DBE Fraud: What Contractors Should Be Doing Now to Avoid Criminal and Civil Liability

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Six years ago, the Spring edition of *The Construction Lawyer* featured a timely article regarding women and minority business enterprise programs, constitutional challenges to these programs, changes in legislation for fraudulent certifications, and advice for how programs could be tailored to meet the needs of disadvantaged business enterprise (DBE) participants and program goals and objectives. This article focuses on criminal and civil liability for DBE fraud and the steps that contractors should be taking to avoid liability.

By now, many federal and state agencies have programs that set goals for DBE participation on public projects. Contractors are often required to certify DBE utilization on forms that are submitted as part of the monthly pay application process and for final payment at the end of the project. As participation requirements rise, the pool of available DBEs has become more limited, and contractors have engaged in unlawful approaches to program compliance, resulting in criminal charges, civil liability, suspensions, and debarment from work on public projects. Large, well-known contractors have been embroiled in high-profile DBE fraud investigations with huge multimillion-dollar settlements,[1] criminal convictions, and imprisonment for company executives.[2]

Federal and state criminal investigations of DBE fraud have become commonplace. They are frequently discussed in newspapers and industry publications,[3] and the fines and penalties, including prison and debarment, continue to shock and alarm people in our industry.[4] In light of the highly publicized nature of these investigations, one would think that practices in the industry would change and the number of DBE fraud cases decline, but that does not appear to be happening.[5] Moreover, many in the industry remain unaware of the elements and consequences of DBE fraud. We can expect civil and criminal DBE fraud investigations, claims, and charges to continue, and our clients would be well-advised to learn and understand what DBE fraud is from both a criminal and civil claims perspective and how to avoid it.

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DBE Fraud Indicators

The Office of the Inspector General for the US Department of Transportation (OIG) defines DBE fraud as:

> A contractor who misrepresents 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.[6]

The example of DBE fraud given by the OIG on its website describes a prime contractor and minority-owned subcontractor submitting false payroll records and preparing false job cost records to indicate that the minority-owned subcontractor performed work that was in fact performed by a non-DBE that controlled and supervised the work.[7] This fact pattern appears in many DBE fraud cases.[8]

OIG has identified the following 10 "red flag" indicators of DBE fraud:

- DBE owner lacks background, expertise, or equipment to perform subcontract work.
- Employees shuttle back and forth between prime contractor and DBE-owned business payrolls.
- Business names on equipment and vehicles are covered with paint or magnetic signs.
- Orders and payment for necessary supplies are made by individuals not employed by DBE-owned business.
- Prime contractor facilitated purchase of DBE-owned business.
- DBE owner never present at jobsite.
- Prime contractor always uses the same DBE.
- There are financial agreements between the prime

and DBE contractors.
- The prime contractor and DBE have joint bank accounts.
- There is an absence of written contracts.[9]

As discussed later in this article, contractors should adopt a DBE compliance program that provides for the appointment of a compliance officer to closely monitor DBE subcontractor relationships to prevent and eliminate these indicators.

The Commercially Useful Function Standard

A key factor in determining whether a DBE subcontractor relationship is lawful is whether the DBE is performing a commercially useful function. This determination is often the primary focus of DBE fraud investigations. The term "commercially useful function" is defined by the Department of Transportation (DOT) regulations 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.[10]

The regulations further provide that with regard to materials and supplies, the DBE must be responsible "for negotiating price, determining quality and quantity, ordering material, and installing (where applicable) and paying for the material itself."[11] The regulations make clear that DBEs that serve as mere "pass through" entities do not perform a commercially useful function:

> 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.[12]

A review of the regulatory definition of "commercially useful function" in the context of the OIG's 10 "red flag" indicators of DBE fraud paints a clear picture of the role a DBE must perform on a project in order for a contractor employing the DBE to claim compliance credit. In sum, the DBE should possess the required experience; be financially independent; employ its own laborers; own or rent its own equipment; and handle its own payroll, invoicing, and negotiations. On the other hand, if the DBE is a mere pass-through or middle man between two performing parties, the contractor seeking participation credits is exposing itself to serious criminal and civil liability.

Notable Criminal Cases

An early and important DBE fraud case involved Tulio Landscaping, Inc., a Pennsylvania contractor that was awarded two contracts to replace storm drain pipes along a railroad line for the Southeastern Pennsylvania Transportation Authority (SEPTA).[13] Tulio's bid certified that a certain percentage of the work would be awarded to a DBE hauler. Tulio did not use the disclosed company. Instead, the DBE was paid a fee for the use of its name on fraudulent DBE utilization reports. Tulio also created false invoices and checks to create a record of payments that were not made. Tulio and its owner, Michael Tulio, were found guilty of mail fraud and conspiracy to commit mail fraud.[14] Michael Tulio was sentenced to 15 months in prison with 24 months of probation and was fined $40,000.[15]

What is notable about the *Tulio* case is how the court determined the loss amount for sentencing. Tulio argued that because the government had received the services it contracted for, the loss amount should be limited to the fair market value of the work that should have been performed less the value of services actually performed.[16] The court rejected this argument and held that the loss amount for sentencing should be the *entire amount* of the DBE subcontract.[17] This is significant because the loss amount is a key consideration under Federal Sentencing Guidelines.[18] The higher the loss amount, the longer the potential prison term.

