CHAPTER 3

DISADVANTAGED BUSINESS ENTERPRISES

INTRODUCTION

Public Procurement

Public Procurement is a tremendous opportunity for construction industry general contractors, subcontractors and suppliers. In 2014, the total value of new federal construction in the U.S. was $22.9 billion.[1] State and local government spending added much more.

Public Procurement typically includes set aside or preference goals for minorities and other disadvantaged groups. The statutory goals established by federal executive agencies are:[2]

23 percent of prime contracts for small businesses;
3 percent of prime and subcontracts for service-disabled veteran-owned small businesses;
3 percent of prime contracts and subcontracts for HUBZone small businesses;
5 percent of prime contracts and subcontracts for Small Disadvantaged Businesses;
5 percent of prime and subcontracts for women-owned small businesses.

This is a total of up to 39% of federal new construction, rehabilitation and maintenance contracts, or a total of almost $9 billion a year in new federal construction alone. This is an opportunity.

Prime contractors (general contractors) must be careful to make sure they are in compliance with DBE set aside or participation requirements on a project. This is important in the bidding process to make sure all bids are responsive and to maximize successful bids. General contractors also want to minimize performance risks and avoid the financial risk of insolvency by DBE subcontractors.

Subcontractors must be aware of DBE participation requirements on a project and the extent to which they will be included in the subcontract. Subcontractors also want to minimize performance risks and avoid the financial risk of insolvency by DBE subcontractors or suppliers. They must also make sure they are in compliance with DBE regulation applicable to that project.

Suppliers want to maximize business opportunities on public contracts, while also avoiding the financial risk of insolvency by their customers. Suppliers must also increasingly make sure they are in compliance with DBE regulation applicable to that project.

Disadvantaged Business Enterprises want to maximize opportunities by obtaining DBE certification for as many governmental agencies and NAICS or division codes as possible. DBEs want to retain DBE certification by making sure they are in compliance with DBE regulation applicable to each project.

Dealing with Disadvantaged Business Enterprise regulation is 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.

Perception

There is a great deal of confusion in the industry regarding the rules of Disadvantaged Business Enterprises (DBE) participation. The rules seem inconsistent. The rules seem inconsistently enforced. There appears to be a great deal of "gaming" of the system and circumvention of the rules. These are all accurate perceptions for a number of reasons.

There are scores of different federal agencies alone. Each can have a different regulatory system for DBE participation. There are 50 different states, each of which may have multiple agencies with a different regulatory system. Local governments now also often have DBE participation policies. We are seeing more private owners interested in DBE participation policies. Each project can present a different set of rules, with different nomenclature.

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[1] http://www.statista.com/topics/1256/public-construction/.

[2] Small Business Act 15 U.S.C.A. §644(g)(1)(A).

This results in a great deal of confusion. Whatever the "rules" were on the last project may have no relevance for the rules on the next project. Many of these rules are relatively new. The players are not familiar with the rules and do not have the benefit of past experience.

Disadvantaged Business Enterprise (DBE) groups go by different names in different federal and state programs, including Disadvantaged Business Enterprises (DBE),[3] Women's Business Enterprise (WBE),[4] Minority Business Enterprises (MBE),[5] Small, Woman-Owned, and Minority (SWaM),[6] Small Business Enterprises (SBE)[7] and Certified Business Enterprise (CBE).[8] 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 and general contractors in the construction and other industries.

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. The industry has been waiting to see promotion of public policy objectives through regulations and enforcement.

Public Policy

All federal and most state and local government agencies have DBE participation goals or requirements. Federal DBE participation goals are mostly set by the Small Business Act, administered by the Small Business Administration (SBA), described in the first paragraph of this chapter.[9] Almost all federal, state or local government agencies have procedures for certifying Disadvantaged Business Enterprises. These rules normally require qualification as a "small business." A Disadvantaged Business must typically be owned at least 51% and actually controlled by a socially disadvantaged and economically disadvantaged person. The DBE must typically be certified by the particular government agency that will procure the contract, although some agencies accept certifications from other agencies. The DBE must be certified for the particular type of services, labor or material the agency will procure,[10] usually expressed in terms of the NAICS code(s). Government agencies typically keep a list of approved and certified DBEs that qualify for the purposes of DBE participation. Almost all federal, state and local public procurement contracts have DBE participation rules in these respects.

