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Doing Business with Disadvantaged Business Enterprises

Public Procurement

When the economy is in a recession, the volume of private work declines. At the same time, federal stimulus money sometimes increases spending for public projects. Public Procurement is sometimes the only game in town and is always an opportunity.

Public Procurement often includes set asides or preferences for minorities and other disadvantaged groups. These groups go by different names in different federal and state programs, including Minority Business Enterprises (MBE), Small Minority Business Enterprises (SBE) and Disadvantaged Business Enterprises (DBE) in federal procurement. Although there is a difference in the qualification and the resulting benefits for each of these groups, they will all be referred to as DBEs in this discussion. Most of these groups are financially disadvantaged. This presents a special challenge for suppliers, subcontractors, general contractors in the construction and other industries.

Prime contractors (general contractors) must be careful to make sure they are in compliance with DBE set aside requirements on a project, while avoiding the financial risk of insolvency by DBE subcontractors. Suppliers want to maximize business opportunities on public contracts, while also avoiding the financial risk of insolvency by their customers. Dealing with Minority Business Enterprises or other disadvantaged groups are an opportunity to do new business and to promote the development of experienced and financially strong minority partners. This opportunity does come with some risk, but that risk can be managed with care and careful document drafting.

Public Policy

The public policy is actual participation by DBEs, so that the disadvantaged groups gain actual experience in government contracting and can develop into financially strong government contractors. The most common standard is that there are no DBE participation points unless the DBE contractor performs a “commercially useful function.”¹ The regulations do not allow the DBE to be an “extra participant in a transaction, contract or project, through which funds are passed in order to obtain the appearance of DBE participation.” A DBE performs a commercially useful function when it is responsible for execution of the work of the contract and is actually performing, managing, and supervising the work. To perform a commercially useful function with respect to materials, the DBE must be responsible for negotiating price, determining quality and quantity, ordering the material and installing materials (where applicable) and paying for the material. For example, controversies exist regarding joint check agreements, because joint check agreements make it more difficult to determine whether the DBE is paying for the material and controlling its operations independently of the general contractor.

When a general contractor determines that it wants a particular non-DBE subcontractor or supplier to participate in a project, there is a temptation to “insert” a DBE between the general contractor and the desired subcontractor or supplier. Suppliers are often reluctant to extend credit to financially disadvantaged DBEs. Sometimes, the result is a DBE involved in a project “in name only.” However, this defeats the public purpose of actual DBE participation. Governmental entities have become more aggressive in scrutinizing these transactions in order to promote actual participation.

Penalties, Checks and Balances

Federal projects will typically have DBE participation goals of up to 24%. This means that twenty four per cent of the work on the project should be performed by disadvantaged business enterprises, usually as subcontractors or suppliers.

Local governments will typically request federal money for major projects. For example, most interstate highways are state projects, but are at least partially funded through the Federal Highway Administration (FHA). Many other state infrastructure projects also receive federal funding, which usually requires a “full funding and grant agreement” with the United States. This makes both the state public procurement code and the federal public procurement code applicable to the project, including DBE participation goals.

The resulting dynamic is that DBE participation may not be a priority to the local government “owner” on the project. Local governments do care about getting federal money for major projects, but there may not be any penalty to local governments for

¹ 49 CFR (Code of Federal Regulations) 26.55 (c)(2).

violation of DBE goals. It is not clear whether the federal government is withholding money on current or future projects if local governments fail to enforce DBE participation. However, this is one area of possible future enforcement that may impact behavior.

DBE participation is often not a genuine priority to general contractors on government projects. General contractors do care about winning bids for government projects and may have to show DBE participation goals in order to win contracts. However, it is again not clear whether and local governments are withholding money on current contracts or refusing to award future projects if general contractors fail to achieve DBE participation goals. Government owners and contractors are usually most concerned with getting projects done as planned and on time. Government owners may begin including penalties in contracts if DBE participation goals are not achieved. However, even this penalty could delay projects and cost taxpayers money. If a DBE contractor fails to perform, is terminated or abandons a project, both the owner and general contractor may be more concerned with getting the project completed than DBE participation.

DBE participation is often not a genuine priority to suppliers or even subcontractors on government projects. Accordingly, it is often unclear whether anybody is “enforcing” DBE participation, while many participants seem to be “gaming” or circumventing the rules to their advantage. To make things worse, there is also uncertainty regarding the rules. The federal Small Business Administration (SBA), the Department of Defense (DOD) and the Federal Highway Administration (FHA) each have differing rules, although federal agencies seem to increasingly follow SBA standards and definitions. Then each state and each local government within the state have varying rules. All of these rules are relatively new. The players are not familiar with the rules and do not have the benefit of past experience.

The result is a great deal of confusion and uncertainty regarding DBE participation policies amongst owners, general contractors, subcontractors and suppliers. Owners, general contractors, subcontractors and suppliers also circumvent the rules or fail to enforce rules, with the result that DBE participation is sometimes “in name only.” Taxpayers pay an increased price for projects, while the public policy objective fails. The public policy objective is getting disadvantaged groups actual experience in government contracting.

It seems quite possible that we will see increasing penalties, checks and balances to make sure we are achieving the public policy goal. Hopefully rules will become more consistent and clear. In any event, in order to maximize business opportunities, it is important to understand the public policy goals and the needs of owners, general contractors, subcontractors and suppliers.

The Negotiating Range

The challenge is to structure transactions to satisfy governmental owners and get “minority participation points” for general contractors, while still leaving suppliers comfortable with the financial risk. The first step in any negotiation is understanding what other players are trying to achieve.

By definition, DBEs are disadvantaged in some respect and are usually financially disadvantaged. Non-disadvantaged subcontractors and suppliers are worried about getting paid and are troubled by the need to depend on financially disadvantaged customers for payment. Accordingly, non-disadvantaged subcontractors and suppliers want security or recourse to a financially strong customer.

General Contractors must obtain DBE participation points, or at least show good faith efforts to get DBE participation. General Contractors are also worried about paying for the same material twice. This is a legitimate concern for government owners and general contractors who wish to hold down the cost of projects. If general contractors consistently have to double pay for some materials, they will increase the risk factor in their pricing. However, general contractors on public projects are used to this risk in the form of federal Miller Act and state Little Miller Act payment bonds. Most payment bonds have no “defense of payment.” A claimant can force a general contractor to pay twice for the same material.