One of the most publicized fraud investigations involved Bovis Lend Lease.[19] In April 2012, the company admitted that it had overbilled clients on several large New York City projects and defrauded public agencies in New York and New Jersey clients by falsely claiming to have met DBE program requirements.[20] As part of its monthly requisition process, Bovis represented that certified DBEs performed a percentage of the work and claimed corresponding participation credits.[21] In fact, the DBEs served only as a pass-through. Bovis performed the work itself by managing union labor that was supposed to be employed by the DBE. Bovis placed many of its own long-term union workers on the DBE's payroll and directed the work.[22] The DBE performed no function other than to serve as a conduit for the issuance of payroll checks.

Bovis admitted and accepted responsibility for the charges and agreed to pay in excess of $56 million in penalties and restitution.[23] The head of the company's New York office was sentenced to two years of probation and ordered to pay a $175,000 fine and perform 750 hours of community service.[24] As part of the settlement, Bovis agreed to create a DBE liaison position to ensure that Bovis meets its federal, state, and local DBE obligations on a project-by-project basis and to verify that each DBE is capable of performing its subcontract and provides a commercially useful function.[25]

Another notable criminal DBE pass-through case involved Schuylkill Products, Inc., in a matter described as the largest DBE fraud case in history.[26] The scheme involved false DBE participation claims that reportedly lasted more than 15 years and involved more than $136 million in public contracts in the State of Pennsylvania.[27] The investigation revealed that beginning in 1993, Schuylkill had diverted more than 300 PA DOT

and Transportation Authority construction contracts reserved for DBE participation.[28] Personnel employed by Schuylkill and its wholly owned non-DBE subsidiary, CDS Engineers, Inc., were found to have routinely posed as employees of a certified DBE, Marikana Construction Company.[29] They used Marikana business cards, email addresses, stationery, signature stamps, and magnetic Marikana decals to cover up Schuylkill and CDS logos on vehicles.[30] Marikana received all the contracts, but the work was performed by Schuylkill and CDS, and they retained the profits.[31] For its part, Marikana received a small fixed fee.[32]

The investigation was conducted by the FBI, OIG, the US Department of Labor, and the Internal Revenue Service and resulted in charges of conspiracy to defraud, wire fraud, mail fraud, and money laundering.[33] Several Schuylkill, CDS, and Marikana executives were convicted, and their sentences included lengthy prison terms, $119 million in restitution, and probation.[34]

Last year, the president and several employees of Boggs Paving, Inc., a North Carolina highway contractor, pleaded guilty to conspiracy and money laundering charges in connection with 35 federally funded projects and two subcontracts worth more than $87.6 million.[35] Boggs reportedly claimed DBE credits of $3.7 million but paid the DBE Styx Cuthberton Trucking Company only $375,432.[36] Like the scheme in the Schuylkill matter, Boggs' personnel falsified records to misrepresent the quantity of DBE work, self-performed the DBE work, and used magnetic Styx logos to cover its own company logo on vehicles.[37]

A review of the OIG website and FBI fraud press releases reveals that many more investigations are underway in all regions of the country.[38] The high rate of investigations, convictions, and headlines should be expected to continue.

Civil Fraud Claims

In addition to criminal charges, suspension, and debarment, contractors who engage in DBE fraud also face civil claims under the federal False Claims Act and/or its state counterparts. Many of these false claims cases include and encourage claims by whistle-blowers.[39]

The federal False Claim Act (FCA) was enacted in 1863 in response to concerns that suppliers of goods to the Union Army during the Civil War were defrauding the government.[40] The statute begins by explaining the types of conduct that create FCA liability.[41] In general terms, the FCA applies to "any person who knowingly submits a false claim to the government or causes another to submit a false claim to the government or knowingly makes a false record or statement to get a false claim paid by the government."[42] FCA penalties are severe and were originally assessed for twice the government's damages plus a penalty for each false claim.[43]

The FCA has been amended several times since its enactment. In 1986, the changes included an increase from double the government's damages to treble damages and an increase in the penalty from $2,000 per claim to a range of $5,000 to $10,000 per claim.[44] In 1999, the penalty amount was again amended to no less than $5,500 and no more than $11,000 per claim.[45] Courts have discretion with regard to the assessment.[46]

With regard to the "knowledge" requirement, the FCA defines knowledge of false information as (i) actual knowledge, (2) deliberate ignorance of the truth or falsity of the information, or (3) reckless disregard of the truth or falsity of the information.[47] These last two categories of "knowledge" can ensnare construction executives who lack actual knowledge of the conduct of their subordinates regarding DBE participation and claims for credit on company projects.

