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Caught in the Middle: What Is a Supplier Supposed to Do When Its Customers Ask to Use a DBE as a Pass-Through?

Michael A. Schwartz | schwartzma@pepperlaw.com
Kristin H. Jones | joneskh@pepperlaw.com

Suppliers are caught in the middle of a new enforcement trend in federal, state, and local investigations of disadvantaged business enterprise (DBE) fraud. Historically, DBE fraud investigations have focused on the relationships between DBE services or labor subcontractors and the prime or subcontractors with whom the DBEs contracted. The government enforcement agencies would allege that the DBE was a sham or "pass-through" because it was incapable of performing, or simply did not perform, the work for which it subcontracted to perform. Investigations of DBE subcontracting have led to a well-known list of fraudulent schemes including, for example, DBEs using the prime contractors' employees and equipment to perform the work or DBEs subcontracting all of the work to non-DBE firms.

The latest enforcement trend focuses on DBE suppliers. Rather than having to explore the nuances of whether a DBE subcontractor did enough work on a project to satisfy the program requirements, investigators and prosecutors who focus on DBE suppliers have found instances of straight pass-through arrangements where the DBE supplier adds no value and performs no commercially useful function, but instead merely lends its name in exchange for a small percentage of the contract value.

Unfortunately, the situations in which DBE suppliers act as pass-throughs create potential liability not only for the prime or subcontractor who benefits from the DBE credits for using such a supplier, but these situations also create investigative interest in and potential liability for the legitimate non-DBE supplier from whom the DBE supplier that is inserted in the transaction purchases merchandise. The scenario for legitimate, non-DBE suppliers is familiar. The supplier provides a quotation and negotiates a subcontract to provide the materials necessary for a project with a prime or subcontractor. The project involves government money, and, after all of the terms of the supply agreement are negotiated and the prime contractor wins the job, the prime or subcontractor tells the supplier that it needs to use a DBE on the project. A "certified" DBE supplier is located. The DBE executes the supply subcontract with the prime or subcontractor and then agrees to purchase the supplies from the non-DBE supplier. The prime or subcontractor provides the DBE supplier with all of the purchase order information, which the DBE puts on its letterhead and submits to the non-DBE supplier. The non-DBE supplier fulfills the purchase order, delivering the supplies straight to the job site. The supplier invoices the DBE, who adds a small percentage fee (often two to three percent) and submits its invoice to the prime subcontractor. When the prime or subcontractor pays the DBE, the DBE takes its two to three percent off the top and remits the balance of the money to the non-DBE supplier.

This scenario is troubling because the non-DBE supplier is potentially committing a crime, despite the fact that (1) the supplier is a legitimate business, and it is the DBE, not the supplier, that is the sham, and, (2) the prime or subcontractor, not the supplier, is the party insisting on using the DBE as a pass-through and taking the DBE credit. Many suppliers believe that the fact that a DBE is certified by a government agency shields them from liability with respect to these transactions. Certification, however, is not a complete defense, because

it only addresses the prerequisites that make a company a DBE, i.e., social and economic disadvantage. Although the exact terminology may vary among DBE regulations, it is a fundamental requirement of every DBE program that, in addition to being certified, a DBE must perform a "commercially useful function" on a project, meaning that the DBE does actual work and adds value to the project.

Suppliers are caught in the middle, but are garnering little sympathy from government enforcement agencies, who just see a scheme in which suppliers are helping to create the false appearance that a DBE is performing a commercially useful function. These schemes have become pervasive in the construction industry, such that it can be difficult for any party in the contracting chain to claim they did not know the DBE was a pass-through. Increasingly, federal and state prosecutors, inspector generals, and other law enforcement investigators are viewing suppliers who allow their customers to put them in these situations as aiding and abetting or conspiring to commit a fraud on DBE programs or to submit false claims for payment to the government.

Recent Prosecutions Illustrate the Risk to Suppliers

Two recent federal criminal cases – one where the defendant just finished her sentence and one where the defendant was just charged – illustrate the trend of DBE fraud cases focused on suppliers.