Many state mechanic’s lien statutes do have a “defense of payment.” A mechanic’s lien claimant usually cannot force an owner or a general contractor to pay twice for the same material. Subcontractors and suppliers on private projects are used to this risk. As long as the owner and general contractor owe enough money on the project, the supplier will have mechanic’s lien rights and will be able to enforce payments against the owner and general contractor.

Will there be a “defense of payment” or will the general contractor provide an outright guarantee as they do on most bonded projects? This is a large part of the negotiating range in DBE participation transactions. What if the DBE defaults or abandons the contract, so that the DBE is not owed any amount on the project? Is the general contractor still at risk to pay in full for all materials? A general contractor is much more likely to agree to an escrow or security arrangement that secures the supplier for any funds that are actually owed to the DBE. However, if the general contractor does not owe the DBE any funds, the supplier will have no recourse.

Let's consider two extreme options to illustrate this tension and negotiating range. The minority participation point rules and the acceptable contractual terms vary between various federal and state agencies. However, a general discussion of possible solutions follows.

Direct Sale to DBE

General contractor often refuse to discuss joint check agreements or any other mechanism and tell suppliers that they must deal directly with the DBE. This certainly solves the general contractor's problems, but often leaves the supplier in unacceptable risk. Because of the "insertion" of the DBE, the supplier is now one tier further removed from the owner and general contractor and may lose mechanic's lien or bond rights as a result. Bond rights will typically extend only to second tier subcontractors. Mechanic's lien statutes often have a similar limitation. Suppliers will often outright refuse to supply materials if they only have an unsecured claim against a financially disadvantaged customer for payment. In any event, suppliers would charge much higher prices with this higher risk factor.

Direct Sale to General Contractor

If there was no concern with minority participation points, a supplier could propose a sale directly to the government or general contractor. The DBE could then separately perform their function on the project, using the supplier's labor or material. This would satisfy the supplier's credit concerns, but it would also decrease the dollar amount of the DBE's contract and decrease the minority participation points for the project and the general contractor. In computing the DBE participation on a project, the government will only include the cost of the material *obtained* by the DBE. This also essentially includes a guaranty from the general contractor to pay the supplier, whether or not the DBE is owed any money on the project. Accordingly, this is often not an option.

Guaranty from General Contractor

A supplier may be satisfied with a guaranty of payment from the general contractor. This might satisfy the supplier's credit concerns, without decreasing the dollar amount of the DBE's contract. Apparently, such a guaranty would not decrease the minority participation points for the project and the general contractor. The DBE can be responsible for negotiating price, determining quality and quantity, ordering the material, installing and paying for the material. The general contractor plays no role unless the DBE fails to pay.

However, general contractors are usually very reluctant to provide a payment guaranty because it could increase their overall costs on a project. The general contractor would have to pay for the supplier's materials, even if the general contractor did not owe the DBE anything. General contractors do not like this, but it is exactly the risk they take on any bonded contract, if the supplier has bond rights. Accordingly, a general contractor guaranty should always be considered, but is often refused by a general contractor.

Payment Bond

In the construction industry, suppliers often benefit from owner required general contractor project payment bonds. For example, a general contractor is usually required to provide a payment bond for all substantial new public construction projects. Private construction project owners also often require bonds. General contractors sometimes require all subcontractors to provide payment bonds, including DBE subcontractors. If a supplier on a construction project does have the protection of a payment bond, this reduces much of the risk of doing business with a DBE.

As explained in the chapter on Payment Bonds in the Construction Law Survival Manual at www.FullertonLaw.com, there is no "defense of payment" under most payment bonds. However, the protection of a payment bond does not extend to all suppliers on a project. A supplier may be too "remote" from the general contractor. Bond protection normally extends only to labor or material supplied to the bond principal (contractor that provided the bond) or subcontractors of the bond principal. When a DBE is "inserted" into the contract hierarchy, any supplier is one step more remote from the bond principal and this may eliminate protection under the bond. Also, if the DBE customer is a "mere materialman" (not supplying on-site labor to the project), a material supplier to the DBE (supplier to a supplier) will not usually have bond protection. Usually, the material supplier's customer must be a "subcontractor" supplying labor and material to the project for the supplier to have bond protection. Suppliers are used to being secure on any public project, but they must be aware that they may become unsecured when a DBE is "inserted" into the project.

A supplier in any industry can consider requiring a custom payment bond from a general contractor on any project. A payment bond can secure a single sale, all sales to a specific project or even all sales to a specific DBE on any of the general contractor's projects. This flexibility can be helpful. A project specific payment bond dedicated to one supplier would not necessarily even result in additional bond premium to the general contractor. The materials from the supplier are already included in the scope of the general contract, are included in the general contract sum and may already be included in a payment bond for the project. Depending upon their relationship, a general contractor may be able to convince the surety to provide the additional bond without additional premium.

However, general contractors may be reluctant to provide a payment bond for the same reasons general contractors do not like to provide a payment guaranty. There is no "defense of payment" under most payment bonds. The general contractor would have to pay for the supplier's materials, even if the general contractor did not owe the DBE anything. The general contractor may need to pay a premium to obtain the bond. However, a general contractor, its surety and a supplier would be free to draft a bond in any manner they chose and could agree to include a defense of payment and other terms, so that a general contractor was not at risk to pay for the same materials twice. Accordingly, a payment bond dedicated to a specific supplier is still an option.

Mechanic's Lien Rights

In the construction industry, suppliers also usually benefit from mechanic's lien rights on most private construction projects. If a supplier on a construction project does have mechanic's lien rights, much of the risk of doing business with a DBE may be eliminated.

