



**Testimony of Chris Bates, National Office Products Alliance
Committee on Small Business, Subcommittee on Contracting & Technology
U.S. House of Representatives**

**Hearing on Ensuring Small Businesses have Fair Access to Federal Contracts
Wednesday, April 16, 2008**

Chairman Braley and members of the Subcommittee, I am Chris Bates, President of the National Office Products Alliance – NOPA – a not-for-profit trade association established in 1904 that represents and serves more than 700 small independent dealers throughout the United States, along with their key suppliers. NOPA members range in size from \$1 million to \$90 million in sales per year. Further pertinent industry background is provided at the end of this prepared statement for the hearing record.

NOPA appreciates the opportunity to speak to the Subcommittee today about the need to ensure that small businesses have fair access to Federal Contracts. This Subcommittee and the full Committee have worked hard on this issue throughout the 110th Congress. HR 1873, passed with a broad bipartisan majority in May 2007 is an important result of your efforts.

This legislation establishes a strong foundation for needed reforms in the areas of contract bundling, data collection, reporting and oversight that will help small businesses in all industries who are working to develop federal government business. HR 1873 also increases the target for total federal purchasing from small business from 23 to 30 percent and would improve federal agency and congressional oversight to help achieve that goal.

NOPA and its members greatly appreciate the leadership of this Subcommittee and Chairman Braley in developing and passing HR 1873. We continue to urge the U.S. Senate to pass similar bipartisan legislation this year but this is an uphill effort.

My primary message today is that NOPA needs additional help from the House Small Business Committee and Congress as a whole to address a serious and growing problem facing small office product dealers who have government business: Small Business “Fronts”, also known as pass-throughs. This problem would not be resolved directly by HR 1873 and affects our 200-plus members who serve federal government customers in offices around the country. Small business “fronts” harm legitimate, independent small businesses and government customers who are trying to boost purchasing from them.

Small Business “Fronts” – What Are They?

Just what are “pass-throughs” or small business “fronts”? In the simplest terms, these are situations in which a large national company approaches a small business and proposes to create a “mentoring” relationship for the sole purpose of gaining improper access to contracts set aside for small business. I refer Subcommittee members to Appendix 1 to my prepared remarks, which compares a legitimate, independent dealer to a “pass-through” or small business “front” dealer.

Let me emphasize that these “fronts” are NOT the same thing as legitimate small business mentoring program relationships. In the latter case, the small firm being mentored plays a commercially useful primary or subcontracting role. That is not the case when a “front” is involved in a federal contract – largely in name only.

The abuses associated with the small business “fronts” problem occur when:

- The small business has little or no prior experience as a reseller of office products, particularly to government customers, and little or no ability to itself support such business;
- The large company offers to performs most or all of the selling, order processing, customer service, product delivery, and invoicing and payments processing for the contract on behalf of the “pass-through” dealer “partner;”
- The small business performs few if any commercially useful functions once the contract award is made, beyond providing an entry point through its website to the full operating infrastructure of the large corporation; and
- The small business typically receives a commission for its willingness to serve as the “front” for this business, which is “passed through” to the large corporation.

Section 301 of HR 1873 (Small Business Size Protest Notification) will help our industry in situations where a legitimate small business is successful, grows and becomes “other than large” according to the U.S. Small Business Administration’s size standards for our industry. However, it will not address those situations in which a very small, but non-qualified company pretends to be a qualified small business prime contractor that merely “outsources” contract fulfillment functions to a larger corporation. This is the “front” situation of concern to NOPA.

Regrettably, several of the large national chains in our industry have used and are using small business fronts to improperly capture federal government, as well as state government, public institution and Fortune 1000 contracts aimed at small businesses. This practice is totally inconsistent with congressional intent as evident in HR. 1873 and other reform legislation, whose underlying goal is to create a level playing field for legitimate small businesses in federal government contracting.

Congress has encountered and dealt with a similar issue in the form of Federal Prison Industries, through which purchasing preferences aimed at enhancing the work skills of federal prisoners often led to “drive-by manufacturing.” In reality, prisoners were paid below minimum wage and received little or no training in the higher-level skills associated with production of office furniture or other products.