On October 25, 2014, the owner of a sham "certified" minority and woman-owned business that acted as a supplier on government-funded projects was released from federal custody after serving the 26-month sentence imposed in the case of *United States v. Azteca Supply Company*, Crim. No. 10-80 (N.D. Ill.). In February 2010, a federal grand jury in the Northern District of Illinois returned an indictment charging Aurora Venegas, her husband, and Azteca Supply Company (Azteca) with mail fraud and false statement charges relating to runway and restroom projects at O'Hare International Airport for the City of Chicago and a landscaping project at a Metra commuter rail station for the Village of Orland Park, a Chicago suburb. According to the indictment, Venegas, as the owner of Azteca, falsely represented that Azteca performed a commercially useful function and made it appear that contractors were purchasing supplies from Azteca. In reality, Azteca acted as a "pass-through," and contractors were actually purchasing supplies from a majority-owned supplier. Venegas allegedly would learn from contractors what supplies they needed, and then Azteca would act solely as a broker causing those items to be shipped from the actual suppliers to contractors, despite the fact that Chicago's M/WBE policy makes clear that credits for using a M/WBE[1] cannot be claimed on a project if the M/WBE's role is limited to "fill[ing] orders by purchasing or receiving supplies from a third party supplier rather than out of its own existing inventory" and the if firm does not provide "substantial service other than acting as a conduit between his or her supplier and his or customer."

Venegas pled guilty to one count of mail fraud and was sentenced to 26 months in prison and ordered to disgorge $482,850 in profits. As part of her plea agreement, Venegas admitted that on the Metra commuter rail station project in the Village of Orland Park, despite having a subcontract to supply plants to the landscaping subcontractor, Azteca had no role in connection with the ordering, warehousing, storage, or delivery of the plants. Rather, Azteca agreed with the landscaping subcontractor and a majority-owned supplier that Azteca would generate invoices and other documents to create the appearance that Azteca had purchased the plants from the majority-owned supplier and supplied them to the landscaping subcontractor. In reality, the landscaping subcontractor directly communicated with and obtained the plants it required from the majority-owned supplier, bypassing Azteca. As a result of its participation in this particular project, Azteca received a net payment of only approximately $2,800, although there was evidence that between 2001 and July 2008, Azteca received in excess of $9 million by acting as a sham M/WBE pass-through on other government projects.

Importantly, although the Azteca criminal case focused on the M/WBE and the individual owners of that business, the indictment named seven unindicted co-conspirators, labeling them as companies "A" through "F." From the indictment, it is clear that these unindicted co-conspirators include majority-owned suppliers, subcontractors, a general contractor, and a manufacturer. Because at the time of indictment these co-conspirators were not charged criminally, the government did not disclose their identities. However, this does not mean that these companies or individuals were not investigated. Indeed, it is likely the unindicted co-conspirators were approached by the government and suffered the substantial costs and disruption caused by being the subject of a federal investigation.

On September 26, 2014, in another federal criminal case, *United States v. Tubbs*, Crim. No. 7:14-mj-02137 (S.D.N.Y.), federal prosecutors in the Southern District of New York charged the regional manager at a general contractor that performed a construction project on Bronx-Whitestone Bridge with fraud for allegedly setting up a pass-through arrangement with a DBE supplier. According to the criminal complaint, in October 2008, the Metropolitan Transportation Authority (MTA) awarded a general contractor identified only as "General Contractor-1" a $192 million contract to repair and replace the approaches to the suspension bridge over the East River that connects the Bronx and Queens. To satisfy the M/WBE goal on this project, General Contractor-1 allegedly claimed, in utilization forms and compliance reports, that structural steel would be supplied by a "certified" MBE supplier, identified only as "MBE-1." According to the criminal complaint, the defendant, Aaron Tubbs, in his capacity as the Regional Manager at General Contractor-1, allegedly participated in setting up a fraudulent scheme whereby the structural steel was actually provided by other companies and MBE-1 was used as a pass-through.

According to the criminal complaint, after a supplier agreed to a contract with General Contractor-1, Mr. Tubbs informed the supplier that the purchases of structural steel had to be run through MBE-1 for purposes of meeting minority requirements. Thereafter, the complaint alleged that General Contractor-1 received purchase order information from the supplier, arranged for the information to be placed on letterhead of MBE-1, and arranged for the purchase order to be submitted to and fulfilled by the supplier. The complaint alleged that, for these reasons, MBE-1 did not meaningfully participate in the bridge project, and it received only a small fraction of the state funds that General-Contractor 1 represented it had received.

