CLIENT ALERT:

CALIFORNIA'S BUDGET WOES THREATEN ITS ABILITY TO PAY ITS CONTRACTORS: WILL YOUR NEXT PROGRESS PAYMENT BE AN IOU?

The desperate disease requires a dangerous remedy.

– Guy Fawkes, November 6, 1605.

Desperate times don't call for desperate measures; desperate times call for creative thinking.

– California State Senate President Pro Tem Darrell Steinberg, December 19, 2008.

I'd gladly pay you Tuesday for a hamburger today.

– J. Wellington Wimpy, *We Aim to Please*, 1934.

As the California budget stalemate reaches unprecedented heights, and the State of the California's cash and credit reaches unprecedented lows, contractors working for State agencies are facing work stoppages, contract suspensions or terminations, and delayed payments.

State agencies also are considering another option: paying their contractors with "registered warrants," a.k.a. IOUs. The pressing questions are "Will the State resort to IOUs?" and "If it does, what will that mean for State contractors?" The short answers are (1) the State is unlikely to issue IOUs unless it has to, but, if there's no budget by the Spring, it probably will have to do so; and, (2) if the banks elect to accept IOUs (as they did the last time the State issued them), then IOUs will have minimal impact on contractors, but, if the banks refuse to accept them, IOUs will have a dramatic effect on contractors that cannot afford to wait for a budget to pass before they can redeem the IOUs for payment. In some instances, contract provisions and prompt payment statutes will afford contractors some relief.

What Are Registered Warrants, a.k.a. IOUs?

Registered warrants are promises to pay that are issued by the State Controller's Office, stamped "registered" and endorsed on the back by the State Treasurer as "not paid for want of funds." Gov. Code § 17270. Under the Government Code, registered warrants are legal investments for funds of all banks and are negotiable instruments. *Id.* §§ 17202-17205. Registered warrants bear interest at a rate fixed by California law from the date of registration to the date of maturity, or, if they bear no date of maturity, the date upon which the California Treasurer advertises that they are payable upon presentation. *Id.* §§ 17212, 17275-17276. The maximum interest is five percent per year. *Id.* § 17.222. In this sense, they are akin to involuntary bonds: the recipient is compelled to invest in the State, and the State is legally obligated to pay the recipient with a specified rate of return.

How Likely Is the State to Issue IOUs in Lieu of Contract Payments?

It is uncertain whether the State will issue registered warrants in the immediate future. As the State Controller recently put it:

> Without a budget solution, my office has few choices to deal with the immediate cash crisis. None of these options are in our best interest, nor do they offer any guarantees.
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> …
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> The last option is issuing Registered Warrants – or IOUs. They bear interest and are issued to replace regular warrants when there is not enough cash available to pay the State's obligations.
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> …
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> There is no prohibition against using [registered warrants] for vendor payments….

December 8, 2008, State Controller John Chiang Statement to the Senate and Assembly Joint Convention, available at http://www.sco.ca.gov/eo/fiscalissues/index.shtml.

As the State Controller stated in December, registered warrants are "rarely issued," having been used only once since the Great Depression. *Id.* On that occasion, in July 1992, California ran out of cash due to its failure to enact a budget for the 1993 fiscal year. Because of the budget impasse, it was unable to borrow money to meet its financial obligations, and State agencies were unable to pay their vendors. In order to meet its general fund obligations, including paying such vendors, California issued registered warrants, and State agencies paid vendors with those warrants. The impact on contractors was minimized because a majority of financial institutions were willing to pay cash for registered warrants at their full face value upon presentation. (The banks, in turn, were entitled to interest at an annual rate of 5% when they were able to redeem the warrants in September 1992, when the Governor signed the budget.) *See California Department of Health Services*, U.S. Dep't of Health and Human Services, Departmental Appeals Board, Appellate Division, Docket No. A-98-30, Control No. CA-98-001-MAP, Decision No. 1670 (9/25/98), available at http://www.hhs.gov/dab/decisions/dab1670.html.

