

Date of Hearing: January 5, 2010

ASSEMBLY COMMITTEE ON JOBS, ECONOMIC DEVELOPMENT AND THE
ECONOMY

V. Manuel Perez, Chair

AB 177 (Ruskin and V. Manuel Perez) – As Amended: January 4, 2010

SUBJECT: Penalties under the State Business Procurement and Contract Act

SUMMARY: Increases and conforms penalties for persons who falsely engage in activities relating to the Small Business Procurement and Contract Act (Small Business Act), including small businesses, microbusinesses, and disabled veteran-owned business enterprises (DVBE). Specifically, this bill:

- 1) Increases penalties for falsely obtaining small business certification. The bill increases the term of the small business certification revocation period from not less than one year to not less than five years. The bill also increases the term of the suspension from doing business with the State of California from 6-36 months to 3-10 years for violating state procurement requirements. For additional and subsequent violations, the bill increases the period of revocation of the small business certification from a maximum of three years to a maximum of 10 years. Subsequent and additional violations also require that the seller's permit be revoked.

These increased penalties apply to violations where the business is found to have obtained small business or microbusiness certification based on fraudulent information and has also been awarded a contract that the business would not otherwise have been awarded except for the business' status as a certified small business.

- 2) Requires recovery of investigation costs for false small business certification. Requires a business that has been found to have fraudulently obtained classification as a small business or microbusiness to pay the awarding department an amount equal to the costs incurred for investigating the improperly obtain certification.
- 3) Increases penalties for a variety of other fraudulent activities related to certified small businesses. The bill increases penalties for any person who willingly and knowingly makes false statements or takes fraudulent actions in order to:
 - a) Represent themselves or aid someone else in representing themselves as a small business;
 - b) Influence a decision on small business certification;
 - c) Obstruct or impede an investigation into a business' qualifications as a certified small business;
 - d) Obtain or help others to obtain public moneys, bid preferences or state contracts; or
 - e) Represent that a commercially useful function (CUF) is being performed in order to obtain or retain a bid preference or state contract.

The increased penalties include raising the maximum civil penalty from \$5,000 to a two-tiered system where the penalty for the first violation ranges from \$10,000 to \$30,000 and each additional and/or subsequent violation ranges from \$30,000 to \$50,000. The small business revocation period is also extended from not more than one year to a period of not less than five years. Businesses would also face longer suspension periods from bidding on, or participating in, state contracts: 6 to 36 months in existing law as compared to 3 to 10 years proposed in this bill. Further, while a business is operating in the suspension period, its seller's permit is revoked and the business is required to reimburse the awarding department and Department of General Services (DGS) for their costs in investigating the violation.

- 4) Extends revocation of DVBE certification and prohibition on further state business. The bill modifies the length of time an individual is suspended pursuant to the Military Code from doing business with the state from not less than three years with no cap on the maximum suspension period to setting a specific limit of between 3 and 10 years. If a DVBE is found to be in violation of the procurement rules below, then its DVBE certificate is revoked for at least an additional two years, from not less than three years in existing law to not less than five as specified in the bill.

For subsequent violations, the bill increases the period of revocation of the DVBE certification from not less than five years to not less than 10 years, with the business' seller's permit also being revoked. The bill also requires recovery of investigation costs for awarding department in successful civil actions. These increased penalties apply for any person who willingly and knowingly makes false statements or takes fraudulent actions in order to:

- a) Obtain themselves or aid others to obtain a DVBE certification;
 - b) Influence a decision on DVBE certification;
 - c) Obstruct or impede an investigation into a business' qualifications as a certified DVBE;
 - d) Obtain or help others obtain public moneys, obtain or retain a bid preference or state contract.
- 5) Creates a new prohibition against knowingly and with intent to make false statements in order to obtain or retain a DVBE preference or state contract. The bill expands the list of prohibited activities under the Military Code to include any person who willingly and intentionally provides a false representation that the DVBE is performing a commercially useful purpose (CUF.)
- 6) Adds further penalty for knowingly and willingly making false representations that a CUF is being performed by a small business, microbusiness or DVBE. The bill requires that all existing contracts between the business and any awarding department be terminated. The State Controller is directed to withhold all payments to the business except for outstanding invoices.

