology equipment to contain the following statement, "It is unlawful for any person engaged in business within this state to sell or use any article or product as a "loss leader." Status: The bill was signed by the Governor, Chapter 490, Statutes of 2009.
- c) *AB 761 (Coto) Small Business Preference for Infrastructure Bonds*: This bill required each state agency awarding contracts that are financed with proceeds from the infrastructure bonds approved by voters in November 2006 to establish a 25% small business participation goal for state infrastructure construction contracts and to provide specified assistance to small businesses bidding on state infrastructure bond-related contracts. Status: The bill was signed by the Governor, Chapter 611, Statutes of 2007.
- d) *SB 115 (Florez) DVBE Procurement Preferences*: This bill made various changes to the DVBE Program, including requiring DGS to establish a state agency-wide mandatory DVBE participation incentive. The bill also requires the DGS Small Business Advocate to provide specified services to small businesses and certified DVBEs. Additionally, this bill requires DGS to adopt a streamlined reporting procedure for state agencies to use in reporting their DVBE participation to the Department of Veterans Affairs. Status: The bill was signed by the Governor, Chapter 451, Statutes of 2005.

REGISTERED SUPPORT / OPPOSITION:

Support

California Small Business Association (joint-sponsor)
Coalition of Small and Disabled Veteran Businesses (joint-sponsor)
California Asian Pacific Chamber of Commerce

Opposition

None received

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