However, fairly few federal, state or local government agencies have rules further defining what valid DBE participation is or looks like. If there are no further rules, then simply using a "certified" DBE may be sufficient.

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. Some government agencies have statutes or regulations defining actual participation in order to achieve that goal. This is usually stated as an affirmative need for the DBE to perform a "commercially useful function" (CUF) by actually performing and managing a portion of the contract.

The U.S. Department of Transportation (DOT) has always had the most complete regulatory scheme for DBE participation goals. U.S. Department of Transportation regulations apply only on a limited number of projects. However, more federal, state and local government agencies are adopting similar regulations.

Penalties, Checks and Balances

Local governments will often 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"

[3] Federal, Virginia and District of Columbia.

[4] Environmental Protection Agency.

[5] Federal SBA, Environmental Protection Agency and Maryland.

[6] Virginia.

[7] Small Business Administration.

[8] District of Columbia.

[9] Small Business Act 15 U.S.C.A. §644(g)(1)(A).

[10] 49 CFR 26.71(n); DOT Official Questions and Answers 49 CFR Part 26. April 15, 2016, pp. 25-28 and 44-46 at https://www.transportation.gov/sites/dot.gov/files/docs/Official%20Questions%20and%20Answers%204-15-16.pdf.

with the United States. This full funding and grant agreement can make both the state public procurement code and the federal public procurement code applicable to the project, including DBE participation goals.

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 violation of DBE goals. It may be politically difficult for the federal government to withhold 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 at least sufficient efforts to achieve DBE participation goals in order to win contracts. However, it is again difficult for federal and local governments to withhold money on current contracts or refuse to award future projects if general contractors fail to achieve DBE participation goals. Government owners and contractors are also usually most concerned with getting projects done as planned, on budget and on time.

DBE participation is often not a genuine priority to suppliers or 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.

We are now starting to see enforcement, at least on DOT projects that have had standing DBE regulations. This has most often come in the form of criminal prosecutions by the U.S. Attorney's office. These cases often involve outright fraud on the government, but do also concern the lack of actual participation by the DBE. DBE participants, general contractors and subcontractors have received prison sentences, probation and large fines. On the DOT Inspector General Website[11] you can find recent federal DOT investigations, prosecutions, settlement agreements and convictions. These cases penalize DBE contractors and non-DBE contractors that ran work through illegitimate DBE contractors. There have now been some instances of penalties for remote suppliers that participated in transactions using "pass through" DBE Suppliers that perform no "commercially useful function" (CUF).

Government owners have also begun including liquidated damage penalties in contracts if DBE participation goals are not achieved. The use of liquidated damage provisions may be advantageous, allowing the timely completion of public projects. Contractors have the option of deciding to commit an "economic breach." They may prefer to pay a penalty for failing to achieve DBE participation goals, rather than breach the contract by late completion. At the same time, a contractor has incentive to achieve DBE participation goals, avoid liquidated damage penalties and increase their profit.

It seems likely that we will see increasing regulation, 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.

FEDERAL DBE REGULATION

The Small Business Administration (SBA) created several certification programs for qualified small business federal procurement preferences. These include: the Women-Owned Small Businesses (WOSB) program; the Historically Underutilized Business Zones (HUBZone) program; the Service-Disabled Veteran-Owned Small Business Concern (SDVOSBC) program; the 8(a) Business Development program (8(a)); and the Small Disadvantaged Business (SDB) program. The 8(a) and SDB programs in particular specifically focus on offering business development assistance and contracting opportunities for firms owned by socially and economically disadvantaged individuals.

Firms may self-represent or self-certify as a Small Disadvantaged Business (SDB). Though firms do not need to fill out an application to obtain SDB status, they must meet eligibility criteria. The firm must be 51% or more owned and controlled by one or more socially and economically disadvantaged persons. The firm must be small, according to SBA's size standards.[12]

The 8(a) Business Development Program (BDP) is a long-term partnership to help 8(a) firms gain competitive footholds in government contracting. Participation in the BDP is divided into two phases over nine years. First,

[11] *See* summaries of DOT enforcement actions for DBE fraud at https://www.oig.dot.gov/oversight-areas/contract-grant-fraud.