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The application of FCA penalties on a per-claim basis can have an enormous effect on an ultimate damage award. In *United States ex rel. Bunk v. Birkart Globalistics GMBH & Co.*,[48] the defendant company stipulated to submitting 9,136 invoices in connection with a bid-rigging scheme to secure a federal contract. Each invoice was counted as a separate false claim for payment.[49] The corresponding penalty amount per claim amounted to between no less than $50,248,000 and no more than $100,496,000, in addition to damages for economic harm to the government.[50] In a widely read opinion, the district court ruled that the minimum penalty of in excess of $50 million would constitute an unconstitutionally excessive fine under the Eighth Amendment.[51] The court awarded no civil penalty.[52]

On appeal, the Fourth Circuit reversed and imposed a civil penalty of $24 million.[53] The penalty was imposed even though actual government damages had not been proven at trial,[54] and the government's total expenditure on the contract was only $3.3 million.[55] Considering the circumstances of the case, the Fourth Circuit concluded that $24 million in civil penalties did not constitute an excessive fine under the Eighth Amendment, "appropriately" reflected the gravity of the defendant's offenses, and provided the necessary and appropriate deterrent effect going forward.[56]

The Fourth Circuit's analysis in *Bunk* is arguably at odds with *United States v. Halper*,[57] wherein the Supreme

Court applied the Eighth Amendment to reverse an FCA penalty that was more than 200 times the amount of the government's damages. The Supreme Court found that the FCA recovery awarded by the court below did not "remotely approximate" the government's harm.[58] Nevertheless, although in extreme circumstances an Eighth Amendment argument can be made to reduce a per-claim FCA penalty assessment, the per-claim remedy remains a part of the statute with enormous consequences for would-be FCA violators, including those engaged in DBE fraud.

The application of FCA penalties on a per-claim basis can have an enormous effect on an ultimate damage award.

Notably, the *Bunk* case was brought by Kurt Bunk, a former employee of Burkart Globalisitics, a whistleblower, and a *qui tam* plaintiff. The FCA allows and encourages private persons to file suit for violations of the FCA on behalf of the government.[59] The person bringing the action is referred to as a relator and, if the government decides to intervene and succeeds on the merits, the relator's recovery is between 15 and 25 percent of the amount recovered by the government.[60] If the government decides not to intervene, and the relator succeeds, the share is increased to 25 to 30 percent.[61] The FCA allows for the court to reduce the relator's award without limitation if the relator is found to have participated in the fraud.[62]

Whistle-blower actions brought under the FCA for DBE fraud are not uncommon.[63] For example, in May 2014, McHugh Construction, a Chicago-based company, agreed to pay $12 million to settle claims that it defrauded federal and state government DBE programs.[64] McHugh allegedly used Perdel Contracting Corp. and Accurate Steel Installers as "pass-throughs" on various federal and state projects between 2004 and 2011.[65] The case was initiated by a project manager for Perdel under federal and state False Claims Act qui tam and whistle-blower provisions.[66] The employee received 17 percent of the $12 million settlement, or $2,040,000, for his participation.[67]

In June 2013, Dayton-based TesTech, Inc., its owner, and several other affiliated entities (CESO) agreed to pay $2,883,947 to settle allegations of widespread DBE fraud on highway and airport construction projects throughout Ohio, Michigan, and Kentucky.[68] The United States alleged that TesTech, a civil engineering contractor, was wholly owned and operated by non-DBE CESO, who used TesTech's status as a DBE to take advantage of DBE programs.[69] The case was initiated by one of TesTech's former employees under the federal False Claims Act *qui tam* and whistle-blower provisions.[70] The relator received $562,370 for his participation.[71]

What Contractors Can and Should Do to Avoid Claims and Charges

The lessons to be learned from more than a decade of criminal and civil DBE fraud claims are clear. It is incumbent on contractors who bid and work on projects with DBE participation requirements to hire independent, certified DBEs to perform a commercially useful function. Contractors should adopt a DBE compliance program to closely monitor its DBE subcontractor relationships, project compliance goals, and reporting requirements.

The compliance program should include the designation of an individual or, for large organizations, a committee to perform program management and oversight functions. Program goals and requirements will vary between federal, state, and local governmental agencies. The program must include a protocol for reviewing requirements on a project-by-project basis and developing a written compliance plan for each. Project-specific DBE goals and requirements will often be found in the project bid documents or specifications.

