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## California IT Vendors Paid by “Registered Warrants” (IOUs) – Issues and Options

by Robert S. Metzger, Benjamin A. Wiles and Karen M. Harkins

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*The State of California normally pays its vendors with general warrants (sometimes known as “regular warrants”), which are akin to checks and are payable on demand. Since July 1, 2009, because of the State’s continuing budgetary crisis, most vendors with state contracts have been paid with “registered warrants” – also known as “IOUs.” These registered warrants are not payable on demand, and they are not accepted by many major financial institutions. As a result, vendors are delayed in receiving payment for services that they provide under state contracts.*

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Not all contracts are paid by registered warrants, however. Some contracts are paid from special funds that contain restrictions which entitle vendors to insist on payment by general warrants. Also, there are a number of court cases and statutory enactments, which will mean that certain vendors must be paid by general warrant.

A vendor paid with registered warrants will receive interest at the rate of 3.75% percent from the date of the warrant until, at the latest, the statutory redemption date (presently set for October 1, 2009). (This assumes that the vendor maintains possession of the physical warrant and tenders it to the State on the redemption date.) For many vendors, however, receipt of interest at the statutory rate will not equal the borrowing cost – whether from internal or external sources – required to finance continuing operations until regular payments are resumed. There are credible arguments that the State of California, in making payment by registered warrants, does not satisfy requirements of the California Prompt Payment Act (“CPPA”). Vendors may be able to claim certain late payment penalties in addition to the statutory interest. Recovery of such additional damages is not assured; the State will argue that the CPPA provides the exclusive remedy for late payment. However, as explained below, there are countervailing arguments that the State has not fulfilled the intent of the CPPA when it pays with instruments not immediately negotiable, and that penalties are payable until redemption.

For some vendors, the cash flow situation may become so acute as to impair their ability to continue to perform. Individual terms employed in IT contracts will govern. Some contracts contain express

requirements that vendors continue to perform even in the event of non-payment. The “model” IT Terms and Conditions, Form GSPD-401IT (Revised and Effective 04/12/2007), at article 41b, requires contractors to “diligently proceed” with the performance of contracts “[p]ending the final resolution of any dispute arising under, related to or involving this Contract.” In extreme situations, however, there is precedent in federal contract cases which suggests that a vendor could treat extended non-payment as a “breach,” discharging its duties to perform. In theory, such a breach is considered “outside” the contract and therefore, arguably, does not arise under, relate to or involve the contract. Vendors should proceed with care before they repudiate a California state contract, even for prolonged non-payment. The same IT standard clause indicates that failure to proceed “shall be considered a material breach” which could expose the contractor to very large damages.

## Background

The State normally pays its vendors, and makes other payments as well, through general warrants. Cal. Gov’t. Code §§ 12440, 17000 et seq. These warrants are akin to checks from the State and are payable on demand. Under State law, warrants can be issued if two requirements are met: the expenditure must be authorized by law, and there must be sufficient unexhausted appropriations to satisfy the warrant in the particular fund on which the warrant is drawn. Most bills paid by the State are paid from the General Fund, which consists of money received into the Treasury and not required by law to be credited to any other fund. Cal. Gov’t. Code § 16300.

The State of California today remains in a budget impasse. The State Controller’s Office (“SCO”) has announced that the State’s current cash deficit requires issuance of individual “registered warrants, also called IOUs, beginning July 2.” See [http://www.sco.ca.gov/eo\\_news\\_registeredwarrants.html](http://www.sco.ca.gov/eo_news_registeredwarrants.html). The SCO describes a “registered warrant” as a “promise to pay,’ with interest, that is issued by the State when there is not enough cash to meet all of the State’s payment obligations.” *Id.* Certain payments, under the State Constitution, or other law, will continue to be made with “regular” or “normal” warrants. See <http://www.sco.ca.gov/5917.html>. As to other payees, including private businesses such as many state vendors, the SCO states that the State has “no alternative but to issue registered warrants.” See [http://www.sco.ca.gov/eo\\_news\\_registeredwarrants.html](http://www.sco.ca.gov/eo_news_registeredwarrants.html).

For otherwise-authorized expenditures where there is insufficient cash in the General Fund to issue general warrants, the State has statutory authority to issue “registered warrants.” Cal. Gov’t. Code § 17221. The SCO explains:

A regular warrant is redeemable by the State Treasurer after it is issued. Registered warrants are negotiable instruments, but they will not be redeemed by the State Treasurer until the warrant matures on October 1, 2009, and the State has enough cash to cover the amount of the warrants.