EXISTING LAW

- 1) Designates DGS to administer the state Small Business Act, including, but not limited to, small business, microbusiness and DVBE certification processes.
- 2) Declares it is state policy that small businesses and microbusinesses receive a fair portion of the total purchases and contracts or subcontracts for state goods, services, information technology, and construction.
- 3) Establishes a 25% small business participation goal for all contracts financed with the proceeds of the infrastructure-related bond acts of 2006.
- 4) Sets an annual DVBE contract participation goal of 3% for each state department, including school districts when expending certain state moneys for goods and services.
- 5) Requires state entities contracting for materials, supplies, equipment, alterations, or repairs to meet specified DVBE participation goals when submitting a bid for a state contract, including the requirement that the bid go to the lowest responsible bidder that meets the DVBE goal.
- 6) Requires DGS to adopt written policies and guidelines for establishing a uniform process for state contracting that provides a DVBE bid incentive. These policies and guidelines are required to include a tracking system to monitor compliance with the 3% contract participation goal. Administratively, awarding departments are authorized to offer DVBE bid preferences of between 0 and 5%.
- 7) Establishes preferences for bids made by certified small businesses and microbusinesses, including:
 - a) Providing a 5% preference for awards of state procurement contracts where 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.
 - b) Limiting a single bid preference to \$50,000. In instances where a small business qualifies for multiple bid preferences, the preference cannot be greater than the bid price or more than \$100,000. Application of the bid preference is also prohibited from resulting in a bid which exceeds the amount of funds appropriated by the Legislature, as specified.
 - c) Permitting non-small businesses that subcontract at least 25% of their contracts with small businesses to qualify for the small business bidder's preference.
- 8) Provides for the following definitions under the Small Business Act:
 - a) Small business: A business that is independently owned, not dominant in its field of operation, domiciled in California, employing 100 or fewer employees, and earning \$10 million or less in average annual gross revenues for the three previous years.
 - b) Microbusiness: A small business that has average annual gross receipts of \$250,000 or less during the previous three years or is a manufacturer with 25 or fewer employees.

- c) DVBE: A business entity that is at least 51% owned or controlled by one or more disabled veterans, as specified.

FISCAL EFFECT: Unknown

COMMENTS:

- 1) Authors' purpose: The purpose of this bill is to address fraudulent behavior by individuals and businesses who seek to improperly obtain or retain small business and DVBE certification, bidding preferences or participation in state contracts.

Testimony in legislative hearings by DGS, small business groups and DVBE advocates has reported that some current and prospective state contractors have fraudulently represented that they are a certified small business, DVBE, or that they will be utilizing the services of a certified small business or DVBE subcontractor.

In other reported cases, individuals and businesses have made false statements in order to assist an ineligible business to become certified or to help them retain their improperly obtained certification once the business is being investigated by state officials. Still other individuals and businesses have fraudulently submitted bid packages that commit to using a certified DVBE or small business, but in actuality the subcontract is never let or the contracted work is inconsequential and only included in order to obtain a bid preference.

While existing law contains penalties for contractors that fraudulently bid, state enforcement of these laws has been limited. This bill, according to the authors, would incentivize enforcement by authorizing awarding departments to be reimbursed for the cost of successful investigations and providing more substantial deterrents to knowingly and willingly making false representations.

- 2) California Small Business: California's dominance in many economic areas is based, in part, on the significant role small businesses play in the state's \$1.8 trillion economy. Businesses with fewer than 100 employees comprise more than 99% of all businesses, and are responsible for employing more than 57% of all workers in the state.

As an example, small- and medium-sized 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. Of the over 52,000 companies that exported goods from California in 2006, 95% were small- and medium-sized enterprises (SME) with fewer than 500 employees. These SMEs generated nearly half (44%) of California's exports in 2006. Nationally, SMEs generated only 29% of total exports.

Historically, small businesses have functioned as economic engines, especially in challenging economic times. During the nation's economic downturn from 1999 to 2003, microenterprises (businesses with less 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. From 2000 to 2001, microenterprises created 62,731 jobs in the state, accounting for nearly 64% of all new employment growth. Unfortunately during the current recession, small business have been especially hard hit with small business bankruptcies up

81% for the 12 months ending September 2009, as compared to the same period in the previous year. Nationally, bankruptcy filings were up 44%, according to Equifax Inc.