Congress has consistently voiced its disapproval of such practices by passing legislation to end them. NOPA asks that Congress now turn its attention to the urgent, comparable problem of small business fronts.

Negative Impact of “Fronts” on Legitimate Small Businesses

The known direct loss of federal business experienced by legitimate independent dealers already totals tens of millions of dollars annually. This loss will grow as these office products dealers continue to unfairly lose access to future multi-year federal, state and local government office products contracts as a result of the small business “fronts” problem. Conservatively, these total losses already have reached more than 100 million dollars per year on a national basis, including federal and state government contracts.

In FY 2006 federal agencies spent between \$322 million and \$540 million on office supplies, according to FederalTimes.com. Estimates are imprecise, because of incomplete government data collection. These data also exclude the large volume of business done through the government’s credit card program.

How Small Business “Fronts” Work

NOPA has conducted research into a variety of small business “front” situations. This research shows a common pattern of unethical and misleading contracting behavior, which in most cases may not be illegal due to loopholes in present federal laws. Appendix 1 compares the legitimate independent dealer to the “pass-through” dealer. Pass-through situations typically work as follows:

- 1) The large office products corporation identifies a small business owner with socio-economic preferential selling status and some business experience – sometimes in a different industry – to serve as its “front” to gain access to government set-aside contracts for small business.
- 2) The large corporation offers to help the small business enter the office products industry with the understanding that the major company will handle all or virtually all of the value-added sales, order placement and processing, product delivery, customer service, quality assurance and even billing functions. In exchange for a commission, the smaller company agrees to serve as a mentored partner “front” through which orders are passed to the major corporate “partner”.
- 3) Government orders placed with the small business “front” are usually captured by the website/customer management computer system of the major corporation, and

the order management, customer service and fulfillment processes are then fully administered by employees of the major corporation.

- 4) Payments may even be handled through “lock boxes” established in the name of the “front”, but with the major corporation making the actual payment collection. The commission is then paid to the “front” to close out the transaction.

NOPA believes that GSA and many federal agencies are trying to provide more opportunities for legitimate small businesses to compete on a level playing field for federal contracts. However, we do not believe they fully understand the “pass-through” phenomenon. The current Army Blanket Purchase Agreement (BPA) and a recent multi-agency strategic sourcing initiative contract awards that include small office product dealers are positive signals that federal agencies are making a greater effort to buy from small businesses in our industry. But even those multi-supplier awards appear to include some dealers that the industry believes are “fronts” for a national office products chain.

Small Business Fronts Harm Government Customers

Small business “fronts” harm not only legitimate, independent small business dealers, but also the federal government as an office products buyer. Federal customers are injured by the steady erosion of effective competition for federal contracts as legitimate small dealers are less willing and able to pursue new government business. Regular, ongoing competition involving multiple alternative office product suppliers – the best way to ensure best price and value – erodes and in some cases no longer occurs.

Pending legislation in the U.S. Senate (S. 2300) would require the General Accountability Office (GAO) to study the small business “fronts” problem at the federal level. Presumably, this study would address the issue of impact on competition for federal government contracts.

However, NOPA notes that there already is strong hard evidence of the negative effects of reduced competition for state government office product contracts in several states. In several cases, state contracts that allow a large prime contractor to work with small business “fronts” have had significant problems and anticipated cost savings to governments in those states have not been realized.

In North Carolina, the state purchasing authority awarded a multi-year sole-source contract in 2006 to one of the large national office product chains. Over the prior 5-10 years, the state steadily eliminated the participation of independent, full-service dealers in this contract despite their long-standing, superior performance records. Competition suffered as a result.

Within a year after the sole-source contract was awarded, the Inspector General for the Department of Administration in North Carolina found significant examples of unauthorized product substitutions and incorrect (usually higher) pricing on a large number of contracted “core” office products, where charged prices did not match the

awarded bid prices. The large office product chain was forced to make restitution, but was not removed from the state contract.