As explained in the chapters on Mechanic's Liens in the Construction Law Survival Manual at www.FullertonLaw.com, the protection of mechanic's lien rights does not always extend to all suppliers on a project. Just like in the case of payment bond, a supplier may be too "remote" from the general contractor and owner. For example, in the state of Pennsylvania, you will not have mechanic's lien rights unless you sold labor or material directly to the owner, general contractor or first tier subcontractor. Also just like in the case of payment bond, if a DBE is "inserted" into the contract hierarchy, any supplier is one step more remote from the owner and general contractor. This may eliminate mechanic's lien protection. However, this varies from state to state. For example, there is no known limit in Maryland and Virginia how remote a supplier can be and still have mechanic's lien rights.

As also explained in the chapters on Mechanic's Liens in the Construction Law Survival Manual at www.FullertonLaw.com, there is a "defense of payment" under the mechanic's lien law of many states, including Virginia. The owner and general contractor must only pay for the project once. Once an owner has paid a general contractor in full, any lien claimant that sold labor or material to the general contractor will fail. Once a general contractor has paid a subcontractor in full, any lien claimant that sold labor or material to that subcontractor will fail. When a DBE is "inserted" into the contract hierarchy in state with a mechanic's lien "defense of payment," any supplier runs the risk of losing mechanic's lien rights because of a defense of payment. If the DBE is not owed any money on the project, because the DBE was paid or because the DBE defaulted on its contract, the supplier will not have enforceable mechanic's lien rights.

If a supplier is doing business in a state with no "defense of payment" and no remoteness issues under the mechanic's lien law, then the supplier's mechanic's lien rights are not directly affected by the insertion of a DBE into the contract hierarchy. These mechanic's lien rights may be sufficient to justify the extension of credit. If a supplier is doing business in a state with either a "defense of payment" or remoteness issue under the mechanic's lien law, however, then the insertion of a DBE into the contract hierarchy may eliminate a supplier's mechanic's lien rights. Therefore, it is important for a supplier to understand the mechanic's lien law of the states in which they are doing business and adjust their credit risk strategy accordingly.

Assignment of Payment Bond or Mechanic's Lien Rights

If a supplier is doing business in a state with mechanic's lien "defense of payment" or remoteness issues, the insertion of a DBE into the contract hierarchy may eliminate a supplier's mechanic's lien rights. There may be a temptation to "solve" this problem by having the DBE "assign" its mechanic's lien rights to the supplier. There is an example of an "assignment" of mechanic's lien or bond rights in the Liquidation Agreement attached in the Appendices.

The most obvious observation is that an assignment of the DBE's mechanic's lien rights will not solve a "defense of payment" problem. The DBE does not have mechanic's lien rights if the DBE is not owed any money on the project. If the DBE was paid or the DBE defaulted on its contract, any supplier with an assignment of mechanic's lien rights has no enforceable rights on the project. Also if the DBE's customer on the project has been paid, any supplier with an assignment of mechanic's lien rights has no enforceable rights on the project. There will be no way to solve this problem, except with alternate security or a guaranty from the owner or general contractor.

An assignment of mechanic's lien rights could solve remoteness issues, by bringing the supplier one tier closer to the owner and general contractor. In Virginia and Maryland, for example, mechanic's lien rights are assignable. However, in many states, a supplier cannot be confident. The law on this question varies from state to state. There has been no attempt here to research the answer in all fifty states. However, there is simply no answer in many states, including Pennsylvania³, because the question has never come up in a recorded case from a high ranking court. This sometimes makes it impossible to be completely confident how a court would view an assignment of mechanic's lien rights.

Legal rights are generally assignable and this does allow a general prediction that mechanic's lien rights are also assignable.⁴ However, some states prohibit the assignment of mechanic's lien rights on public policy grounds. The state legislature has granted mechanic's lien rights to certain classes of labor and material suppliers.⁵ The limitations of these rights can not be circumvented by private contract. The mechanic's lien rights are "personal" to the claimant that supplied labor or material.⁶

In some states, the assignability of mechanic's lien rights depends on whether the labor or material has already been supplied, so that the mechanic's lien rights already exist at the time of assignment. In other states, the assignability of mechanic's lien rights depends on whether the mechanic's lien has already been perfected (filed) at the time of assignment.⁷ In some states, there is clear case law that mechanic's lien rights are assignable, but sometimes this case law is quite old and may have been based on an older version of the statute.⁸ In some states, you will have some certainty that mechanic's lien are assignable. In other states, you will have some certainty they are not. In many states, you just will not know for sure.

Federal Miller Act bond rights do have some certainty on assignability. The case law seems fairly clear that federal Miller Act bond rights are assignable.⁹ This federal law should be applicable to federal projects in all fifty states.

Many states have Little Miller Acts that are very similar to the federal Miller Act. However, the assignability of Little Miller Act bond rights will be state specific. State courts tend to look to the federal Miller Act to interpret their state Little Miller Act, unless the state law has a relevant difference in wording. However a state court is not bound to follow federal Miller Act case law and this will create uncertainty, unless a high ranking court has ruled on the issue in a recorded case. There is no known case law of this subject in the Mid-Atlantic states. Accordingly, you can make a general prediction that state Little Miller Act bond rights are assignable. However, you do not have certainty unless there is clear high level state case law that Little Miller Act bond rights are assignable.¹⁰

Private bond rights would not have the same public policy questions. A bond is a private contract. Contract rights are generally assignable. Accordingly, you can make a general prediction that private bond rights are assignable. However, the answer to this question will be state specific. There seems to be little case law on this subject and no known case law in the Mid-Atlantic states. You do not have certainty. Since a private bond is a private contract, there are also no restrictions how the bond form is worded. Any owner and general contractor would be free to agree in the bond that rights would be nonassignable. This would further complicate the issue.

² *McCrea v. Johnson*, 104 Cal. 224 (1894); *Lovett v. Brown*, 40 N.H. 511 (1860).

³ But See *Hartman v. Keown*, 101 Pa. 338, (1882) (finding a valid assignment of a lien on a mare on the sale of the debt).

⁴ *Davis v. Bilsland*, 85 U.S. 659 (1873) [Based on Montana mechanic's lien statute, U.S. Supreme Court ruled that mechanic's liens are assignable.

Claimant had "completed his claim by filing his lien before assigning it to the plaintiff. It was perfectly lawful for him to assign his claim. It was not against any principle of public policy to do so."].