The program should provide a protocol for the identification of eligible certified DBE participants. Many times the awarding governmental agency will maintain a list of certified DBE contractors. A DBE's appearance on such a list does not, however, confirm that it is ready or capable of performing a commercially useful function on a project. Although such appearance may support an "intent" defense, it is not dispositive of DBE compliance. In other words, contractors are not necessarily immunized from liability simply by using a DBE that has been certified by the awarding agency. A critical program function will be to remove nonperforming or pass-through DBEs from the list of eligible participants. Questions the DBE should be asked to cull the nonperformers include

- How long has your company been in business?
- How many employees does your company have?
- What experience does your company have with the scope of work it is being asked to perform on this project?
- What DBE certifications does the company currently hold?
- Please confirm that your company will be performing the requested services and provide the required labor, materials, and equipment.
- Please confirm your company will be performing the administrative tasks necessary to complete the work including payroll and material and equipment orders.

The questions should be designed to confirm that the DBE is ready and able to perform a "commercially useful function." The questions and answers should be stored in a project file. Once a list of certified firms is obtained,

a written log should be kept to record contractor efforts to solicit certified and capable DBEs, including when they were contacted, how they were contacted, and their response to the solicitation. The log also should be stored in the project file so if there is an inquiry, the company can demonstrate compliance efforts.

On pending projects, the DBE compliance program should provide for the designation of an individual charged with monitoring existing DBE subcontractor relationships to ensure that the 10 "red flag" indicators discussed above are not present. Lastly, the program should include periodic reports and meetings with management on the status of the program on each project, and reviews with the project management team to ensure that they remain aware of, and in compliance with, program goals and reporting requirements on their projects.

The development and implementation of an effective DBE compliance program may seem like a daunting task, but, as discussed above, the risks of noncompliance are simply too great to be ignored any longer.

Endnotes

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2. *See* U.S. Attorney's Office, *Two Former Vice Presidents of Schuylkill Products Inc. Sentenced in Largest Disadvantaged Business Enterprise Fraud in Nation's History*, FBI.gov (Jan. 13, 2014), https://www.fbi.gov/philadelphia/press-releases/2014/two-former-vice-presidents-of-schuylkill-products-inc.-sentenced-in-largest-disadvantaged-business-enterprise-fraud-in-nations-history (discussing the sentencing of Dennis F. Campbell and Timothy G. Hubler to 24 months and 33 months in prison respectively, as well as combined restitution in the amount of $119 million); *Execs Get Prison in Record DBE Fraud*, Paintsquare.com (Aug. 5, 2014), http://www.paintsquare.com/news/?fuseaction=view&id=11785 (discussing the sentencing of former Schuylkill Products, Inc. COO and co-owner Ernest G. Fink to 51 months in prison).

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5. E. Michael Powers, *U.S. DOT Is Cracking Down on DBE Contracting Fraud*, ENR.com (May 8, 2006), http://enr.construction.com/news/finance/archives/060508f.asp ("Officials said that DBE fraud seems to be on the rise."); Matthew E. Orso, *DBE Fraud Enforcement on the Rise While OIG Cites Program's Significant Weaknesses*, Lexology.com (June 12, 2013), http://www.lexology.com/library/detail.aspx?g=bf5a7e5f-db7b-44eb-b51f-bd3434576fe0 (citing a 2010 OIG report indicating that "DBE fraud and abuse cases sharply increased.").

6. Office of Inspector Gen., U.S. Dep't of Transp., *Disadvantaged Business Enterprise (DBE) Fraud in Transportation*, OIG.dot.gov (Aug. 30, 2012), http://www.lexology.com/library/detail.aspx?g=bf5a7e5f-db7b-44eb-b51f-bd3434576fe0.

7. *Id.*

8. Jason Meisner, *McHugh Construction to Pay $12 Million Fine as Part of Federal, State Probe*, ChicagoTribune.com (May 1, 2014), http://articles.chicagotribune.com/2014-05-01/news/chi-mchugh-construction-to-pay-12-million-fine-as-part-of-federal-probe-20140501_1_suburban-firm-mchugh-construction-elizabeth-perino (reporting that Perdel Contracting Corp. employee-turned-whistle-blower Ryan Keiser spent his days "falsifying purchase orders, labor hours and other paperwork to show that his company—which was owned by a woman—was doing jobs that were actually being handled by McHugh Construction").

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11. *Id.*

12. *Id.* § 55(c)(2).

13. United States v. Tulio, 263 F. App'x 258, 260 (3d Cir. 2008).

14. *Id.*

15. United States v. Tulio, Dkt. No. 2:06-cr-00133-MMB (E.D. Pa. 2006).

16. *See Tulio*, 263 F. App'x at 258–64.

17. *Id.*

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20. *Construction Giant Lend Lease*, *supra* note 4.

21. *Id.*

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27. *Id.*

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