See <http://www.sco.ca.gov/5935.html>.

This is not the first time that a budgetary crisis has caused the State of California to issue registered warrants instead of general warrants. A similar budget crisis occurred in 1992 and the State was forced to resort to registered warrants. Then, as now, there was an initial period when most banks and financial institutions were willing to accept (“negotiate”) registered warrants, giving immediate credit to depositors. In 1992, as the budget crisis continued, several of the larger financial institutions publicly expressed doubt as to whether they would continue to accept registered warrants in lieu of ordinary payment. In 2009, this already has happened – as after only a few days’ “grace period” in which they accepted registered

warrants, many of California's leading banks, such as a Bank of America, Wells Fargo, Chase, US Bank and Union Bank, have ceased accepting registered warrants as of July 10, 2009.

The budgetary crisis, until resolved, means that the State of California, since July 1, 2009, is paying many of its IT vendors using registered warrants.

#### Issues & Options

##### 1. *Will All State Vendors Be Paid By Registered Warrants?*

No. Statutory restrictions, caselaw and other constraints will mean that some vendors will be paid by general warrants – and some may be paid by a combination of regular and registered warrants, depending on the source of funds.

In California, many “*special funds*” are created by statute to serve particular purposes and to receive payments from other sources of funds associated with such purposes. The statutory basis for creation of special funds is located at Cal. Gov't. Code §§ 16360 *et. seq.* The State Controller has the legal authority, at Cal. Gov't Code § 16310, to borrow from special funds if the General Fund in the Treasury is or will be exhausted upon authorization of the Governor. On December 8, 2008, Controller John Chiang made a statement to the California Senate and Assembly Joint Convention, in which he indicated that the State has 1,100 special funds and that the State borrows internally from 600 of these in order to minimize the costs associated with external borrowing. State Controller's Office, [http://www.sco.ca.gov/eo\\_fiscalissues\\_statement\\_dec08.html](http://www.sco.ca.gov/eo_fiscalissues_statement_dec08.html) (last visited July 14, 2009). He also said that “State law prohibits borrowing from 500 other funds including CalPERS and CalSTRS, and other protected accounts such as the Local Agency Investment Fund.” Payments made from some – but not all – special funds must be made by general warrant and cannot be made by registered warrant, as the latter, as a form of borrowing, would violate the statutory requirements which govern certain special funds.

Vendors should make due inquiry to determine the source of funds used by the State to pay particular contracts. Grounds may be present to assert that the State must pay only by general warrant. There is no single answer common to all state contracts; rather, the answer will be the product of several factors.

An initial question is whether the particular contract is governed by a statutory special fund. As noted, there are 1,100 such statutory funds – and there are material variations in the statutory language. For example:

- Some special funds are created with express statutory authority for the Controller to borrow from such special fund. For instance, there is express statutory authority for the special funds created by the Public Utilities Act, such as the Public Interest Research, Development, and Demonstration Fund, to be used by the Controller for loans to the General Fund. Cal. Pub. Util. § 281.
- Some special funds are expressly exempted from borrowing by the State Controller. For example, Cal. Gov't. Code § 16310(d) provides that the Local Agency Investment Fund and funds classified in the State of California Uniform Codes Manual as bond funds or retirement funds (such as the Public Employees Retirement Fund) may not be used by the Controller for borrowing.
- Other funds do not contain any express guidance regarding whether the Controller may use them for borrowing. The main limitation on borrowing from such special funds is language in Cal. Gov't. Code § 16310(a) to the effect that the Governor may only “direct the transfer of all or any part of

the moneys *not needed* in other funds or accounts to the General Fund” (emphasis added). An example that may be relevant to many IT vendors is the Department of Technology Services Revolving Fund (“Technology Fund”), which was created “to receive all revenues from the sale of technology or technology services provided for in this chapter[.]” Cal. Gov’t. Code § 11544. Its purpose is “to pay, upon appropriation by the Legislature, all costs arising from this chapter, including, but not limited to, operating and other expenses of the board and department and costs associated with approved information technology projects.” *Id.* (emphasis added.)

As of May 10, 2009, when California Governor Schwarzenegger’s IT Reorganization Plan became effective, the Department of Technology Services became the Office of Technology Services (“OTech”), a division within the State Office of Chief Information Officer. See <http://www.dts.ca.gov/> (last visited July 14, 2009). OTech is responsible for administration of the Technology Fund. Vendors may be able to argue that funds in the Technology Fund are needed to pay those who contract with OTech to provide IT services to the State, and therefore such “needed” funds are not available for borrowing pursuant to Cal. Gov’t. Code § 16310. Vendors whose projects are ordinarily funded by the Technology Fund may wish to demand of OTech that it explain and justify whether (and to what extent) the Office believes it has statutory authority to pay by means other than general warrants.