State Controller Chiang has been reluctant to issue registered warrants but recently acknowledged that the State is running out of options. In his December 8 statement, Mr. Chiang stated that "[t]here is no reason to believe [issuing registered warrants] is a viable option" because it "sends the wrong message to our creditors by showing that we cannot pay our bills." He added that issuing these warrants "could put the State in serious legal and financial trouble" and frustrate its ability to manage cash by putting non-priority payments (*i.e.*, repaying the warrants) ahead of priority payments (*see* Gov. Code § 17280).

Still, while there are many reasons to believe the State should not issue registered warrants, the State's financial woes may leave it with no choice. In his December 8 statement, Mr. Chiang explained that the State typically covers revenue shortfalls by internal borrowing (from special funds) and external borrowing. In recent years, the total amount available to the State from internal borrowing has been approximately $18 billion. As of November 30, 2008, there was only $4 billion remaining, and Mr. Chiang projected that by March 2009 there will be nothing left to borrow from these funds. The State also has resorted to external borrowing every year but one in the past 25 years, ranging from $1 billion in 1999 to $12.5 billion in 2002. In 2008, the State determined that it needed to externally borrow $7 billion, but, due to the severely weakened condition of the State's finances coupled with the global financial crisis, it was only able to borrow $5 billion. The Controller's office anticipates the size of the State's revenue shortfall for the remainder of the fiscal year will be in excess of $9.7 billion. His office found that this shortfall poses a clear threat to the State's ability to pay all of its bills starting this Spring and "this Summer looks much worse." *Id.*

More recently, on January 16, 2009, Mr. Chiang announced that he will be forced to delay $3.7 billion in payments, including payments to vendors, starting in February unless the Legislature and Governor reach a budget-balancing deal before February 1, 2009. Mr. Chiang also stated that, if no budget is passed through the Spring, his office is prepared to issue registered warrants, and that his staff has been in discussions with banks to determine whether any would cash the warrants for recipients. So far, no bank has committed to do so. January 16, 2009 Press Release: "Chiang Announces Payment Delays to Manage Cash Crisis," available at http://www.sco.ca.gov/eo/pressbox/2009/01/pr09003.pdf.

Can the State Legally Issue IOUs to Contractors?

While it is clear that the issuance of registered warrants is constitutional and that Sections 17200, *et seq.*, of the Government Code authorize issuance of these warrants (1967 A.J. 4110), payment by IOUs may violate the State's contractual or statutory duties to pay contractors promptly.

The State's authority to issue registered warrants in lieu of cash payments withstood constitutionality challenges when they were issued during the Great Depression. The courts validated the use of IOUs by invoking the "appropriation doctrine," which states that an obligation is not considered a debt or liability within the State Constitutional limitation on indebtedness (Section 1 of Article XVI) if an appropriation is made from existing funds or reasonably anticipated funds subject to appropriation. *Riley v. Johnson*, 219 Cal. 513, 520 (1933) ("*Riley I*"); *Riley* v. *Johnson*, 6 Cal. 2d 529, 531-32 (1936) ("*Riley II*"); *Raymond v. Christian*, 24 Cal. App. 2d 92 (1938).

More recent court decisions evaluating other State debt relief actions have cited the *Riley* decisions favorably. *Flournoy v. Priest*, 5 Cal. 3d 350, 352 (1971) ("In the past the problem of dealing with temporary insufficiencies of the funds in the state treasury to meet current operating expenses of the state government has been solved by the use of registered warrants. The validity of the registered warrant procedure was established in [*Riley I* and *Riley II*], which upheld the constitutionality of chapter 605 of the Statutes of 1933"); *Pooled Money Inv. Bd. v. Unruh*, 153 Cal. App. 3d 155, 162-64 (1984).

Although warrants are constitutional, the issuance of warrants payable only in the future may subject the State to liability for prompt payment interest penalties. State civil service employees successfully challenged State payments by IOUs in 1992 under the Fair Labor Standards Act. *Biggs v. Wilson*, 1 F.3d 1537 (9th Cir. 1993), *cert. denied*, 127 L. Ed. 2d 94, 114 S. Ct. 902 (1994); *see also Caldman v. California*, 852 F. Supp. 898, 900-02 (E.D. Cal. 1994). In *Biggs*, the court held that the State's failure to distribute paychecks on payday, notwithstanding the circumstances of the budget impasse, constituted a violation of the implied "prompt payment" requirement under the FLSA, and subjected the State to liquidated damages and prejudgment interest.