Mr. Tubbs was charged with one count of wire fraud. He has not yet been indicted and is presumed innocent. Recently filed court documents show that his counsel "has been engaging in preliminary discussions with the Government concerning possible disposition of this case without trial." Regardless of what happens in Mr. Tubbs' case, the criminal complaint suggests that there is an active and ongoing investigation of other MTA contractors, subcontractors, and suppliers. As in the *Azteca* case, there are a number of unindicted co-conspirators identified in the complaint, including a General Contractor-1, Supplier-1, and MBE-1. Indeed, the complaint alleges that MBE-1 has been "used by general contractors repeatedly on large construction projects in Westchester County, the Bronx, Manhattan, Staten Island, and elsewhere, to obtain credit toward MBE/WBE goals and/or their federal equivalent" as part of a pervasive "pass-through fraud" scheme.

While Azteca and Tubbs were defendants in federal criminal cases, not all DBE fraud cases result in federal criminal charges. Sometimes suppliers, DBEs, and prime and subcontractors have been named in federal civil cases brought under the False Claims Act. For example, in October 2012, the United States Attorney for the Western District of New York announced that Lafarge North America, Inc. (Lafarge), a national supplier of building a construction materials and manufacturer of concrete and concrete products, paid $950,000 to the United States to resolve False Claims Act Claims. According to the government's press release, Rayford Enterprises, Inc. d/b/a Rayford Concrete Products (Rayford), a Buffalo company, was awarded subcontracts on highway construction projects in the Western District of New York which were partially funded by Federal Highway Administration and, therefore, had DBE requirements. The U.S. Attorney who handled the case described how Rayford obtained the subcontracts "based on its representations that it was a DBE manufacturer of concrete" when "Rayford was not, in fact, a manufacturer of concrete, nor did the company have a concrete batching facility or other equipment necessary to manufacture concrete." According to the government, "[i] nstead, Rayford had an agreement with Lafarge North America to manufacture and deliver concrete for these projects" and "Lafarge North America is not a DBE." A separate press release from the U.S. Department of Transportation, Office of Inspector General, which jointly investigated the matter, summarized that, "the settlement was based on claims that [Lafarge] fraudulently obtained subcontracts that were supposed to be performed by [DBEs], by virtue of an alleged fraudulent agreement with Rayford." The owner of Rayford pled guilty to mail fraud and was sentenced to probation while LaFarge agreed to pay $950,000 in a civil settlement without admitting liability.

And, of course, not all DBE fraud cases are brought at the federal level. Many state and local agencies have active and ongoing DBE fraud investigations and, increasingly, those investigations are focused on suppliers. In January 2012, the City of Philadelphia announced that "in the wake of a Philadelphia Office of the Inspector General investigation into a sham minority contracting scheme," the City had "begun debarment proceedings against one contractor, removed a second from

its list of certified minority businesses and reached a no-fault settlement with a third contractor, which … agreed to pay the City $100,000." The Philadelphia Inspector General alleged that William Betz, Jr., Inc. (Betz), JHS and Sons Supply Company (JHS), and UGI HVAC, Inc. (UGI) colluded to create the appearance that JHS, a certified minority vendor, provided equipment and supplies for a $1 million contract UGI signed with the Philadelphia Housing Development Corporation to weatherize houses for low-income residents of Philadelphia. According to the Inspector General, in reality, UGI actually purchased those products from Betz, which paid JHS three percent of the contract proceeds for the use of its name and minority certification. UGI and Betz allegedly generated false invoices to conceal their scheme. Similar investigations and enforcement actions are being brought by local and state Inspector Generals and local and state prosecutors' offices across the country.

So What Are the Rules for DBE Suppliers?

These case examples beg the question of whether and how a DBE supplier can legitimately participate as a subcontractor on a publicly-funded project. A fundamental requirement of every DBE program[2] is that the DBE perform a "commercially useful function," meaning, in plain terms, that a DBE must actually perform work before its services can be counted toward the DBE goal for a project. The phrase "commercially useful function" comes from the federal Department of Transportation (DOT) regulations, which define the requirement as follows:

> A DBE performs a commercially useful function when it is responsible for execution of the work of the contract and is carrying out its responsibilities by actually performing, managing, and supervising the work involved.

49 C.F.R. § 26.55(c)(1). With respect to materials and supplies used to perform a contract, the DBE must be responsible "for negotiating price, determining quality and quantity, ordering the material, and installing (where applicable) and paying for the material itself." 49 C.F.R. § 26.55(c)(1). The DOT regulations make clear that a DBE serving as a "pass-through" entity is not sufficient:

> A DBE does not perform a commercially useful function if its role is 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.