## 2. *Can the State Legally Pay By Registered Warrants Without Violation of the Prompt Payment Act?*

In 1998, the State of California enacted the CPPA, Cal. Gov’t. Code §§ 927 *et. seq.*, which extended the assurance of prompt payment by the State to all its vendors, not just small businesses. The CPPA, at § 927.1(a)(1), provides that “[a] state agency that acquires property or services pursuant to a contract with a business [...] shall make payment to the person or business on the date required by the contract and as required by Section 927.4 or be subject to a late payment penalty.” Cal. Gov’t. Code § 927.4 provides that “[e]xcept as otherwise provided in this chapter, to avoid late payment penalties, the maximum time from state agency receipt of an undisputed invoice to issuance of a warrant for payment is 45 calendar days, including not more than 30 calendar days from the state agency to submit a correct claim schedule to the Controller, and not more than 15 calendar days for the Controller to issue the warrant.”

A credible argument may be made that payment by registered warrant subjects the State to a late payment penalty under the CPPA – even though a vendor which receives, and holds, a registered warrant will receive the face amount and statutory interest at the time of redemption. The core of the argument is that the CPPA, which requires issuance of a payment “warrant” within a time certain, cannot be satisfied with a registered warrant (as it is a mere promise to pay) and can only be satisfied with a general warrant.

The intent of the California Legislature in enacting the CPPA was that state agencies pay properly submitted, undisputed invoices within 45 days of receipt, or automatically calculate and pay the appropriate late payment penalties as specified in this chapter. Cal. Gov’t. Code § 927(b). The Assembly bill analysis of the CPPA indicates that purpose of the CPPA is that “all companies, regardless of size, be paid within 45 days.” Assembly Floor Analysis, AB 2275, 8/20/1998. When the CPPA was introduced, it was noted that “California has been criticized for having a poor record of paying vendors, and that as a result the number of suppliers willing to contract with the state has substantially decreased.”<sup>1</sup> *Id.*

The function of general warrants issued by the Controller is to allow funds to be drawn from the California Treasury. Cal. Gov’t. Code §§ 17000 *et seq.* General warrants are payable on demand from existing state

<sup>1</sup>

Payment by registered warrants fundamentally conflicts with the purposes of the CPPA. Vendors do not receive the economic benefits of the supposed payment; rather, and especially when many (or most) vendors will not accept the warrants, they receive only an instrument which may be held, with some risk, to await the promise of future payment.

funds. The issuance of such general warrants allows creditors of the state to be paid immediately. In contrast, registered warrants are a “promise to pay.” No state funds exist to pay registered warrants when they are issued, so they are not payable on demand. Registered warrants are payable only when (or if) the state calls them for redemption.<sup>2</sup> As acknowledged by the SCO, the time for redemption is uncertain; registered warrants are “redeemable by the State Treasury only when the General Fund has sufficient money. See <http://www.sco.ca.gov/5935.html> (last visited on July 14, 2009).

The CPPA requires that the State “make payment” to a person within a defined period of time. Fundamentally, the notion of “payment” presumes that the recipient will have the ability to receive and use monies (cash or cash equivalent) upon deposit of such a payment. Although there is little guidance from the courts on this topic, federal courts have ruled that registered warrants do not constitute “prompt payment” for the purposes of the Fair Labor Standards Act. *Biggs v. Wilson*, 1 F.3d 1537 (9th Cir. 1992), *cert. denied*, 114 S. Ct. (1994). Additionally, in a decision that was subsequently withdrawn, a federal court further expounded on nature of registered warrants. *Parr v. California*, No. CIV-S-92-1115 GEB-PAN (E.D. Cal., Dec. 2, 1992), *op. withdrawn*, 878 F. Supp. 168 (E.D. Cal. 1995). The *Parr* court observed that “registered warrants are not cash” under an ordinary definition of “cash,” 54 Am.Jur.2d, MONEY, § 2 at 552, “because they are not readily negotiable or freely disposable, since they are not payable on demand.” Registered warrants are not “payable” until the State calls them for payment because the word “payable” in this context means “the final act which extinguishes a negotiable instrument.” 11 Am.Jur.2d, BILLS and NOTES, § 963. Although the *Parr* opinion was subsequently withdrawn, its reasoning is instructive.