In Georgia, a similar audit found even more widespread product substitutions and overcharges by the large national chain. In February 2008, the State terminated its contract with the large national chain and has reopened office products business to all qualified suppliers, including independent dealers.

In the Georgia situation, the large national chain was awarded the state office products contract with the understanding that it would work with a consortia of small dealers in the State as “subcontractors”. Ultimately, the national chain could not find any small dealers in Georgia willing to participate in a “sham” arrangement with them and they therefore became the sole supplier involved in the contract. Several legitimate dealers lost their prior business with the State when the national chain won the bid but failed to live up to its promise of “small business involvement.”

A similar state contract arrangement with one of the national office product chains prevails in California, with most of the 9 small business consortia members having no apparent significant prior experience in the office supplies business. That situation too has recently come under closer legislative and administration scrutiny. The State is now auditing all contract participants and the California Assembly has introduced legislation (AB 1942) to address the small business “front” problem. Other states are reported to be looking into their office supplies contracts as a result of these episodes.

NOPA believes that similar situations would be discovered if individual agencies conducted thorough audits of actual versus bid pricing and the scope of unauthorized product substitutions under federal office product contracts. In recent years, a growing number of federal office product contracts have been awarded to one of the large national office product chains on a multi-year basis and/or to their small dealer “fronts”.

These “fronts” are expanding as vehicles for large corporations to demonstrate their “commitment to small business” subcontracting, and specifically to provide “assistance” to disadvantaged or under-represented socio-economic groups. Unfortunately, the reality does not match the public claims or image presented.

Federal Legislation Essential to End Small Business “Fronts”

NOPA and its members greatly appreciate the exceptional efforts this Subcommittee has made, particularly in the past 18 months, to assist small businesses in our industry and others. The results have been legislation to:

- 1) Require more complete and accurate government accounting of purchases from small businesses;

- 2) Create better standards for determining which federal contracts are appropriate for “bundling,” a growing federal contracting practice that has taken new form under GSA’s “Strategic Sourcing Initiative; and
- 3) Encourage increased government-wide contracting opportunities for small businesses through closer congressional oversight and more ambitious agency-level goal setting, monitoring and reporting to Congress.

None of these reforms, however, have become law as yet. And none will directly address the small business fronts problem, which can only be curbed or eliminated through more specific legislative and regulatory reforms.

Small Business “Fronts” Inconsistent with Recent Reform Legislation

There are three elements of the “fronts” problem, each of which must be addressed:

- 1) Federal agencies should not receive credit for small business awards when the work done under a given contract is largely performed by employees of a large corporation;
- 2) Small business “fronts” should not be allowed to gain access to set-aside government contracts when they effectively serve as brokers that receive a commission from large companies, and when they add little or no value added to the contracted work; and
- 3) Large national companies should not improperly gain a larger piece of the federal market through sham mentoring programs.

In stark contrast, legitimate independent office product dealers typically perform a high percentage of the service work associated with government contracts. Appendix 1 provides a visual comparison of the typical functions performed by independent small office products dealers versus small business “fronts”. One such “front”, Faison, was recently determined by the Small Business Administration to be “other than small.” And this decision was upheld on appeal (Appendix 2).

Independent dealers meet long-standing FAR requirements for government service subcontractors (50% minimum value-added rule) operating under set-aside contracts for small business. They also meet relevant state procurement requirements, such as the “commercially useful function” criteria used in California. A copy of those standards appears in Appendix 3.

Because there are no specific criteria in current U.S. law or the Federal Acquisition Regulation (FAR), small business “fronts” may be not be illegal and federal agencies have either not seen or tolerated the practice, despite having reservations about it.

With new requirements in place to more accurately measure and report federal small business contracting and pending legislation (HR 1873) to reform small business contracting in general, it is time to address small business fronts, which are one of the most glaring and widespread unfair federal contracting problems our industry faces.