⁵ *Gould, Inc. v. Dynalectric Company*, 435 A.2d 730 (Sup.Ct. Del 1981).

⁶ *Georgia-Pacific Corp. v. First Wis. Fin. Corp.*, 625 F. Supp. 108, 116 n.4 (N.D. Ill. 1985).

⁷ *Talco Capital Corp. v. State Underground Parking Comm'n*, 324 N.E.2d 762, 767 (Ohio Ct. App. 1974); *Gould, Inc. v. Dynalectric Company*, 435 A.2d 730 (Sup.Ct. Del 1981).

⁸ *Bristol Iron & Steel Co. v. Thomas*, 93 Va. 396, 397 (1896) [As a general rule, any contractual right is assignable, and the assignment carries with it all liens given for its security. An assignee was entitled to perfect the inchoate lien which existed for the benefit of his assignor]; *Iaeger v. Bossieux*, 56 Va. 83 (1859)[There is nothing in public policy or in the language or the policy of our act to forbid it; and if the statute be exclusively for the benefit of the builder and material-man it would certainly impair the value of his lien to declare it non-assignable.]; *Nat'l Elec. Indus. Fund v. Bethlehem Steel Corp.*, 296 Md. 541, 552 (1983)(A Union could enforce the mechanic's lien rights of subcontractor-employees for the purposes of collecting Union fees); See also *District Heights Apartments v. Noland Co.*, 202 Md. 43, 46 (1952)[The subcontractor, having encountered financial difficulties, had assigned all its right, title and interest in the money which the general contractor owed it. However, the dispute in this case addressed only delivery and notice issues. Apparently, the assignment was not directly addressed or contested.].

⁹ *U.S. ex rel. Sherman v. Carter*, 353 U.S. 210, 219 (1957).

¹⁰ *Quantum Corporate Funding, Ltd. v. Westway Indus.*, 4 N.Y.3d 211 (N.Y. 2005); *Trs. for Mich. Laborers' Health Care Fund v. Seaboard Sur. Co.*, 137 F.3d 427 (6th Cir. 1998); *Shoshoni Lumber Co. v. Fidelity & Deposit Co.*, 46 Wyo. 241 (Wyo. 1933); *Finch v. Enke*, 54 S.D. 164 (S.D. 1929).

In summary, the assignability of mechanic's lien or bond rights will be very state specific, except for federal bonds. In some states, you can say that mechanic's lien or bond rights are assignable. In other states you will know for certain that they are not. In many states, you will have the general prediction that legal rights are assignable, but there will be no certainty.

For credit management planning purposes, an assignment of mechanic's lien or bond rights will always be helpful, but may not be an entirely dependable solution. A supplier may need to have another mechanism to have confidence.

However, a creditor that has already supplied labor or material is in a very different posture. The creditor certainly should have better managed their credit decision before supplying labor or material. However, if a buyer is in default, a creditor's choices are more limited.

It is often a good strategy to get an agreement that the creditor can enforce the DBE's mechanic's lien or bond rights in the DBE's name. The DBE can agree that the creditor's law firm can bring the action in the DBE's name, that the creditor has the right to decide how or when to settle the case and that the creditor receives all proceeds until paid in full. As a practical matter, the opposing parties may never know that it is the creditor enforcing these rights and may never raise assignability questions. It is also arguable that this is not an assignment at all. Any "assignment" of mechanic's lien or bond rights should be worded this way for this reason, whether negotiated before or after the supply of labor or material. An example of such a Liquidation Agreement is attached in the Appendices.

Joint Check Agreement

Three way agreements (often called joint check agreements) are often used to reduce credit risks to suppliers and promote favorable supplier pricing. A joint check agreement is an option, but some governmental entities have denied minority participation points if the joint check agreement circumvents actual participation policies.

For example, the Federal Highway Administration has published "Guidance on the Use of Joint Checks Under the DBE Program," applicable to any federal aid highway project.¹¹ Joint checks are not prohibited, but are subject to conditions. The general contractor must act "solely as a guarantor"; the DBE must release the check to the supplier; the use of joint checks must be a commonly recognized business practice in the industry (for non-DBE contractors also); the state transportation agency must approve the practice before it is used; and the state agency must monitor the practice to avoid abuse. The requirement of governmental approval before using any joint check arrangement makes this option cumbersome for general contractors and suppliers.

As explained in Chapter Two of the Construction Law Survival Manual at www.FullertonLaw.com, there are risks to a creditor in any joint check agreement. Most importantly, it will only help if a check is ever written. If the DBE defaults on its contract and general contractor does not owe any payment, the supplier will never receive payment. In other words, there is a defense of payment feature to most joint check agreements and a general contractor is not at risk to pay for the same materials twice. As is also discussed above in the section on Joint Check Agreements, a supplier would want a trust fund agreement or a security interest in the joint check agreement. These mechanisms preserve the defense of payment feature and do not increase the risk or cost to the general contractor. However, these features will dramatically improve the supplier's standing compared to other creditors of the DBE in the event of insolvency.

The wording of joint check agreements varies widely and sometimes waives more legal rights than they provide. Accordingly, a general contractor must carefully structure a joint check arrangement to make sure they can get minority participation points and a supplier must carefully structure a joint check arrangement to make sure it increases the chances of payment.

The government will not normally sign a joint check agreement, so this is not an option if the DBE has a contract directly with the government. It is possible that the government modify the general contract to say that payment will be made jointly to the general contractor and the supplier.¹² However, the supplier may or may not have a direct cause of action against the government if it fails to issue a joint check and instead pays the general contractor directly. Court case law on this subject is mixed.¹³ A supplier may be able to make a similar arrangement, however, with the Assignment of Claims Act.

Trust or Escrow Arrangement

It is possible to create an escrow or trust payment agreement for the benefit of both the DBE and the supplier. This arrangement has been approved or even proposed in the past by some federal government procuring agencies without impacting

¹¹ See Federal Highway Administration Guidance on Use of Joint Checks Under the DBE Program, dated August 30, 2006, at <http://www.fhwa.dot.gov/civilrights/memos/dbe083005.htm>

¹² *Winter v. Floorpro, Inc.*, 570 F.2d 1367 (Fed. Cir. 2008).

