BY WILLIAM CHAD HAYES & ANTONY L. SANACORY

CONTRACTING WITH
Disadvantaged Business Enterprises

The OIG is specifically examining instances where the “contractor misrepresented who performed the contract work in order to increase job profit while appearing to be in compliance with contract goals for involvement of minority- or women-owned businesses.”

In recent years, courts have issued severe punishments to businesses and individuals caught in DBE fraud schemes. In 2012, a federal jury convicted a contractor on 26 out of 30 counts in the largest reported DBE fraud case in U.S. history, including conspiracy to commit fraud and money laundering, 11 counts of wire fraud, six counts of mail fraud, and 11 counts of money laundering.

The defendant was sentenced to 51 months in federal prison (later reduced by 10 months), with the sentencing judge stating, “DBE fraud is pervasive in the construction industry, and persons so inclined to commit the same kind of fraud need to be aware that they face serious consequences...”

In June 2016, a California contractor was required to pay $5.4 million to settle a federal False Claims Act suit involving DBE fraud on two military projects. And then in August 2016, federal prosecutors in South Carolina handed down an 18-count indictment against seven construction executives and two companies for allegedly using multiple sham DBEs to win more than $350 million in government contracts. If convicted, they face sentences of up to 20 years in prison and fines from $250,000 to $10 million.

Given a steady increase in fraudulent activity, the U.S. Department of Transportation Office of Inspector General (OIG) has recently sharpened its focus on policies related to disadvantaged business enterprises (DBEs).

In fact, DBE fraud accounted for 35% of all active grant and procurement fraud cases in early 2016 – up from 25% in 2010 and 29% in 2013.
Given the recent attention by federal, state, and local prosecutors to DBE fraud cases and potentially devastating consequences of becoming embroiled in a DBE fraud investigation, contractors and suppliers must consider strong compliance practices for working with DBEs.

**DBEs & the Commercially Useful Function Requirement**

DBE is a term used to describe federal, state, and local programs designed to encourage business opportunities on publicly-funded projects for women-owned, minority-owned, veteran-owned, disabled-owned, and other “disadvantaged” businesses. The specific requirements for DBE certification and participation can vary, but generally require that a business 1) be majority (51%) owned by someone belonging to one of the previously mentioned groups and 2) usually be a small business.

“Disadvantaged” in DBE refers specifically to a particular group’s overall historical level of participation in public projects – that is, the group is historically underrepresented in bidding for and winning work on public projects.

Also, DBEs are often disadvantaged financially in that DBE participation goals may open the doors to projects that are larger or require more financial commitment than a particular DBE may otherwise normally engage. In such instances, non-DBEs take on uncertainty and greater risk when supplying or contracting with DBEs if they desire to remain involved in public works projects. This greater risk can include gaps in a DBE’s technical experience or lack of financial means to withstand problems on the project. After all, the primary purpose of DBE policies is to include DBEs in projects from which they might otherwise be excluded.

Contractors must be aware that the temptation to mitigate DBE-related risk by minimizing the DBE’s role can open the door to DBE fraud. For most jurisdictions that require specific levels of DBE participation, the DBE must be performing a “commercially useful function” in order for DBE participation credit to apply. The DBE entity must be more than a pass-through entity and cannot exist in name only.

While the specific requirements may vary slightly across jurisdictions, the “commercially useful function” requirement usually focuses on whether the DBE is acting like a non-DBE contractor or non-DBE supplier would under similar circumstances. Examples of the criteria include:

- Whether it is actually managing its own labor and performing work;
- Whether a DBE contractor is providing its own materials;
- Whether a DBE supplier is transporting, storing, or delivering the materials;
- Whether it is paying for its own labor; and
- Whether there are consequences if the DBE fails to perform.

**What Not to Do**

DBE fraud typically involves one of two schemes – the front company scheme and the pass-through scheme.

**Front Company**

As its name indicates, the front company scheme involves a fraudulent DBE set up as a front for a non-DBE firm. The sham DBE appears on paper to be a certified, independent DBE. But in reality, it is operated and controlled entirely by the non-DBE firm. The sham DBE will typically be paid a small fee for the sake of appearances, but the majority of the project’s proceeds go to the non-DBE firm that actually performs the work.

A recent federal criminal case in Pennsylvania provides a good example of the front company scheme. In that case, two men used a sham DBE, Karen Construction, to fraudulently obtain $19 million in bridge and highway construction contracts for their family’s steel business, Weber Steel, over a span of 16 years. On paper, Karen Construction was woman-owned and independent from Weber Steel. However, these documents were falsified by the owners of both companies. In reality, Karen Construction shared offices and workers with Weber Steel, leased all of its equipment from Weber Steel, and was entirely controlled by the male owners of Weber Steel, who were also employees of Karen Construction.

**Pass-Through**

The pass-through scheme is subtler than the front company scheme because it can occur seemingly unintentionally, without the overt intent to commit fraud. Pass-through cases can involve a legitimate, certified DBE that acts as middle man so that a contractor can obtain DBE participation credits on a project. The DBE then “passes through” the majority of the payment it receives from the prime contractor to the non-DBE firms that actually perform the work.
The DBE may perform some work, but it is not serving in the same capacity as a non-DBE contractor would under similar circumstances: It is not managing its own labor, providing its own materials, paying for its own labor, or liable for nonperformance. In other words, it is not serving a “commercially useful function.”