[12] 13 CFR 124.1002.

there is a four-year "developmental" phase and then a five-year "transition" phase, to graduate the firm from SBA assistance.[13] Firms that qualify for the SBA's 8(a) BDP automatically qualify for the SDB program.[14]

The approval requirements for the 8(a) BDP are different and more rigorous than the Small Disadvantaged Business program. The individual owners of the firm may need to prove both social disadvantage and economic disadvantage and must manage the firm on a full-time basis. The individual(s) must be an American citizen, by birth or naturalization. The firm must be a small business under SBA's definition, just as under the SDB program; the firm must demonstrate potential for success; and the principals must show good character.[15] There are separate eligibility requirements for businesses owned by American Indians, Native Alaskans, Native Hawaiians or Certified Development Companies.

There is considerable overlap between the certification requirements of the SBA's small disadvantaged business programs (8(a) BDP and the SDB program) and the U.S. Department of Transportation's (DOT) Disadvantaged Business Enterprise (DBE) program, described below. The two agencies attempted to streamline and expedite their processes by allowing recognition and acceptance of certifications from one agency by the other.[16] The mutual recognition is not automatic. There are additional requirements that a SBA certified firm must meet in order to obtain DOT DBE certification. Likewise, there are additional requirements for a DOT certified DBE to satisfy the SBA regulations.[17]

Almost all federal agencies have procedures for certifying Disadvantaged Business Enterprises. However, fairly few federal, state or local government agencies have rules further defining the required quality of valid DBE participation, with a commercially useful function (CUF) or similar requirement. The U.S. Department of Transportation has the most developed regulations in that regard.

DBE Regulation on U.S. Department of Transportation Projects

To participate as a DBE on U.S. Department of Transportation (DOT)-assisted contracts, firms must meet federal eligibility standards, very similar to the SDB program discussed above.[18] DOT regulations have additional requirements. The 51% ownership of the firm by the disadvantaged individuals "must be real, substantial, and continuing, going beyond pro forma ownership of the firm as reflected in ownership documents."[19] The applicant firm must be controlled independent of any outside firms, and its "viability must not depend on its relationship with another firm."[20]

Firms apply for federal DOT DBE certification through their state transportation agency. The state agencies are required to make on-site visits to confirm eligibility. The DOT provides an application on its website that may be submitted to state certifying agencies.

The DOT has always had the most complete regulatory scheme for DBE participation goals. The DOT regulations are a good place to start any discussion of DBE regulation. These regulations are the most complete, have been in existence the longest and have the most court and administrative case law to explain how they work. They are, in effect, the "gold standard" of DBE regulations and have served as the template for other federal and state agencies. If you are in compliance with DOT DBE regulations, you are probably in compliance with the regulation of any agency.

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[13] 13 CFR 124.2.

[14] *See* SBA's website for more information: https://www.sba.gov/contracting/government-contracting-programs/8a-business-development-program/about-8a-business-development-program.

[15] 13 CFR 124.101-108.

[16] *See* https://www.transportation.gov/civil-rights/disadvantaged-business-enterprise/memorandum-understanding-between-us-small-business.

[17] For a summary of these additional requirements *see*: https://www.transportation.gov/osdbu/disadvantaged-business-enterprise/interim-reciprocal-implementation-procedures.

[18] 49 CFR 26.61. A DBE in the DOT program must meet the SBA definition of a small business. *See* 49 CFR 26.65. The DOT regulations also follow the SBA definition of socially and economically disadvantaged individuals, with minor modifications. *See* 49 CFR 26.67 and Appendix E to 49 CFR 26. A firm must be at least 51 percent owned by socially and economically disadvantaged individuals, like the SDB program. *See* 49 CFR 26.69.

[19] 49 CFR 26.69.

[20] 49 CFR 26.71.

The DOT regulations state, for example, that there are no DBE participation points unless the DBE contractor performs a "commercially useful function" (CUF).[21] In essence, the DBE must actually participate and add value to the project.