¹³ *Id.*; *D & H Distributing Co. v. United States*, 102 F.3d 542 (Fed. Cir. 1996).

minority participation points to the general contractor. Any government owner, private owner or general contractor could agree to this arrangement, especially with the precedent set by some federal agencies. An advantage is that only the DBE and general contractor need to agree. No agreement from the government is necessary. However, the supplier would want the general contract, or at least the subcontract, to contain an obligation to make payment pursuant to the escrow agreement.

In an escrow or trust arrangement, the general contractor makes payments to an escrow agent, who then holds the funds in trust until both the DBE and supplier provide the escrow agent instruction on the amount the escrow agent should disburse to each. For example, this law firm has acted as escrow agent in such arrangements in the past. An example of an escrow or trust agreement is available in the Appendices.

If the DBE and supplier do not provide the escrow agent instruction, then the DBE, supplier or escrow agent can request a court order regarding the proper disbursement. Legal action can result in additional costs, but that threat of additional cost normally motivates the parties to make an agreement. There is a defense of payment feature to an escrow or trust agreement. If no payment is due to either the DBE or the supplier, then the general contractor is not obligated to make any payment. However, an escrow or trust arrangement does reduce the risk of insolvency or misappropriation of funds, while allowing the general contractor the minority participation points. As explained in chapter on Trust Funds Laws and Agreements in the Construction Law Survival Manual at www.FullertonLaw.com, both general contractors and suppliers benefit from trust fund provisions. They reduce the risk of both general contractors and suppliers, without increasing costs.

An escrow or trust agreement will normally work only if the DBE is a subcontractor. The government will not normally sign an escrow or trust agreement, so this is not an option if the DBE has a contract directly with the government. It is possible that the government modify the general contract to say that electronic payment will be made directly to a specific bank account. That bank account could be in the name of the escrow agent or even in the name of the supplier. However, the supplier may or may not have a direct cause of action against the government if it fails to follow the contract payment terms, because only the DBE has a contract with the government, not the supplier. A supplier may be able to make a similar arrangement, however, with the Assignment of Claims Act.

Assignment of Claims

If the DBE has a contract directly with the federal government, it is possible for the DBE general contractor to assign the monies due under the government contract through the Assignment of Claims Act.¹⁴ A proper Assignment of Claim requires the government to pay the assignee directly and will give a proper assignee a claim directly against the government if it fails to make proper payment.

There are strict rules to make an Assignment of Claim enforceable. An assignee must make sure that the general contract does not prohibit assignment. It is also preferable that the general contract does not allow the government to set off the receivable against indebtedness the DBE may have to the government,¹⁵ although the government may not be willing to give up these rights of setoff. The assignee must file three copies of the assignment with the Contracting Officer or the head of the procuring agency, the disbursing official for the contract and with any surety on any bond for the general contract. If properly filed, the assignee will have a claim against the government if payment is not properly made to the assignee. Any surety will still have priority over the receivable.

The Assignment of Claim must assign the entire receivable under the general contract. The Assignment of Claim must be to a bank, trust company or other financing institution.¹⁶ However, the assignment may be made to one party as agent or trustee for two or more parties participating in such financing. It is questionable whether a bank, trust company or other financing institution could act as agent or trustee for a trade supplier in a valid Assignment of Claim.¹⁷ Some courts have held that any bank assignee must show that it loaned money for the performance of the government contract.¹⁸

However, the government can accept an assignment, even if the assignment was legally invalid under the Assignment of Claims Act.¹⁹ This would be similar to the government agreeing to a joint check or other arrangement. The government could

¹⁴ 31 U.S.C. §3727 and 41 U.S.C. §15.

¹⁵ *Chelsea Factors, Inc. v. United States*, 149 Ct. Cl. 202 (Ct. Cl. 1960).

¹⁶ *Fireman's Fund Ins. Co. v. Eng.*, 313 F.3d 1344, 1350 (Fed. Cir. 2002).

¹⁷ *Chelsea Factors, Inc. v. United States*, 149 Ct. Cl. 202 (Ct. Cl. 1960). Some courts have held that subcontractors are not valid assignees under the Federal Assignment of Claims Act. See *Pan Arctic Corp. v. United States*, 8 Cl. Ct. 546 (1985); *Diamond Mfg. Co. v. United States*, 3 Cl. Ct. 424 (1983); *United States v. Russell Elec. Co.*, 250 F. Supp. 2 (S.D.N.Y. 1965). However, it is not clear whether this authority may be applied to a subcontractor as a beneficiary of a valid assignee under the Assignment of Claims Act.

¹⁸ See *American Nat'l Bank & Trust Co. v. United States*, 22 Cl. Ct. 7 (1990); *Manufacturers Hanover Trust Co. v. United States*, 590 F.2d 893 (1978); *Applied Companies v. United States*, 37 Fed. Cl. 749 (1997).

¹⁹ *United States v. Russell Elec. Co.*, 250 F. Supp. 2 (S.D.N.Y. 1965).

also modify the general contract to change the remittance address, so that the government makes contract payments to a payee other than the general contractor. That would essentially result in an assignment. Without actually using the Assignment of Claims Act, the payee under the general contract could enforce payment from the government.²⁰ In other words, an Assignment of Claim or the equivalent is still an option, even though there are technical problems with the Assignment of Claims Act.

UCC Security Interest

The assignment should also be recorded as a Uniform Commercial Code Security interest. Even if an assignment is not valid under the Assignment of Claim Act, it may also still be a valid assignment or security interest under the Uniform Commercial Code, with priority over other security interests or a bankruptcy trustee. A conventional assignment or security interest under the Uniform Commercial Code is also a good option to consider in any event, to secure debts from any government contractor or any subcontractor. This will not provide a claim against the government and will be inferior to the claim of a bond surety, but will provide priority over other junior security interests or a bankruptcy trustee.

General Contract Modification

Apparently, it is always possible that the government can modify a general contract in a manner that will improve payment security for a supplier. As mentioned above, the government could modify the general contract, so that the government is required to make the general contract payments to a supplier. The result is very similar to an assignment. Similarly, the general contract could be modified to require payment by joint check or payment to an escrow agent. The court case law is a little inconsistent, but any of these arrangements could give a supplier a claim directly against the government, as long as the supplier can file suit in the Federal Court of Claims, rather than the Federal District Court.

