

# PRATT'S GOVERNMENT CONTRACTING LAW REPORT

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# Suppliers Beware: U.S. Government Continues Prosecution of Disadvantaged Business Enterprise Fraud Cases Involving Supplies Passed Through Disadvantaged Business Enterprises

*By Michael A. Schwartz, Kristin H. Jones and John J. Gazzola\**

*In this article, the authors explain that federal law enforcement agencies, including the U.S. Department of Transportation Office of Inspector General, the FBI, U.S. Attorneys' offices nationwide, and the U.S. Department of Justice Fraud Division continue to prioritize the investigation and prosecution of disadvantaged business enterprise fraud as both criminal wire/mail fraud and as civil False Claims Act matters.*

The U.S. Court of Appeals for the Third Circuit has affirmed the convictions of a painting subcontractor and its owner (defendants) under the federal wire fraud statute for conspiring to defraud the U.S. Department of Transportation (DOT) and the Pennsylvania Department of Transportation (PennDOT) by exploiting the DOT's disadvantaged business enterprise (DBE) program involving two Philadelphia construction projects.

As explained below, the charges, conviction, and appellate opinion serve as a strong reminder to suppliers that they remain caught in the middle when their customers request to use a DBE as a pass-through for services on federally-funded construction projects.

## **BACKGROUND**

The convictions arose out of the defendants' participation in two federally funded projects involving repairs to the Girard Point Bridge and Amtrak 30th Street Train Station in Philadelphia. Each project included certain DBE requirements, which the defendants intended to satisfy by purchasing paint supplies from Markias, Inc., a certified DBE. Markias, however, did not actually supply materials for either project (that is, Markias did not perform a commercially useful function).

Instead, Markias merely "passed through" supplies from non-DBE paint suppliers to the defendants, adding a 2.25% fee to the suppliers' invoices for those materials. In exchange, the defendants issued two sets of checks to

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Markias: one check paid Markias its fee for acting as a “pass-through,” and the other check paid the paint and other material suppliers for services rendered.

The defendants misrepresented their compliance with DBE regulations to PennDOT, and on that basis, PennDOT awarded the defendants DBE credits for the full amount of paint “supplied” by Markias.

On these facts, a federal grand jury in Philadelphia charged the defendants with, and a jury later convicted the defendants for, violating the federal wire fraud statute.

### **THE THIRD CIRCUIT’S DECISION**

The defendants appealed their convictions and sentences, arguing, among other things, that the government failed to prove the “property” element of wire fraud, and the district court miscalculated PennDOT’s losses for purposes of sentencing. The Third Circuit affirmed the defendants’ convictions, but it reversed the district court’s loss calculation and remanded the matter for resentencing.

In affirming the defendants’ convictions under the wire fraud statute, the Third Circuit rejected the defendants’ argument that the wire fraud statute was inapplicable because there was no “property” at issue here. The court of appeals concluded that “PennDOT’s dollars establish the requisite property interest here.” Indeed, the court of appeals found that the object of the defendants’ fraudulent scheme was to obtain PennDOT’s money by obtaining millions of dollars that the defendants would not have received but for their fraudulent misrepresentations. Thus, the defendants secured PennDOT’s funding under false pretenses, and the value that PennDOT received from the defendants’ painting services was not a defense to criminal prosecution for wire fraud.

Notably, the Third Circuit found error in the district court’s calculation of PennDOT’s losses, which bore directly on the defendants’ sentencing. The district court considered PennDOT’s losses in adjusting the defendants’ base offense level, reasoning that the defendants’ “ill-gotten profits” were the appropriate measure of PennDOT’s loss. The court of appeals, however, concluded that such an approach is inappropriate where the defrauded party contracted for work performed by both DBE and non-DBE entities. The court of appeals explained that PennDOT’s loss did not equal the defendants’ profits because not all of the defendants’ profits were “ill-gotten” as the DBE services they committed to comprised only a portion of its scope of work.

The court of appeals concluded that the “government benefits rule” under Note 3(F)(ii) to the sentencing guidelines does not apply to DBE procurement fraud cases like this because the rule contemplates situations where the benefit of the bargain is unilateral. Procurement contracts, however, are bilateral

because the government receives services in return for payment. For this reason, the court of appeals remanded the loss calculation to the district court for reexamination.<sup>1</sup>

## CONCLUSION

The defendants' conviction indicates that suppliers are still caught in the middle when their customers request to use a DBE as a pass-through. In light of the anticipated increase in federally funded transportation projects, coupled with the court of appeals' conclusion that DBE fraud fits squarely within the wire fraud statute, suppliers must remain on high alert when their customers make such a request.

Federal law enforcement agencies, including the U.S. Department of Transportation OIG, the FBI, U.S. Attorneys' offices nationwide, and the Department of Justice Fraud Division continue to prioritize the investigation and prosecution of DBE fraud as both criminal wire/mail fraud and as civil False Claims Act matters.

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<sup>1</sup> Additionally, the court of appeals found no error in the district court's jury instructions and vacated the district court's forfeiture order. The court's holding about loss for sentencing purposes could provide the basis for an argument about the appropriate measure of damages in a False Claims Act case.