A supplier was accused of participating in a pass-through scheme in an August 2015 federal criminal case that was settled for $5 million. HD Supply Waterworks allegedly conspired with several GCs to use a Native American-owned DBE – the now-defunct American Indian Builders & Suppliers, Inc. – as a pass-through.

Under the alleged scheme, HD Supply Waterworks performed the work and supplied the materials; the DBE collected its invoices, added its own markup, and then passed those invoices through to the prime contractors, allowing them to claim DBE participation even though the DBE performed no “commercially useful function.”

It is easy to imagine that a party to a construction project could relegate a DBE to a passive role or a pass-through entity without the intent to defraud the government. Since the concept of DBE is to facilitate a greater financial participation in a public works project, one could equate that concept with providing assistance to the DBE in order to minimize risk.

Thus, almost counterintuitively, the more a contractor helps a DBE, the more it could increase the risk of not only relegating the DBE to being a “pass-through,” but also removing the DBE from a “commercially useful function.”

This could happen almost by accident and without the individuals involved realizing that they are creating this risk. For this reason, a strong compliance effort is advisable.

Be Aware of Known Red Flags

The OIG has published a list of 10 red flags that it uses to evaluate whether to investigate a contractor or supplier for DBE fraud:

1) DBE owner lacks background, expertise, or equipment to perform subcontract work
2) Employees shuttling back and forth between prime contractor and DBE-owned business payrolls
3) Business names on equipment and vehicles covered with paint or magnetic signs
4) Orders and payment for necessary supplies made by individuals not employed by DBE-owned business
5) Prime contractor facilitated purchase of DBE-owned business
6) DBE owner never present at job site
7) Prime contractor always uses the same DBE
8) Financial agreements between prime and DBE contractors
9) Joint bank accounts
10) Absence of written contracts

While many of these warning signs may have legitimate explanations, contractors and suppliers should undertake reasonable efforts to identify and avoid them where possible in DBE transactions. The chart at the end of the article lays out considerations to ensure your company’s DBE compliance.

And keep in mind that even if your company is not engaging in these red flags, subcontractors and suppliers hired by a front company or pass-through DBEs run the risk of becoming embroiled in costly investigations, or worse yet, being labeled as knowing participants or co-conspirators in DBE fraud.

Conclusion

Proper due diligence in contracting with DBEs is critical to avoiding the associated risks and potential penalties. Rather than leaving it to a fraud investigator to speculate or guess as to your involvement in a potential fraud, a rigorous compliance effort can help demonstrate efforts to ensure compliance with relevant DBE requirements for a particular project.
Endnotes


8. Ibid.


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DON’T MISS THE GUIDE TO APPROACHING DBE COMPLIANCE ON THE NEXT PAGE
## A Guide to Approaching DBE Compliance

Here are some important considerations to undertake with your legal counsel in developing your approach to complying with DBE requirements.

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<th>QUESTION</th>
<th>CONSIDERATIONS</th>
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<td><strong>Who is funding the project?</strong></td>
<td>DBE requirements or incentives typically flow from the project owner and the source of funding. Ensure you are focusing on the correct requirements and programs on a project-by-project basis. Be aware that requirements can be both statutory and contractual – depending on the project, the owner, and the source of funds – and ensure you are complying with all requirements.</td>
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| **Is the DBE performing a “commercially useful function”?** | Confirm the specific definition of “commercially useful function” for the project and, if there is any doubt, disclose the specific function the DBE is intended to fulfill. Common questions for determining whether DBE is performing commercially useful function include:  
1. Is the DBE limited to that of an extra participant in a transaction, contract, or project through which funds are passed in order to obtain the appearance of DBE participation?  
2. Is the DBE performing actual services and contractual liability for the failed delivery of such services?  
3. Is the DBE performing some distinct element of work in which the business has the skill, expertise, or other necessary capabilities and/or attributes as well as the responsibility for actually performing, managing, and supervising the work or manufacture and/or delivery of goods?  
4. Did the DBE have responsibility for negotiating price, quality and quantity of materials, ordering the materials, and installing (where applicable) and paying for the materials?  
5. Did the DBE perform or exercise responsibility for meaningful portion of the total cost of its contract with its own workforce? Did the DBE subcontract a greater portion of the work of a contract than would be expected on the basis of normal industry practice for the type of work involved? |
| **Are there certification requirements?** | Identify certification requirements in advance and know whether the certification is being represented to local, state, or federal agencies. Have any forms or requirements in hand before your company starts doing any work or providing materials. |
| **Who is appointed with formal compliance responsibility?** | Make sure someone is formally assigned to ensure compliance with the legal and contractual requirements. It is usually safest and best to have some form of internal reporting to a supervisor to make sure the compliance efforts are thorough. |
| **Does your DBE partner have documentation confirming its DBE status?** | Conduct adequate research regarding the reputation and past dealings of your DBE. Confirm your DBE partner’s status and certification are current, that it is the proper certification for the particular project, and that the name on the certification matches the name of your DBE partner. |
| **Are there creative financing tools to minimize the impact of the financial failure of the DBE on the project?** | There usually are commercial terms and financial security options that can be agreed to that will minimize the risk of non-performance or non-payment by a DBE without relegating the DBE to a pass-through entity. The available or appropriate options under the circumstances will depend on the parties’ respective roles on the project. A construction attorney should be able to provide practical and efficient solutions. |