Advance Payment

Some government programs allow a DBE general contractor to receive advance payment of contract funds, which would then allow the DBE to make an advance payment to a supplier. Similarly, any general contractor could agree to make an advance payment to a DBE subcontractor. Advance payments do increase the risk of the owner or general contractor, so this option can be difficult.

Conclusion

Dealing with Minority Business Enterprises or other disadvantaged groups are an opportunity to do new business and to promote the development of experienced and financially strong minority partners. This opportunity does come with some risk, but that risk can be managed with care and careful document drafting.

James D. Fullerton is an attorney and president of the law firm of Fullerton & Knowles, P.C., with attorneys licensed in Virginia, Maryland, Pennsylvania and the District of Columbia. Visit the firm website at www.FullertonLaw.com where you can use the **Free 550 page** online internet **Construction Law Survival Manual** with valuable information about construction contract litigation, mechanic's liens, payment bond claims, bankruptcy, the Uniform Commercial Code, and credit management. The website also offers over 30 commonly used contract forms, including Change Orders, Waivers, Joint Check Agreements, Quotes, Proposals, Credit Applications and Guarantees.

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²⁰ *Kawa v. United States*, 77 Fed.Cl. 294 (2007).

LIQUIDATION AGREEMENT

This Agreement made the _____ day of _____, 20____, between _____ (“Supplier Creditor”) and _____ (“Account Debtor”).

WITNESSETH

WHEREAS, on or about _____, Account Debtor entered into several contracts with _____ (“General Contractor”), pursuant to which Account Debtor agreed to perform and complete certain work required for work on various projects (“Projects”), all as more specifically set forth in those contracts between Account Debtor and General Contractor (“Contracts”); and

WHEREAS, Supplier Creditor is now owed an outstanding balance for labor and materials supplied to Account Debtor (“Supplier Creditor Receivable”) which has been liquidated in the form of a promissory note (“Promissory Note”); and

WHEREAS, Account Debtor’s records show it is now owed an outstanding balance of \$_____ for labor and materials supplied to General Contractor on the Projects (hereinafter the “General Contractor Receivable”); and

WHEREAS, Account Debtor wishes to assign its rights to the General Contractor Receivable to Supplier Creditor;

-OR-

WHEREAS, on or about _____, Account Debtor entered into several contracts with _____ (“General Contractor”), pursuant to which Account Debtor agreed to perform and complete certain work required for work on various projects (“Projects”), all as more specifically set forth in those contracts between Account Debtor and General Contractor (“Contracts”); and

WHEREAS, Supplier Creditor will supply labor or material to Account Debtor, for which the Account Debtor will owe the Supplier Creditor payment (“Supplier Creditor Receivable”); and

WHEREAS, Account Debtor’s will supply labor and materials to General Contractor on the Projects , for which the General Contractor will owe the Account Debtor payment (hereinafter the “General Contractor Receivable”); and

WHEREAS, Account Debtor wishes to assign its rights to the General Contractor Receivable to Supplier Creditor;

ACCORDINGLY, in consideration of the sum of One Dollar (\$1.00) in hand paid, the receipt of which is hereby acknowledged, Account Debtor and Supplier Creditor agree:

1. Account Debtor assigns to Supplier Creditor any and all accounts receivables, contract rights, mechanic’s lien rights, payment bond rights, and any other legal or equitable rights owned by Account Debtor with relating to the Projects, General Contractor and/or the owners of the Projects.
2. Account Debtor agrees that Fullerton & Knowles, P.C. may bring mechanic’s lien, bond, contract or any other type of claim or legal action against the Projects, General Contractor and/or the owners of the Projects in the name of Account Debtor or in the name of Supplier Creditor.
3. Account Debtor agrees to be responsible for the costs, including reasonable attorney’s fees, incurred by Supplier Creditor in connection with this Agreement and in efforts to collect the General Contractor Receivable.
4. Account Debtor agrees that any monies collected on the above referenced accounts receivables will be distributed in the following manner:
 - (a) First, to all Supplier Creditor’s legal fees incurred in association with this Agreement and the collection of the Supplier Creditor Receivable.

- (b) Second, to pay off all accrued interest on the Promissory Note.
- (c) Third, to pay towards principal on the Promissory Note.
- (d) Lastly, all remaining monies will go to Account Debtor.

5. Account Debtor acknowledges and agrees that Fullerton & Knowles, P.C. will represent Supplier Creditor, and not Account Debtor, in connection with this agreement and the collection of the General Contractor Receivable and Supplier Creditor Receivable and that Account Debtor has been authorized and encouraged to hire its own counsel to represent Account Debtor in connection with this Agreement and the collection efforts by Supplier Creditor of the General Contractor Receivable.

6. Supplier Creditor may prosecute as it sees fit, arbitrate, settle, compromise or abandon Account Debtor's claim against General Contractor and may settle or compromise at any amount it deems adequate in its sole discretion. In the event the claim against General Contractor is abandoned by written notice from Supplier Creditor to Account Debtor, Account Debtor may continue the claim at its own choosing and expense.

7. Except as expressly modified by the terms of this Agreement, Credit Agreement and Promissory Note from Account Debtor to Supplier Creditor remains in full force and effect. Unless expressly modified herein, nothing herein shall modify any rights of Supplier Creditor relating to the Supplier Creditor Receivable. Supplier Creditor shall credit Account Debtor for the reimbursement of legal fees, principal and interest on the Promissory Note actually received by Supplier Creditor.

8. Account Debtor agrees to assist Supplier Creditor in the prosecution of any claims or rights set forth herein in any reasonable manner, including but not limited to providing Supplier Creditor with originals of all documents relating in any way to the Supplier Creditor Receivable, the General Contractor Receivable or any Project and any material supplied thereto, providing access to Account Debtor's books, records, personnel, agents, employees and officers to testify during any proceeding, hearing, trial or arbitration.