Other, published cases have characterized registered warrants as “temporary borrowings” akin to cash and not subject to state debt limits. See, e.g., *Fluorney v. Priest*, 5 Cal. 3d 350 (1971). However, registered warrants fundamentally conflict with the purpose of the CPPA, as they delay payment until such indeterminate future time as the Controller may designate them for repayment. Therefore, a good argument is present that *registered* warrants do not satisfy the obligation, of Cal. Gov’t. Code § 927.4, that the State make “issuance of a warrant for payment [within] 45 calendar days.” Only a general warrant satisfies the statute.

Receiving this argument, the State likely would argue that the CPPA was enacted after the 1992 budget crisis and that the Legislature, therefore, was aware of registered warrants and the distinction between these and general warrants. The State, we anticipate, would contend that the CPPA, at § 927.4 (requiring timely issuance of a warrant), did not discriminate between “registered” and “regular” warrants and that the statute is satisfied equally with either. It also may contend that vendors contracting with the State of California should be deemed cognizant of the statutory authority, Cal. Gov’t Code §§ 17200, *et seq.*, permitting payment by registered warrant (as well as aware of the 1992 experience).

### 3. *What Might be Recovered for Noncompliance with the CPPA?*

The CPPA requires state departments to pay properly submitted, undisputed invoices within 45 calendar days of initial receipt. If the requirement is not met, departments must “automatically” calculate and pay the appropriate late payment penalties as specified in Government Code §§ 927, *et seq.* The penalty

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When California last issued registered warrants in 1992, federal banking regulators treated the registered warrants not as cash or checks, but as *debt securities*, regulating them in the same manner as State-issued general obligation bonds. The registered warrants received “the same risk-based capital treatment as general obligation bonds.” Interagency Position on California Registered Warrants, June 30, 1992, by the Controller of the Currency, Federal Deposit Insurance Corporation, Federal Reserve Bank of San Francisco, and Office of Thrift Supervisor.

amount is set at “a rate of 1 percent above the rate accrued on June 30 of the prior year by the Pooled Money Investment Account,” not to exceed a certain amount. Cal. Gov’t. Code § 927.6(b).<sup>3</sup>

A state vendor paid by registered warrants that waits to receive payment until the formal date of redemption may have an argument that it should recover the CPPA penalty in addition to the statutory interest. A “conservative” approach would seek only the 1 percent penalty above the statutory interest rate, where receipt of payment was more than 45 days after the State received a properly submitted invoice. While a one percent additional penalty may seem modest, it could have financial significance depending on the amounts at issue. A more aggressive position also appears to have a principled basis. A vendor, presuming 45 days have passed since the State received the invoice, could claim the *entirety* of the CPPA penalty (i.e., the “Pooled Money Investment Account” rate *plus* the 1 percent penalty) in addition to the interest component received at the time of redemption of the registered warrant. The argument behind this more aggressive position is that the vendor’s *damages* from late receipt of valid payment were satisfied at the time of redemption and by payment of the face amount of the registered warrant plus its accrued interest, but that the CPPA *requires* that the State pay a *penalty* amount which serves a different purpose than the interest paid on the registered warrant.

The California State Administrative Manual states that “[s]tate agencies will pay other legally authorized late payment penalties. These include the Public Utilities Commission (PUC) approved late payment charges in invoices from utilities operating under the authority of the PUC. However, when State agencies pay other authorized penalties, they must take care to do so in lieu of the penalties authorized in the California Prompt Payment Act.” California State Admin. Manual § 8474.1(o). A vendor might argue that payment of the statutory interest on a registered warrant, pursuant to Cal. Gov’t Code § 17221, is *not* a “penalty” and that, therefore, it is entitled to be paid both that interest and the full penalty amount calculable under the CPPA.

Undoubtedly, however, the State will argue that the vendor should not recover both an interest amount and a penalty amount. It also will assert that penalties under the CPPA function as the sole recourse for late payment.<sup>4</sup> If the net to a vendor is interest that is in excess of the amount that would be recovered by the penalty under the CPPA, the State will argue that the vendor has violated the intent of the legislative scheme.

#### 4. *Can a Vendor Claim Further Remedies under the California Public Contracts Code?*

Sections 10261.5 and 10853 of the California Public Contracts Code provide that contractors are entitled to collect interest in the amount of 10 percent per year upon failure by the State or University of California (“UC”) to make timely progress payments. Additionally, § 7107 of the Public Contracts Code provides that 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. Vendors may be able to argue that that issuance of registered warrants violates those code sections and entitles them to interest

#### 5. *Are Other Contractual Remedies Available?*



<sup>3</sup> As noted, registered warrants carry interest “at the rate fixed pursuant to law from the date of the registration to the date of maturity, or the date upon which the Treasurer advertises that it is payable upon presentation if it bears no date of maturity.” Cal. Gov’t. Code § 17221. Section 17222 provides that, by majority vote, “the committee shall fix the rate of interest paid on registered warrants at not more than 5 percent per annum.” The “committee” which sets this rate is the Pooled Money Investment Board. Cal. Gov’t. Code § 17220(b).