Specifically, NOPA asks the Committee and Congress to draft and approve legislation to:

- 1) Establish strict bid evaluation and post-award review criteria to ensure that federal contracts set aside for small business are not awarded to companies that play only minimal roles in servicing such contracts;
- 2) Require federal agencies to ensure that all bidders on small business set-aside contracts fully disclose and certify the functional roles they will play in contract fulfillment, as well as the specific functions their primary suppliers and subcontractors, if any, will perform;
- 3) Require each federal agency to report annually to the appropriate committees of jurisdiction in the U.S. House of Representatives and the U.S. Senate regarding their implementation of these provisions to end the use of small business “fronts” in federal contracting; and
- 4) Establish meaningful penalties for companies found in violation of the proposed new legislative and FAR provisions aimed at elimination of “fronts”.

Office Products Industry Background

Government and commercial customers typically buy office products from small independent dealers or from one of the four large national corporations that operate in this market. The same manufacturers and wholesalers sell to both dealers and the large national chains.

A few dealer-owned purchasing cooperatives negotiate direct purchasing agreements with manufacturers to buy large quantities of the highest-volume office products to help their independent dealer members stay cost-competitive with the major national office product specialist chains. For lower-volume products, both independent dealers and the national chains rely heavily on wholesalers to supply them.

With similar costs for goods they sell, the main differences between independent office product dealers and the national chains is their size and how they operate. Dealers are entrepreneurial businesses focused on government, institutional and commercial delivery accounts and are known for their flexibility and exceptional customer service. They usually are not retailers. The large national chains are mixed retailers and commercial resellers. Not surprisingly, their strategies for serving customers are quite different from those of independent dealers.

To serve government and commercial customers in multiple locations – especially for large national contracts, independent dealers often participate in special “teaming arrangements”. There are several such teaming arrangements in operation, including but not limited to the American Office Products Distributors (AOPD), which has operated successfully since the 1970s, and dealer networks managed by the is.group and the George W. Allen Company on behalf of the TriMega Purchasing Association.

For these reasons, “subcontracting” is not necessary and generally has not been used in the office products industry, except in the context of the collaborative teams of independents I just mentioned. Independent dealers and large national chains are competitors who do not work well together, and have different operating strategies and philosophies.

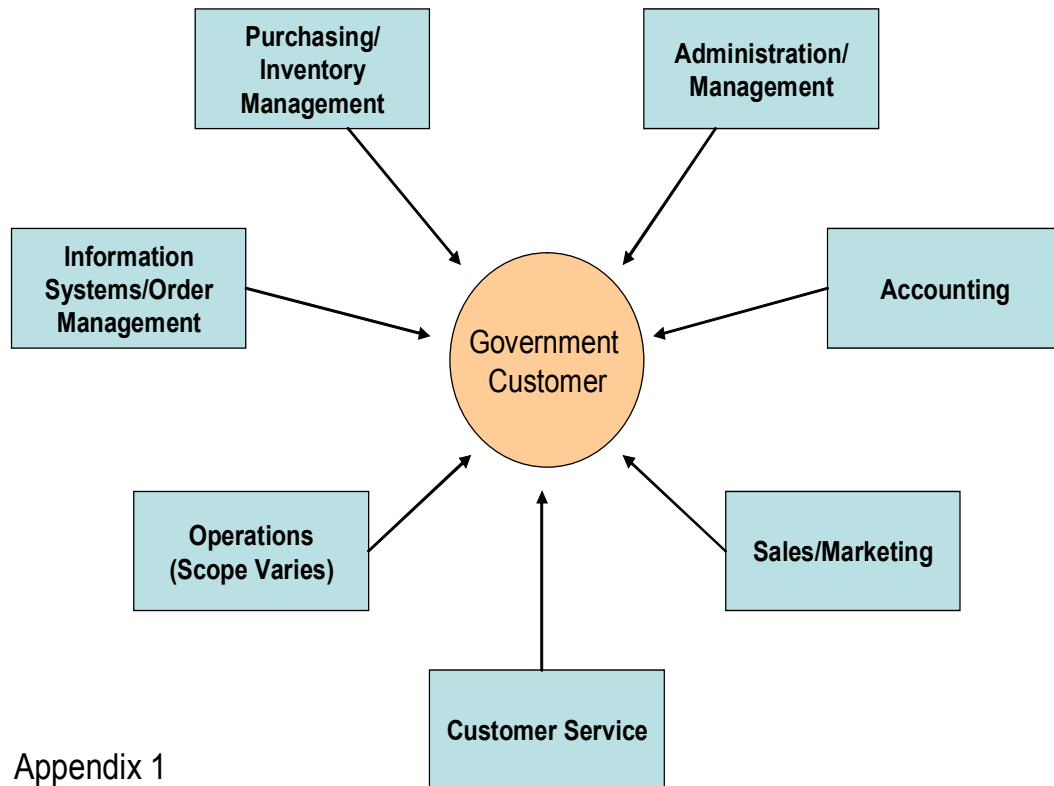
As a standard industry practice, the legitimate independent dealer has the sole responsibility to negotiate contracts with its supporting business partners as well as government customers, and remains legally liable for the performance of any and all functions to be performed under those contracts. In known pass-through situations, this is not typically the case, with the larger company playing the central role in bid development and negotiations with supporting vendors and the government customer.