9. The parties agree that the preamble to this Agreement is an express part of this Agreement.

10. This Agreement is binding on the successors and assigns of Account Debtor and Supplier Creditor.

IN WITNESS THEREOF, the parties hereto have, on the date set forth, caused the Agreement to be executed by their respective fully authorized officers, each of whom has the authority to sign this Agreement on behalf of his respective company.

ACCOUNT DEBTOR, INC.

By: _____

SUPPLIER CREDITOR, INC.

By: _____

Guidance on Use of Joint Checks Under the DBE Program



Memorandum

U.S. Department of Transportation

Federal Highway Administration

Subject: INFORMATION: Guidance on Use of Joint Checks Under the DBE Program

Date: August 30, 2006

From: Frederick D. Isler
Associate Administrator for Civil Rights

Reply to Attn of: HCR

To: Division Administrators

Recently, several concerns have been raised about the use of joint checks under the Disadvantaged Business Enterprises (DBE) program. We have observed that a number of State Transportation Agencies (STA) have allowed the use of joint checks. From our experience a joint check is a two-party check between a DBE, a prime contractor and the regular dealer of material/supplies. Typically, the prime contractor issues the check as payor to the DBE and the supplier jointly (to guarantee payment to the supplier) in payment for the material/supplies used by the DBE. Due to the issues and concerns brought to our attention and requests for guidance, this memorandum sets forth FHWA's policy on the use of joint checks on Federal-aid highway projects.

A primary concern with allowing joint checks is that such a practice may make it difficult to determine whether the DBE is performing a commercially useful function. It also makes it much more difficult to gauge the extent to which the DBE is controlling its operations (independent of the other party involved in the joint check arrangement). The cost of material and supplies purchased by the DBE is part of the value of work performed by the DBE to be counted toward the goal. To receive credit, the DBE must be responsible for negotiating price, determining quality and quantity, ordering the materials, and installing (where applicable) and **"paying for the material itself."** See 49 CFR 26.55(c)(1). When joint checks are used, a question is raised as to whether the transaction being carried out complies with regulatory requirements because of the involvement of another party other than the DBE in the issuance of the check for payment to the supplier.

In light of these concerns, FHWA will not object to the use of joint checks when the following conditions are met: (1) the second party (typically the prime contractor) acts solely as a guarantor, (2) the DBE must release the check to the supplier, (3) the use of joint checks is a commonly recognized business practice in the industry, (4) the STA approves the practice before it is used, and (5) the STA monitors its use closely to avoid abuse.

As part of its approval process (programmatically or on a case-by-case basis), the STA should analyze industry practice. Standard industry practice is one of several factors to consider in approving the use of joint checks. However, using joint checks should not be approved if doing so conflicts with other aspects of the DBE regulations regarding commercially useful function (CUF). For example, the practice of joint checks might be standard industry practice in a State, but the regulations do not allow the DBE to be used as an "extra participant in a transaction, contract, or project through which funds are passed in order to obtain the appearance of DBE participation. In determining whether a DBE is such an extra participant, [the STA] **must** examine similar transactions, particularly those in which DBEs do not participate." See 49 CFR 26.55 (c)(2). Thus, standard industry practice cannot be shown unless the practice is commonly employed outside of the DBE program for non-DBE subcontractors on both federal and state funded contracts.

A STA that approves the use of joint checks in their DBE program should have a well defined monitoring process that ensures its use comports with agreed upon conditions and that such practice is not in conflict with the requirements of the DBE program. Furthermore, the STA should incorporate its policies and procedures for handling joint checks in its DBE program. This will ensure that all parties (internally and externally) are informed of the STA's process and that the DBE staff, field project engineers, and others implement it consistently statewide. A method for monitoring the use of joint checks used by some STAs is to require the prime contractor/DBE furnish the cancelled check used for the payment of materials/supplies under the contract.

The attached document lists a set of circumstances and conditions that should be considered in approving the use of joint checks. This guidance has been coordinated with the FHWA Office of Chief Counsel. We trust this information is helpful to you and your respective STA. Should you have any questions, comments or additional concerns regarding this subject, please contact Calvin Gibson (202) 366-2024.

Attachment

DBE Program -Joint Checks

The practice of using joint checks in the DBE program is not a new phenomenon. In fact FHWA addressed the use of joint checks as far back as the mid 1980s. The FHWA has always maintained that joint checks could be allowed but needs to be closely monitored to ensure that such a practice did not erode the independence of the DBE firm. Close monitoring also ensures that the use of joint checks does not inhibit the DBE's ability to control its work and perform a commercially useful function (CUF). The STA should establish a solid basis for the use of joint checks that strikes a reasonable balance between the benefit to the DBE and the potential for abuse. Joint checks should not be allowed simply for the convenience of the prime contractor.

General circumstances to be present to support joint checks:

1. - Standard Industry practice applies to all contractors (federal and state contracts)
2. - Use of joint checks must be available to all subcontractors
3. - Material industry sets the standard industry practice, not prime contractors
4. - Short term not to exceed reasonable time (i.e., one year, two years) to establish/increase a credit line with the material supplier
5. - No exclusive arrangement between one prime and one DBE in the use of joint checks that might bring independence into question
6. - Non-proportionate ratio of DBE's normal capacity to size of contract and quantity of material to be provided under the contract
7. - DBE is normally responsible for both to install and furnish the work item
8. - DBE must be more than an extra participant in releasing the check to the material supplier

General conditions for allowance:

1. - DBE submits request to STA for action
2. - Subject of formalized agreement between all parties that specify the conditions under which the arrangement will be permitted
3. - Full and prompt disclosure of the expected use of joint checks
4. - Require prior approval
5. - Even with joint checks, DBE remains responsible for all other elements of 26.55(c)(1)
6. - State clearly determines that independence is not threaten because the DBE retains final decision making responsibility
7. - State clearly determines that request is not an attempt to artificially inflate DBE participation.
8. - Standard industry practice is only one factor
9. - State is to have a well-established monitoring process that has oversight mechanisms such as, for example, receipt of cancelled checks and/or certification statement of payment
10. - No requirement by prime contractor that DBE is to use a specific supplier nor the prime "contractors" negotiated unit price