Because of their importance in the state economy, small business issues have been a particular focus of the Assembly Committee on Jobs, Economic Development and the Economy (JEDE) for the past several years. In March 2009, JEDE produced a state economic recovery strategy that included several key recommendations on the needs of small business, including helping small businesses meet their short term capital needs. In May 2009, JEDE held a special hearing to learn more about how the recession was impacting small businesses and in October, JEDE's review of the California Enterprise Zone Program included a panel on how the program responds to needs of small business.

Improving enforcement of state procurement laws, as proposed in AB 177, would also address small business access to capital needs by keeping small business contracting preferences to legitimate small business.

- 3) The Small Business Act: The Small Business Act, administered through DGS, was implemented more than 30 years ago to establish a small business preference within the state's procurement process for the purpose of increasing the number of contracts between the state and small businesses.

In 1989, a DVBE component was established with the Small Business Act to address the special needs of disabled veterans seeking rehabilitation and training through entrepreneurship and to recognize the sacrifices of Californians disabled during military service. Under the provisions of the DVBE program, each state agency is required, in awarding contracts throughout the year, to honor California's disabled veterans by taking all practical actions necessary to meet or exceed an annual 3% DVBE participation goal.

Since 2001, there have been four Executive Orders (EOs) and a number of statutory advancements made to strengthen the Small Business Act, including SB 115 (Florez), Chapter 451, Statutes of 2005, which required DGS to establish a DVBE incentive program for state contracts; and AB 761 (Coto), Chapter 611, Statutes of 2007, which specifically codified the 25% small business participation goal for contracts related to revenues expended from the 2006 infrastructure bonds.

Despite the longstanding existence of the Small Business Act, statutory upgrades, and EOs, the state's success in obtaining small business and DVBE participation goals in state procurement contracts has been inconsistent.

For only the second time since the 25% small business participation target was established in 2001 through EO, DGS reported that the state achieved its small business target by awarding 28.31%, or \$2.65 billion, of the value of all contracts to small businesses in the 2006-07 fiscal year. This represents a \$1.3 billion increase in contracts from 2005-06. The state did not, however, achieve its 3% DVBE participation goal in 2006-07, as only 2.8% of contract dollars, \$186 million, was awarded in contracts including DVBE participation.

- 4) Conflicting Codes: Laws that relate to state contracting appear in several California codes, including the Public Contract, Government, and Military and Veterans Codes. This broad distribution of statute related to state procurement has sometimes led to conflicting and

potentially inefficient contracting activities, as state contracting staff try to blend the different laws together when issuing solicitations of state goods and services. While some of the differences occur simply because an issue is addressed in one code and not another, others provide for a separate treatment of small business and DVBE solicitations. Since DGS estimates that over 80% of DVBEs are also eligible to be certified as a small business, it may be useful to minimize these differences to only those cases when state policy warrants a difference.

As an example, the small business bid preference appears in statute and the DVBE preference only appears in the code of regulations. In another example, a prime contractor who submits a bid package identifying a small business subcontractor may, with the approval of DGS, substitute another certified small business subcontractor when actually doing the work in the contract. This provision is used in cases where the performance of the contract is actually undertaken months after the bid package has been submitted and the original small business subcontractor is no longer available to complete the work. Existing law, however, does not offer such a statutory option for DVBE subcontractors. In this instance, it appears as if similar flexibilities between the small business and DVBE programs may be advantages for encouraging DVBE subcontractor participation.

While this bill harmonizes some of the inconsistencies between the DVBE and small business programs, others still remain. The authors may wish to consider further harmonizing amendments as the measure moves forward.

