

Suppliers Beware: US Government Continues Prosecution of DBE Fraud Cases Involving Supplies Passed Through DBEs

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On April 21, the Third Circuit Court of Appeals affirmed the convictions of a painting subcontractor and its owner (defendants) under the federal wire fraud statute for conspiring to defraud the 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.^[1]

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 Markias: One check paid Markias its fee for acting as a "pass-through," and the second 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 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 Court of Appeals 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 Court of Appeals 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 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 Court of Appeals 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 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 it 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.^[2]

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. attorney's 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.

Troutman Pepper's White Collar + Government Investigations and Construction practice groups are well-suited to help suppliers, prime contractors, and subcontractors navigate the challenges inherent in these requests. Please contact one of the authors of this article to learn more about Troutman Pepper's capabilities regarding DBE compliance on government-funded projects.

^[1] See "[Caught in the Middle: What is a Supplier Supposed to Do When Its Customers Ask to Use a DBE as a Pass-Through?](#)" by Kristin Jones and Michael Schwartz of Troutman Pepper Hamilton Sanders LLP (February 24, 2015) for an overview of this topic.

^[2] 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.

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