<sup>4</sup> This approach has also been followed by the California Public Utilities Commission. See *Re: San Diego Gas and Electric Company*, D. 88-12-085 (December 19, 1998) (“In no event should governmental facilities be charged a late payment fee that exceeds the amount authorized by the Government Code”).

Whether the CPPA provides the exclusive remedy for late payment by the State is a question that has not been addressed by the courts. The CPPA does not expressly exclude additional damages in contract or tort arising from delayed payment. The “model” IT terms and conditions, GSPD-401IT, at article 30 (“Required Payment Date”) say no more than that “[p]ayment will be made in accordance with the provisions of the California Prompt Payment Act ....” The standard terms, at article 41 (“Disputes), section b), requires contractors to “diligently proceed” with they performance of contracts “[p]ending the final resolution of any dispute arising under, related to or involving this Contract.” In extreme situations, however, there is precedent in federal contract cases which suggests that a vendor could treat extended non-payment as a “breach” discharging its duties to perform. *Morganti Nat., Inc. v. U.S.*, 49 Fed. Cl. 110, 141 (2001); *Northern Helex Co. v. U.S.*, 455 F.2d 546, 550-51 (1972). In theory, such a breach is considered “outside” the contract and therefore, arguably, does not arise under, relate to or involve the contract. To evaluate whether delay in payment may be sufficient grounds for terminating a contract for breach, federal case law suggests considering the amount of money involved, the length of non-payment, and the payment procedures to which the parties agreed. *Morganti Nat., Inc.*, 49 Fed. Cl. at 140. Vendors should proceed with care before they repudiate a California state contract, even for prolonged non-payment. The same IT standard clause indicates that failure to proceed “shall be considered a material breach” and that could expose the contractor to very large damages. Article 41, GSPD-401IT.

IT Vendors to the State of California are unlikely to have more than limited options to refuse continued performance even in the event of extended non-payment. Few state contracts will contain provisions expressly allowing vendors to stop work for non-payment. Many contracts will contain only general reference to the CPPA, which provides for a penalty for late payment, not an excuse from continuing performance. Many state contracts also will contain dispute resolution procedures which, ordinarily, must be followed, even if the only basis for dispute is failure on the part of the State to pay. By the time that the process is complete, the dispute could be moot if the State in fact has redeemed outstanding registered warrants.

Also acting as a deterrent is the risk that the State would treat a vendor’s refusal to perform as a material breach entitling the State to seek damages. Absent State agreement, or a court order, it would be risky to risk such a breach and the damages exposure. It is not inconceivable, however, that one or more vendors could be forced to confront this difficult choice. Should the budget crisis continue indefinitely, some less well capitalized firms, or others finding the credit markets dry, may face a situation where they are not able, financially, to continue to perform. In that situation, vendors at the prime level would be well counseled to bring their financial situation to the attention of their state customer(s), as perhaps the agencies or departments could secure relief from the SCO. Otherwise, vendors “at the brink” could consider legal action, in the nature of a suit seeking declaratory relief that excuses their suspension or cessation of performance, and/or which includes claims for writ of mandate to require the State to pay by general warrant.

## Conclusion

The State of California has put thousands of vendors in the uncomfortable and unplanned situation of having to finance the State’s purchase and use of their supplies and services for a period that may end with just a few weeks’ delayed payments but which could extend for many weeks or even months. This will work a serious hardship on state prime contractors and on their lower tier subs and their supply chain. Vendors have every reason to examine their particular contracts carefully and to evaluate whether they have grounds to insist upon payment by general warrant. Vendors also have a basis to consider and assert claim for penalties in addition to any interest paid on registered warrants. In extreme situations, there could be grounds for vendors to seek a court order excusing further performance of a state contract.

For further information, please contact:

Robert S. Metzger  
Los Angeles  
213.488.7437  
robert.metzger@pillsburylaw.com

Benjamin A. Wiles  
San Francisco  
415.983.1426  
benjamin.wiles@pillsburylaw.com

Karen M. Harkins  
San Diego  
619.544.3231  
karen.harkins@pillsburylaw.com

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