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."[22] A DBE performs a commercially useful function when it is actually performing, managing and supervising the work. To perform a commercially useful function with respect to materials, the DBE must also 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.[23]

Is It Possible to Be a DBE Material Supplier under DOT Regulations?

General contractors, subcontractors and traditional non-DBE suppliers now more often insist that DBE suppliers actually negotiate the price, determine the quality and quantity, order the material and pay for the material. These are sometimes referred to as the four "pillars" or "touchstones" of legitimate CUF participation, and are discussed immediately below.

Is this a safe harbor? Or is it possible that a DBE Supplier is still a "pass through" or "extra participant in a transaction, contract or project, through which funds are passed in order to obtain the appearance of DBE participation?" It is questionable whether the public policy objectives are achieved, although there may be good experience in negotiating price, determining quality and quantity. Reliance on these four "pillars" or "touchstones" may be misplaced and may not satisfy the DOT regulations for legitimate CUF participation.

An Internet search for 49 CFR 26.55 will locate the U.S. Department of Transportation Code of Federal Regulations on this subject. You will see that these four "pillars" or "touchstones" appear in 49 CFR 26.55(c). However, this and the immediately prior subsections seem to be speaking about subcontractors and not suppliers, stating that "[w]hen a DBE participates in a contract, you count only the value of the work actually performed by the DBE toward DBE goals"[24] and that you "[c]ount the entire amount of that portion of a construction contract ... that is performed by the DBE's own forces. Include the cost of supplies and materials obtained by the DBE for the work of the contract."[25]

49 CFR 26.55(c) then states [emphasis added]:

> (c) Count expenditures to a DBE <u>contractor</u> toward DBE goals only if the DBE is performing a commercially useful function on that contract.
>
> (1) A DBE performs a commercially useful function when it is <u>responsible for execution of the work of the contract and is carrying out its responsibilities by actually performing, managing, and supervising the work involved. To perform a commercially useful function, the DBE must also be responsible, with respect to materials and supplies used on the contract, for negotiating price, determining quality and quantity, ordering the material, and installing (where applicable) and paying for the material itself</u>. To determine whether a DBE is performing a commercially useful function, you must evaluate the amount of work subcontracted, industry practices, whether the amount the firm is to be paid under the contract is commensurate with the work it is actually performing and the DBE credit claimed for its performance of the work, and other relevant factors.
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> (2) 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. In determining whether a DBE is such an extra participant, you must examine similar transactions, particularly those in which DBEs do not participate.

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[21] 49 CFR 26.55 (c)(2).

[22] 49 CFR 26.55 (c)(2).

[23] DOT Official Questions and Answers 49 CFR Part 26. April 15, 2016, pp. 46-50 at https://www.transportation.gov/sites/dot.gov/files/docs/Official%20Questions%20and%20Answers%204-15-16.pdf.

[24] 49 CFR 26.55 (a).

[25] 49 CFR 26.55 (a)(1).

(3) If a DBE does not perform or exercise responsibility for at least 30 percent of the total cost of its contract with its own work force, or the DBE subcontracts a greater portion of the work of a contract than would be expected on the basis of normal industry practice for the type of work involved, you must presume that it is not performing a commercially useful function.[26]

The "four pillars" appear in a discussion of a "DBE contractor" that is "actually performing, managing, and supervising the work involved" in the contract. Immediately following is the statement that the DBE cannot be "an extra participant in a transaction, contract, or project through which funds are passed in order to obtain the appearance of DBE participation."

What do we make of the next subsection? It states that the DBE must "perform or exercise responsibility for at least 30 percent of the total cost of its contract with its own work force."[27] How does that apply to a DBE Supplier with no on-site presence? All of these provisions, including the "four pillars," may apply only to a subcontractor with an on-site presence and the materials that the subcontractor purchases. DBE subcontractor labor counts towards DBE participation goals if the work is performed by the DBE's own forces. The materials that the DBE subcontractor uses do NOT count unless that DBE subcontractor was responsible for "negotiating price, determining quality and quantity, ordering the material and paying for the material."[28] The materials do not count if the general contractor performed any of these roles in acquisition of the materials.