DBE ESCROW AND TRUST AGREEMENT

This Escrow Agreement (“Agreement”) made this ____ day of _____, 20____, by and between Vendor Supplier, Inc., (“VENDOR”) and Disadvantaged Construction Group, Inc., (“DBE CONTRACTOR”), General Contractor, Inc. (“General Contractor”) and Fullerton & Knowles, P.C., the Contract Escrow Agent (“Escrow Agent”);

WITNESSETH:

WHEREAS, DBE CONTRACTOR has entered into a Contract dated _____, 20____ with General Contractor (“Contract”) for the construction of a project known as the Community Hospital (“Project”); and

WHEREAS, DBE CONTRACTOR has entered into a subcontract with VENDOR for construction of portions of the work on the Project (“Subcontract”); and

WHEREAS, DBE CONTRACTOR and VENDOR have agreed that all payments (whether progress or final) to be made by General Contractor to DBE CONTRACTOR and VENDOR for work performed on the Project shall be placed in escrow with the Escrow Agent, who shall hold such payments in trust for the benefit of DBE CONTRACTOR and VENDOR, and that the Escrow Agent shall pay DBE CONTRACTOR and VENDOR the amounts due them pursuant to the terms of the Subcontract and this Escrow Agreement; and

WHEREAS, DBE CONTRACTOR and VENDOR desire to appoint the Escrow Agent to serve in that capacity in accordance with terms and conditions of this Agreement and the Escrow Agent is willing to serve as provided herein;

NOW, THEREFORE, in consideration of these premises and the covenants herein contained, DBE CONTRACTOR, VENDOR and the Escrow Agent do hereby agree as follows:

1. Appointment: DBE CONTRACTOR and VENDOR hereby appoint Escrow Agent to be the trustee and escrow agent for the purposes of this Agreement. The Escrow Agent hereby accepts this appointment.

2. Trust Fund: All payments made by General Contractor pursuant to the Contract shall be deposited with the Escrow Agent. Funds shall be deposited in a separate account with National Bank or such other federally insured bank as the Escrow Agent selects. Escrow Agent shall receive and hold those funds in trust three per cent (3%) for the benefit of DBE CONTRACTOR and ninety seven per cent (97%) for the benefit of VENDOR or to the extent that those funds are otherwise due to either party pursuant to the Subcontract or this Agreement. DBE CONTRACTOR and VENDOR each agree that they have no interest in funds held in trust for the benefit of the other party. The account shall be opened using the tax identification number of _____.

3. Purpose of the Escrow Fund: The purpose of the Escrow Fund is to provide for payment to DBE CONTRACTOR and VENDOR according to the terms of the Contract and Subcontract for work performed in connection with the Project.

4. Payment into and from Escrow Fund: When DBE CONTRACTOR has satisfactorily completed construction efforts to the extent that General Contractor has approved payment and has made payment to the Escrow Agent by wire transfer, DBE CONTRACTOR and VENDOR shall provide written instruction to the Escrow Agent specifying the amount to be released from the Escrow Fund and the Escrow Agent will disburse the funds in accordance with that written instruction. To the extent either DBE CONTRACTOR or VENDOR is unable to agree on a distribution of funds the Escrow Agent is authorized to disburse uncontested portions of the funds to the parties.

5. Disputes as to Disbursement of Escrow Fund: In the event of disputes as to the disbursement of Escrow Funds, the parties agree that Escrow Funds shall be disbursed by the Escrow Agent from the Escrow Fund only in accordance with a joint instruction from DBE CONTRACTOR and VENDOR; or the parties agree that one or the other may institute litigation in the Circuit Court for Fairfax County, Virginia, but shall not implead or name as an additional party defendant the Escrow Agent,

but rather, authorize the Escrow Agent to act as Escrow Agent pending a decision by the Court. The Escrow Agent shall then be authorized to act upon such court order.

6. Interpleader action: In the event of disputes as to the disbursement of Escrow Funds, the parties also agree that Escrow Agent may, at its sole option, institute an interpleader action, pertaining to the Escrow Fund, in the Circuit Court for Fairfax County, Virginia and may either pay the Escrow Funds into the registry of the court, or continue to hold the funds as Escrow Agent pending a decision by the Court.

7. Compensation: DBE CONTRACTOR and VENDOR shall each pay one half the Escrow Agent compensation hereunder. Escrow Agent shall charge no fee for its designation as Escrow Agent, but shall be entitled to payment of its regular hourly rates for attorney and staff time and all out of pockets costs actually incurred. Any such compensation and reimbursement to which the Escrow Agent is entitled shall be promptly paid by DBE CONTRACTOR (50%) and VENDOR (50%) upon receipt of the Escrow Agent's invoice. Should the Escrow Agent institute an interpleader action, pertaining to the Escrow Fund, Escrow Agent's compensation and court costs associated with the interpleader proceeding and advanced by the Escrow Agent shall also be borne 50% by VENDOR and 50% by DBE CONTRACTOR. Any fees and expenses of the Escrow Agent or its counsel that are not paid as provided herein may, at the Escrow Agent's option, be deducted from the Escrow Fund.

8. Limited Responsibility: This Agreement expressly sets forth all of the duties of the Escrow Agent with respect to any and all matters pertinent thereto. No implied duties or obligations shall be read into this Agreement against the Escrow Agent. The Escrow Agent shall not be bound by the provisions of any agreement among the Parties hereto except as are contained in this Agreement.

9. Agreement and Modification: This Agreement supersedes provisions in the Subcontract relating to the disbursement of funds to be deposited into and disbursed from the Escrow Fund. All other provisions, rights, obligations, and duties set forth in the Contract and Subcontract remain in full force and effect. This Agreement may not be amended except by a written addendum executed by the Parties and the Escrow Agent. This Agreement shall be binding upon and shall inure to the benefit of the Parties hereto and their respective heirs, executors, administrators, successors and assigns.

IN WITNESS WHEREOF, the Parties and the Escrow Agent hereto have executed and delivered this Escrow Agreement as of the date first above written.

Disadvantaged Construction Group, Inc.

Vendor Supplier, Inc.

Name and Title

Name and Title

Fullerton & Knowles, P.C.

General Contractor, Inc.

Name and Title

Name and Title