- 5) Increased penalties: AB 177 significantly increases penalties for fraudulent behaviors that are determined to have been undertaken with the intent and knowledge of the individual or business. The bill proposes to increase the length of time a contractor is prohibited from doing business with the state, revoke sellers' permits, and terminate other state contracts for individuals and business found guilty of specified violations. As an example, the bill increases the suspension term for doing business with the state from 6-36 months to 3-10 years for certain small business related violations. In some cases, these penalties may be more extreme than necessary to discourage fraudulent behavior and others, based on the significant size of a state contract, may still be too little. The authors may wish to consider providing more specific statutory direction regarding sizing the penalty to the total value of the contract.
- 6) Good faith effort eliminated: As part of the July 2009 budget deal, the Governor signed AB 21 (4th Extraordinary Session), Chapter 19, Statutes of 2009, which eliminated the "good faith effort" (GFE) option for potential state contractors in meeting the 3% DVBE contracting goal. Previously, when the compulsory DVBE participation clause was included in a solicitation, a prospective contractor had three compliance options:
 - a) Identify and commit to subcontracting with a certified DVBE for at least 3% of the work;
 - b) Demonstrate a credible effort to obtain DVBE participation, sometimes referred to as making a GFE; or
 - c) Reference a DGS-approved DVBE Business Utilization Plan.

Bidders would have been considered to have made a GFE if their bid package included information on the steps they took to locate and consider DVBE subcontractors. DGS proposed removing the GFE option as a way to eliminate the cost to the state to review the contractors' documented efforts. DGS estimates that the state spent \$3.5 million annually evaluating prospective bidders' GFEs and that bidders spent nearly \$18 million annually to perform the GFE – all of which still resulted in less than 3% of all state contracts including DVBEs in the last reporting period.

As a new program modification, there are still questions as to whether the elimination of the GFE will actually lead to higher DBVE participation rates or will simply increase fraudulent behavior by contractors trying to obtain state contracts.

- 7) Related legislation: These provisions were originally included in SB 1942 (Ruskin) from the 2007-08 Session, which was vetoed. According to the Governor's message, "The historic delay in passing the 2008-2009 State Budget has forced me to prioritize the bills sent to my desk at the end of the year's legislative session. Given the delay, I am only signing bills that are the highest priority for California. This bill does not meet that standard and I cannot sign it at this time." Other related legislation includes the following:
- a) AB 31 (Price): This bill made several key changes to state procurement procedures, including increasing the maximum contract threshold amount for awards to a small business or DVBE, under a specific streamlined procurement process, from \$100,000 to \$250,000. Further, the bill requires contractors that made contract commitments to include small business or DVBE participation to report the final percentage of the contract actually paid to these entities. Status: Signed by the Governor, Chapter 202, Statutes of 2009.
 - b) AB 761 (Coto): 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: Signed by the Governor, Chapter 611, Statutes of 2007.
 - c) AB 1189 (Assembly Committee on Veterans Affairs): This bill would have required awarding departments, prior to issuing an award, to obtain a copy of a contractor's DVBE certification letter with reference number and to check the contractor's standing as a certified DVBE on the DGS website. Status: The bill was amended on the Senate Floor and all language relating to DVBEs was removed.
 - d) AB 2773 (Price): This bill would have increased the maximum contract threshold amount for awards to small business, including microbusiness and DVBEs under the streamlined procurement process, from \$100,000 to \$250,000, as specified. Further, the bill required contractors that made contract commitments to include small business or DVBE participation to report the final percentage of the contract actually paid to these entities. Status: Held under submission in Senate Appropriations Committee in 2008.
 - e) SB 115 (Florez): This bill made various changes to the DVBE procurement program, including requiring DGS to establish a state agency-wide mandatory DVBE participation

incentive. This 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: Signed by the Governor, Chapter 451, Statutes of 2005.

f) SB 642 (Denham): This bill would have increased the maximum contract threshold amount for awards to small business, including microbusiness and DVBEs under the streamlined procurement process, from \$100,000 to \$250,000, as specified. Further, the bill required contractors that made contract commitments to include small business or DVBE participation to report the final percentage of the contract actually paid to these entities. Status: Held under submission in Senate Appropriations Committee in 2008.

8) Double Referral: When AB 1942 was introduced in 2008, Assembly Rules Committee referred the measure to JEDE and the Assembly Committee on Business and Professions. Should AB 177 receive a favorable vote from JEDE, the bill may need to be similarly referred.

REGISTERED SUPPORT / OPPOSITION:

Support

None received

Opposition

None received

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