Conclusion

On behalf of NOPA and its members, I thank you for opportunity to testify before this Committee about one of the most damaging and unfair practices that often prevents independent office product dealers from competing on a level playing field for federal government contracts.

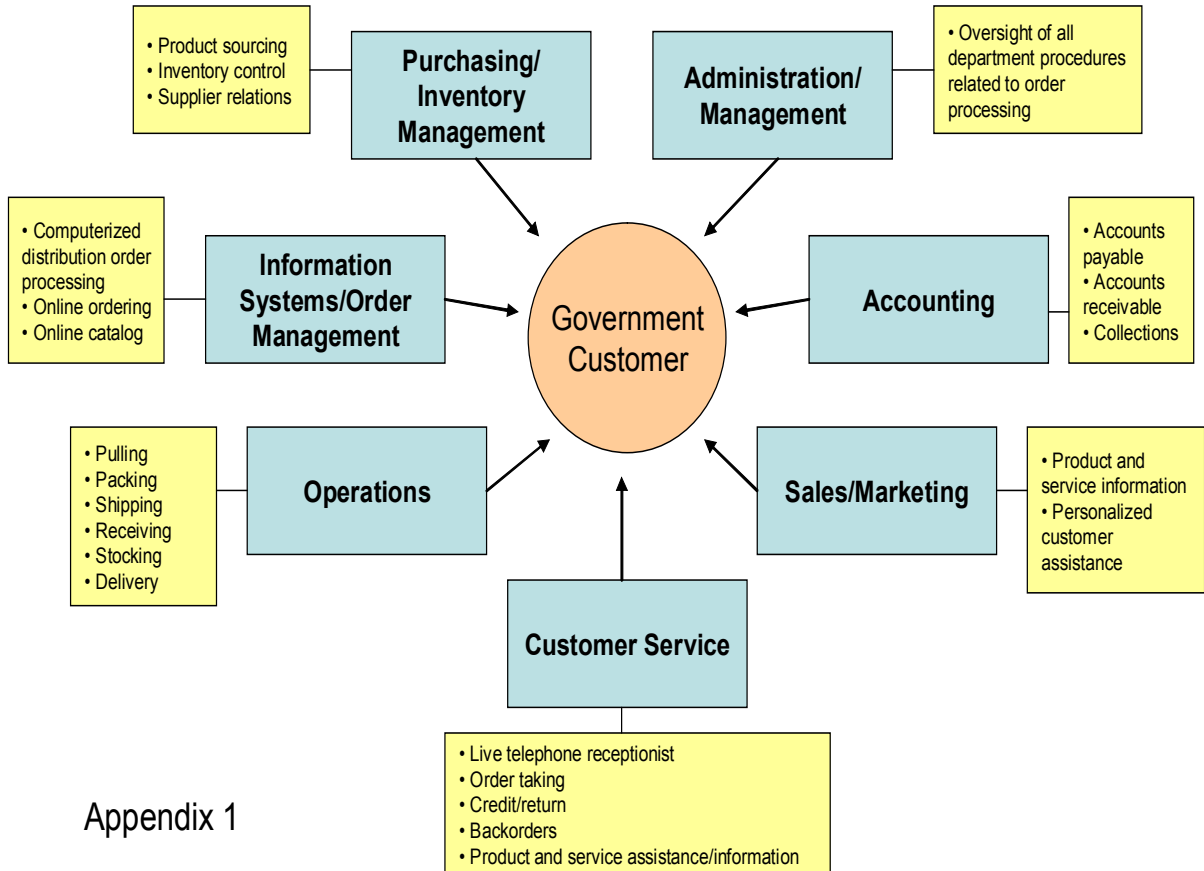
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Independent Small Dealer Business Functions for Customers