The next subsection of the DOT regulations discuss the special factors in determining whether a DBE trucking company is performing a commercially useful function, discussed in greater detail below.[29]

Then the following subsection of the DOT regulations state [emphasis added]:

(e) Count expenditures with DBEs for materials or supplies toward DBE goals as provided in the following:

(1)(i) If the materials or supplies are obtained from a DBE manufacturer, count 100 percent of the cost of the materials or supplies toward DBE goals.

(ii) For purposes of this paragraph (e)(1), a manufacturer is a firm that operates or maintains a factory or establishment that produces, on the premises, the materials, supplies, articles, or equipment required under the contract and of the general character described by the specifications.

(2)(i) If the materials or supplies are purchased from a DBE regular dealer, count 60 percent of the cost of the materials or supplies toward DBE goals.

(ii) For purposes of this section, a regular dealer is a firm that owns, operates, or maintains a store, warehouse, or other establishment in which the materials, supplies, articles or equipment of the general character described by the specifications and required under the contract are bought, kept in stock, and regularly sold or leased to the public in the usual course of business.

(A) To be a regular dealer, the firm must be an established, regular business that engages, as its principal business and under its own name, in the purchase and sale or lease of the products in question.

(B) A person may be a regular dealer in such bulk items as petroleum products, steel, cement, gravel, stone, or asphalt without owning, operating, or maintaining a place of business as provided in this paragraph (e)(2)(ii) if the person both owns and operates distribution equipment for the products. Any supplementing of regular dealers' own distribution equipment shall be by a long-term lease agreement and not on an ad hoc or contract-by-contract basis.

(C) Packagers, brokers, manufacturers' representatives, or other persons who arrange or expedite transactions are not regular dealers within the meaning of this paragraph (e)(2).

(3) With respect to materials or supplies purchased from a DBE which is neither a manufacturer nor a regular dealer, count the entire amount of fees or commissions charged for assistance in the procurement of the materials and supplies, or fees or transportation charges for the delivery of materials or supplies required on a job site, toward DBE goals, provided you determine the fees to be

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[26] 49 CFR 26.55 (c)(1) – (3).

[27] 49 CFR 26.55 (c)(3).

[28] 49 CFR 26.55 (c)(1).

[29] 49 CFR 26.55 (d). There are several specific provisions applicable to trucking, because of its unique features and past abuse.

reasonable and not excessive as compared with fees customarily allowed for similar services. Do not count any portion of the cost of the materials and supplies themselves toward DBE goals, however.
(4) You must determine the amount of credit awarded to a firm for the provisions of materials and supplies (e.g., whether a firm is acting as a regular dealer or a transaction expediter) on a contract-by-contract basis.

(f) If a firm is not currently certified as a DBE in accordance with the standards of subpart D of this part at the time of the execution of the contract, do not count the firm's participation toward any DBE goals, except as provided for in §26.87(i).
(g) Do not count the dollar value of work performed under a contract with a firm after it has ceased to be certified toward your overall goal.
(h) Do not count the participation of a DBE subcontractor toward a contractor's final compliance with its DBE obligations on a contract until the amount being counted has actually been paid to the DBE.[30]

This may be the only portion of the DOT regulations that contemplates the purchase of materials from a DBE Supplier, defined as either a DBE manufacturer or a "regular dealer."

Accordingly, supplies purchased from a DBE may count towards DBE participation goals on a DOT project only if:

1. They are used by a DBE subcontractor that performed a portion of a construction contract with the DBE's own forces and negotiated the price, determined the quality and quantity, ordered and paid for the material, or
2. If the materials were purchased from a DBE manufacturer, or
3. If the materials were purchased from a certified DBE regular dealer, in which case only sixty percent (60%) of the cost counts towards DBE participation goals.

Regular Dealers

As discussed in the immediately prior subsection, a regular dealer must own, operate, or maintain a store, warehouse, or other establishment in which the materials required under the contract are kept in stock, and regularly sold to the public in the usual course of business. The regular dealer must be an established, regular business. Sixty percent (60%) of the cost of materials purchased from a qualified regular dealer count towards DBE participation goals.[31]

A DBE must meet the criteria as a regular dealer on a contract-by-contract basis. In other words, a DBE that acts as a regular dealer on one contract (receiving DBE credit for 60 percent of the value of the goods supplied) does not necessarily act as a regular dealer on other contracts. The DBE may act simply as a "transaction expediter" or "broker" (receiving DBE credit only for the fee or commission).