While the FLSA will not protect contractors from getting IOUs, contractors may argue that they are due the same protections under California's prompt payment statutes. Section 927 of the Government Code applies to most State procurement contracts and requires payment within 45 days after the contractor submits an undisputed invoice. If a contractor were to assert that issuance of an IOU within that time does not satisfy the statute, the State would likely point to language in Section 927.4 stating that the Controller must issue a "warrant for payment" within the statutory deadline.

For contracts for public works projects in California, Sections 10261.5 and 10853 of the Public Contract Code provide that failure by the State or University of California to make timely progress payments will entitle the contractor to collect interest in the amount of 10 percent per year. Section 7107 of the Code provides that a failure by the State or UC to release undisputed retention within 60 days of completion of a work of improvement will entitle the contractor to recover a charge of 2 percent per month. Contractors working on covered projects may argue that issuance of IOUs in lieu of progress payments or retention releases violate these code sections. In response, the State may argue that IOUs do not violate Sections 10261.5 and 10853 because they each provide that "a payment request shall be considered properly executed if funds are available for payment of the payment request." The State would not be able to make this argument under Section 7107, however, since that language is absent from that section 7107.

The courts have not yet addressed how any of these statutes would be applied where the State has issued IOUs in lieu of payments.

If the State Issues IOUs, How Will Contractors Be Affected?

The impact IOUs would have on contractors would depend on several factors: whether banks will accept the IOUs; whether the contractor can afford to wait for the money it is due; and whether their contracts provide for additional relief.

If, as occurred the last time the State issued IOUs, financial institutions agree to accept the IOUs (they are not legally obligated to do so), then contractors will be able to deposit them – the same as cash or checks – and have immediate use of the funds paid. If, on the other hand, the banks refuse to honor the IOUs, then the contractors will have to hold the IOUs until a new budget is passed. Only then will the contractors be able to redeem the IOUs for their face value, plus interest.

If the banks will not accept the IOUs, then the impact on contractors will depend on their ability to wait for payment and on how long that wait will be. Given the interest they will earn on the IOUs until they may be redeemed, contractors may recoup some benefit. For many other contractors, however, especially smaller contractors that do a lot of State work, the impact on their cash flow may be devastating. They may not be able to afford to wait for funds until the State can agree on a budget and then allow contractors to redeem the IOUs. The State could take months to pass a budget. There also remains the possibility, however remote, that the State will never pass a budget. If that were to happen, California may become the first state in history to declare bankruptcy (although it is unclear whether it could do so under federal bankruptcy law), which in turn would leave contractors unable to redeem their IOUs.

Finally, even if the State has the power to issue IOUs to pay a contractor, doing so may still be a breach of contract entitling the contractor to recover its resulting damages. Many State contracts provide for progress and final payments upon the contractor's completion of specified work and do not include lack of funds as an excuse for delayed payment. *See, e.g.,* CalTrans General Conditions for Building Construction, ¶ 7-1.05, available at www.dot.ca.gov/hqlesc/oe/project_ads_addenda/05/05-0L6204/050L62046bk1.pdf. The State may be in breach of those contracts if it issues only IOUs at the times the contracts specify for payment. Many other state contracts incorporate applicable prompt payment statutes into their contractor payment provisions. *See, e.g.,* General Provisions Non-IT Commodities, ¶ 30, available at www.documents.dgs.ca.gov/pd/modellang/GPrionIT0407.pdf; and IT General Provisions, ¶ 30, available at www.documents.dgs.ca.gov/modellang/GeneralProvisions.htm. To the extent that issuing IOUs in lieu of contractor payments violates those statutes, the State would also breach those contracts and entitle the contractors to recover the direct damages they suffer as a result.

If you have any specific questions about registered warrants, please do not hesitate to contact us.

Aaron P. Silberman
ROGERS JOSEPH O'DONNELL
311 California Street
San Francisco, CA 94104
asilberman@rjo.com
415.365.5339