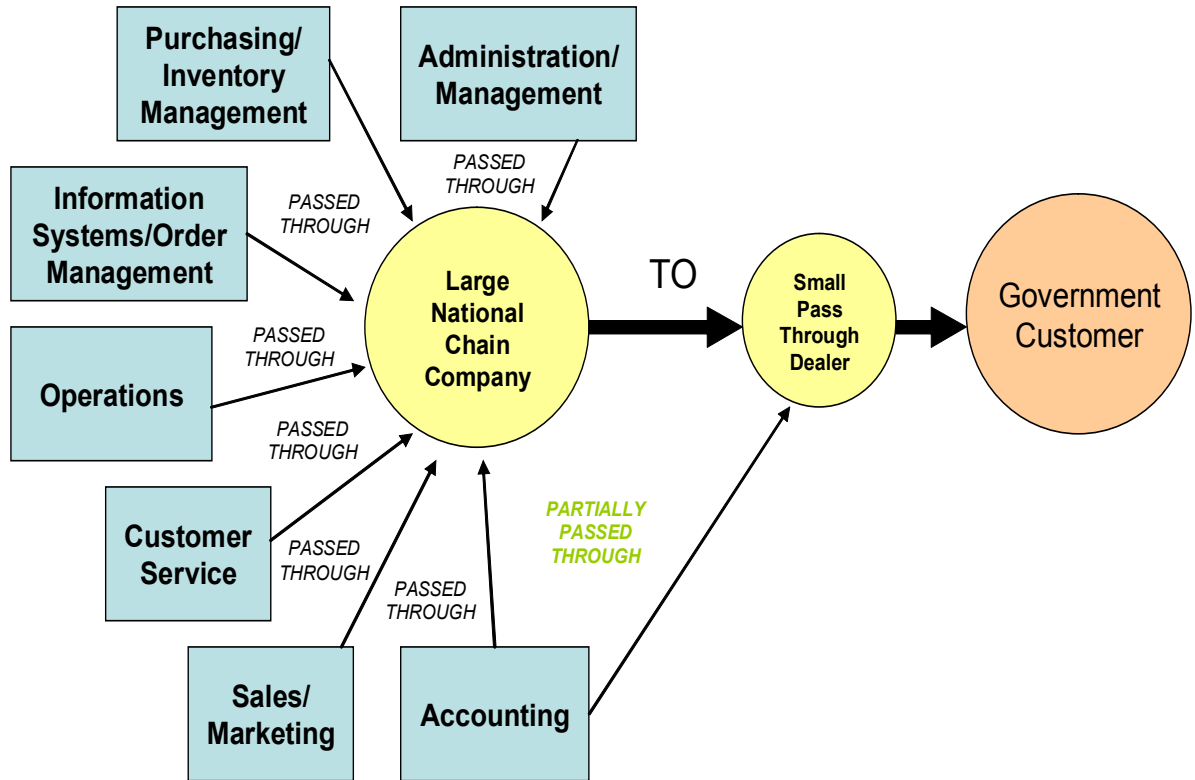
Appendix 1

Independent Small Dealer Business Functions for Customers (Detail)



Appendix 1

Large Company Business Functions Passed Through Small Business “Front” to Customer



Appendix 1