In order to qualify as a regular dealer on a particular contract, the DBE must "regularly" engage in the purchase and sale or lease of the products involved in the contract to the general public. This involves attention to the activities of the business over time, both within and outside of the DBE program. There is a difference between the regular sale or lease of the products and merely occasional or ad hoc involvement with them. It is not critical that every single item be physically present in the DBE's store or warehouse before it is sold to a contractor. However, the store or warehouse should be more than a token location. For example, a mere showroom, the existence of a hard-copy or online catalog, or the presence of small amounts of material are generally not sufficient to demonstrate that a firm regularly deals in the items.[32]

In some circumstances, items are "drop-shipped" directly from a manufacturer's facility to a job site, never in the physical possession of or transported by a supplier. In many such cases, the supplier's role may involve nothing more

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[30] 49 CFR 26.55 (e)(1) – (4) & (f), (g) and (h).

[31] It is not clear whether a regular dealer must be separately certified as a regular dealer by the DOT, in addition to certification as a DBE. The DOT Official Questions and Answers 49 CFR Part 26. April 15, 2016, pp. 50- 51 indicate that there is no separate certification, only a later administrative decision that the DBE acted as a regular dealer. https://www.transportation.gov/sites/dot.gov/files/docs/Official%20Questions%20and%20Answers%204-15-16.pdf.

[32] This explanation seems somewhat circular and inconstant, but does come from the DOT Official Questions and Answers 49 CFR Part 26. April 15, 2016, pp. 50-51 at https://www.transportation.gov/sites/dot.gov/files/docs/Official%20Questions%20and%20Answers%204-15-16.pdf.

than contacting the manufacturer and placing a job-specific order for an item that the manufacturer then transports to the job site. The supplier's role may then be better described as that of a "broker" or "transaction expediter."[33]

Notice that there is no apparent CUF requirement in this definition of a regular dealer in the DOT regulation. There is also no apparent prohibition in the regulation against acting as an "extra participant in a transaction, contract or project, through which funds are passed in order to obtain the appearance of DBE participation,"[34] although there is discussion of CUF and "extra participants" in DOT's Official Questions and Answers.[35] In the regulation itself, both of these requirements appear only in the discussion of expenditures to a DBE contractor, discussed above.[36] This may make the result in the $4,950,000 fine case, discussed below, curious.

Notice that 49 CFR 26.55 (e)(2)(ii)(B) states that a person may be a regular dealer in such bulk items as petroleum products, steel, cement, gravel, stone, or asphalt without owning, operating, or maintaining a place of business, if the person both owns and operates distribution equipment for the products. As discussed below, legitimate DBE participation credit is available for the trucking services provided by a DBE trucker that owns at least one truck. DBE participation credit is also available for sixty percent (60%) of the cost of bulk items delivered by that DBE trucker, even if the DBE trucker has no store or warehouse. This is an opportunity for DBE truckers.

DBE Trucking Companies

DBE trucking companies have special provisions in the DOT regulations, because of the unique features of that industry and some history of past abuse. The concerns are primarily control, independence, management, profits and whether the disadvantaged person truly owns, controls and manages the DBE business.

Historically, common violations have involved false or illegitimate DBE truckers set up or controlled by non-DBE truckers. Sometimes, the trucks used by the DBE are owned by the non-DBE truckers and "leased" to the DBE. Sometimes, the employees doing dispatch, supervising and performing work are former or current employees of the non-DBE trucker.