49 C.F.R. § 26.55(c)(2). While other local and state and federal agencies use different phrases for commercially useful function and vary slightly in defining this requirement, the concept is the same: the DBE cannot just be inserted in the transaction and must participate in more than name only.

The DOT regulations recognize two different ways in which a contractor can receive credit for materials supplied by a DBE. First, a contractor can receive DBE credit for the fee or commission a DBE "broker" receives for arranging the procurement of the supplies, but not for any of the value of the supplies obtained through a DBE broker. A DBE broker is defined by the DOT regulations as a firm that arranges for or expedites transactions, e.g., a firm that purchases and resells to the contractor materials that become a permanent part of the project. A DBE broker may be a facilitator, packager, manufacturer's representative or other person who arranges or expedites transactions, but does not supply on a regular basis and cannot be a regular dealer. (49 CFR § 26.55(e)(3)). Not many contractors look to engage DBE brokers because of the limitations on the amount of credit the contractor can receive in this situation.

On the other hand, under the DOT regulations, a contractor can receive DBE credit equal to 60% of the value of the supplies it procures from a DBE supplier that qualifies as a "regular dealer." In order to qualify as a "regular dealer," a DBE must be an established, regular business that engages, as its principal business and under its own name, in the purchase and sale or lease of products of the same general character as those involved in the contract and for which DBE credit is sought. (49 CFR § 26.55(e)(2)). A DBE "regular dealer" must maintain a store, warehouse, or other establishment where the products are bought, kept in stock, or sold or leased to the public in the usual course of business. It is not necessary for every item the DBE firm supplies be stored in the DBE's warehouse, however, the place where the DBE firm keeps the supplies should be more than a token location or, as some cases have demonstrated, an empty warehouse. A DBE supplier may be a dealer in bulk items such as petroleum products, steel, cement, gravel and stone, or asphalt without owning or operating a place of business, if the firm owns and operates the distribution equipment for the products.

A DBE supplier performs a commercially useful function if it performs tasks such as sourcing materials/supplies, negotiating price, ensuring that the quality and quantity of materials meet contract requirements, purchasing and making payment for the materials from its own funds, making arrangements for and scheduling the delivery materials, and invoicing. A DBE supplier is not a "regular dealer" and does not perform a commercially useful function if it merely places an order with a manufacturer or other supplier who delivers the supplies directly to the job site, and then merely invoices the customer and collects payment on a "pay when paid" basis.

A DBE supplier's status is a factual, contract-by-contract determination. Most importantly, as noted above, the fact that the DBE has been "certified" by a local, state, or federal entity does not mean that it will be performing a commercially useful function on any particular project. As prosecutors often point out, certification focuses on the ownership status and control structure, not on the actual performance of the entity.

When analyzing whether it is proper to take credits for a DBE supplier's performance, it is important to know which DBE regulations govern the project. Unlike the DOT regulations, some state and local regulations do not recognize the distinction between brokers and regular dealers and provide no credit for commissions earned by DBE brokers. Other state and local regulations allow the contractor to take dollar-for-dollar credit for supplies obtained from a DBE "regular dealer." Even the DOT regulations allow dollar-for-dollar credit for supplies obtained for a project by a DBE if the DBE then installs those materials or if the DBE is the manufacturer.

Regardless of the exact details of the applicable regulations, many of the questions investigators will ask about DBE suppliers are the same. Investigators who are looking for fraudulent, pass-through relationships will ask questions such as:

- Is the DBE supplier engaged in, as its principal business and in its own name, the purchase and sale or lease of the products being supplied?
- Is the DBE an established business that regularly engages in the purchase and sale of the products being supplied?
- Does the DBE supply materials to non-DBE goal projects?
- Does the DBE supply materials to more than one contractor?
- Does the DBE maintain a store, warehouse, or other establishment where products are bought, kept in stock, and sold to the public?
- Whose equipment will be used to deliver the DBE's supplies to the project site?

Investigators also believe that indicators of sham DBEs include when the DBE firm works for only one contractor, the work is outside of the DBE's known experience or capability, and the volume of work is beyond the DBE firm's capacity. For example, in the *Azteca* case described earlier, federal investigators may have questioned how a single DBE could be in the business of regularly supplying widely disparate projects such as runway projects, restroom projects, and landscaping projects.

What Should Suppliers Do?

To avoid becoming a subject or target of a DBE fraud investigation, suppliers must avoid participating in arrangements where DBE suppliers are serving merely as pass-throughs, doing nothing more than placing an order with the supplier and invoicing the prime or subcontractor when the supplier delivers the materials to the job site. Unfortunately, investigators and prosecutors are often skeptical of the supplier's claim that it did not know the DBE supplier with whom it was directed to do business by a prime or subcontractor was a sham.

If all of the facts and circumstances suggest that the DBE is doing nothing more than "renting" its name to a project, the investigators and prosecutors can pursue the supplier under a "willful blindness" theory. Willful blindness can be a substitute for proving knowledge when the evidence shows that a defendant intentionally avoided confirming facts or learning the truth. In other words, a defendant is willfully blind when the defendant is deliberately ignorant about matters that would make the person criminally liable. For example, when the supplier bid on a project but was then told by the prime or subcontractor that the supplier would have to lower its price by 3%, or honor prices originally quoted to the contractor, and "sell" its products to a DBE supplier so that the prime or subcontractor could get DBE credits, investigators and prosecutors likely will conclude that the supplier did know or was willfully blind to the fact that the DBE supplier was nothing more than a pass-through.

Similarly, investigators and prosecutors generally reject the supplier's defense that it believed the DBE was legitimate because it was "certified" as a DBE by the relevant government agency. The law is clear that just because a DBE is "certified," meaning that it is owned and controlled by a socially and economically disadvantaged individual, does not mean that it is performing a commercially useful function on any given contract. It also may not be a defense for a supplier to claim that they did not know the DBE pass-through arrangement was illegal, because conspiracy, aiding and abetting, and false claim statutes do not necessarily require that a defendant act with the purpose to disobey or disregard a specific law. Rather, it may be sufficient that a defendant knew of or was willfully blind to the objectives of the conspiracy and assisted a prime or subcontractor to claim DBE credits for a transaction in which the DBE was a mere pass-through.

Practically speaking, a supplier cannot function as a quasi-government agency and conduct an exhaustive investigation of every DBE supplier that wants to become a customer. And, suppliers must consider the business risks associated with refusing to do business with any DBEs, legitimate or not. But what suppliers can do when their regular contractor customers ask them to work with a DBE supplier is to conduct some basic due diligence: ask the prime or subcontractor and/or the DBE what commercially useful function the DBE will be performing. If a supplier does not receive a satisfactory answer to that question, then the supplier should raise its concerns with the prime or subcontractor to ensure that the use of the DBE is in compliance with all of the applicable laws and regulations. If the supplier does not receive such assurances, then the supplier should not participate in the transaction.

If there is no legitimate DBE capable of performing a commercially useful function on a given project, suppliers should consider talking to the regular contractor customers about obtaining a waiver. The DOT's DBE regulations, and most local and state DBE programs, make clear that DBE participation goals are not to be treated as quotas. A contractor cannot be penalized, or treated as having failed to comply with the DBE regulations, if its DBE participation falls short of the goal, unless the contractor has failed to make a good faith effort to meet the DBE participation goal. The various regulations often provide extensive guidance on what constitutes adequate good faith efforts including, for example, "conducing market research to identify small business contractors and suppliers and soliciting through all reasonable and available means the interest of all certified DBEs that have the capability to perform the work of the contract." Making and documenting good faith efforts requires a proactive approach early in the contracting process, and suppliers may be able to assist in educating their contractor customers on this issue.

In addition, traditional suppliers should either develop or strengthen their internal DBE compliance programs and work to educate their employees and industry business partners on the perils of participating in pass-through arrangements. This protects not only the supplier, but their valued customers and the DBE, who may not fully appreciate the risks of such relationships, especially in this heightened enforcement environment.

Endnotes

1. Some state and local jurisdictions set separate utilization goals for minority-owned business enterprises (MBEs), women-owned business enterprises (WBEs) and other designations, such as local business enterprises (LBEs).
2. While we use the federal term DBE to refer to Disadvantaged Business Enterprises, local, state, and federal programs designed to encourage the use of, among others, minority owned, women owned, disabled owned, local business enterprises, and service disabled veteran owned businesses have been the subject of increased scrutiny.