49 CFR 26.55 (d) of the DOT regulations state:

> (d) Use the following factors in determining whether a DBE trucking company is performing a commercially useful function:
>
> (1) The DBE must be responsible for the management and supervision of the entire trucking operation for which it is responsible on a particular contract, and there cannot be a contrived arrangement for the purpose of meeting DBE goals.
>
> (2) The DBE must itself own and operate at least one fully licensed, insured and operational truck used on the contract.
>
> (3) The DBE receives credit for the total value of the transportation services it provides on the contract using trucks it owns, insures and operates using drivers it employs.
>
> (4) The DBE may lease trucks from another DBE firm, including an owner-operator who is certified as a DBE. The DBE who leases trucks from another DBE receives credit for the total value of the transportation services the lessee DBE provides on the contract.
>
> (5) The DBE may also lease trucks from a non-DBE firm, including from an owner-operator. The DBE that leases trucks equipped with drivers from a non-DBE is entitled to credit for the total value of transportation services provided by non-DBE leased trucks equipped with drivers not to exceed the value of transportation services on the contract provided by DBE-owned trucks or leased trucks with DBE employee drivers. Additional participation by non-DBE owned trucks equipped with drivers receives credit only for the fee or commission it receives as a result of the lease arrangement. If a

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[33] DOT Official Questions and Answers 49 CFR Part 26. April 15, 2016, pp. 51 at https://www.transportation.gov/sites/dot.gov/files/docs/Official%20Questions%20and%20Answers%204-15-16.pdf. [In such a situation, the supplier's role may often be better described as that of a "broker" or "transaction expediter" (*see* 26.55(e)(2)(ii)(C)) than as a "regular dealer." In such a case, DBE credit is limited to the fee or commission the firm receives for its services. If the firm does not provide any commercially useful function (i.e., it is simply inserted as an extra participant in a transaction), then no DBE credit can be counted].

[34] 49 CFR 26.55 (c)(2).

[35] *See* DOT Official Questions and Answers 49 CFR Part 26. April 15, 2016, pp. 51 at https://www.transportation.gov/sites/dot.gov/files/docs/Official%20Questions%20and%20Answers%204-15-16.pdf.

[36] 49 CFR 26.55 (c)(1) – (2).

recipient chooses this approach, it must obtain written consent from the appropriate DOT operating administration.

Example to paragraph (d)(5): DBE Firm X uses two of its own trucks on a contract. It leases two trucks from DBE Firm Y and six trucks equipped with drivers from non-DBE Firm Z. DBE credit would be awarded for the total value of transportation services provided by Firm X and Firm Y, and may also be awarded for the total value of transportation services provided by four of the six trucks provided by Firm Z. In all, full credit would be allowed for the participation of eight trucks. DBE credit could be awarded only for the fees or commissions pertaining to the remaining trucks Firm X receives as a result of the lease with Firm Z.

(6) The DBE may lease trucks without drivers from a non-DBE truck leasing company. If the DBE leases trucks from a non-DBE truck leasing company and uses its own employees as drivers, it is entitled to credit for the total value of these hauling services.

Example to paragraph (d)(6): DBE Firm X uses two of its own trucks on a contract. It leases two additional trucks from non-DBE Firm Z. Firm X uses its own employees to drive the trucks leased from Firm Z. DBE credit would be awarded for the total value of the transportation services provided by all four trucks.

(7) For purposes of this paragraph (d), a lease must indicate that the DBE has exclusive use of and control over the truck. This does not preclude the leased truck from working for others during the term of the lease with the consent of the DBE, so long as the lease gives the DBE absolute priority for use of the leased truck. Leased trucks must display the name and identification number of the DBE.[37]

Accordingly the DBE must be responsible for the management and supervision of the entire trucking operation and must itself own and operate at least one fully licensed, insured and operational truck used on the contract.

The DBE and prime contractor also get full DBE participation credit for any trucks and drivers leased from another DBE firm.[38] The DBE and prime contractor also get full DBE participation credit for any trucks leased from a non-DBE firm, if the trucker driver operators are employees of the DBE.[39]

The DBE can lease trucks from other non-DBE firms, with drivers from the non-DBE firm, if the state transportation agency has chosen this option.[40] However, as shown in the examples provided in the regulation, a "matching" rule applies. The DBE gets full credit for non-DBE leased trucks equipped with drivers, not to exceed the value of DBE-owned trucks or leased trucks with DBE employee drivers. As shown in the examples, if the DBE owns three (3) trucks that are used by DBE employee drivers and also leases three (3) trucks and drivers from a non-DBE firm, then the DBE and prime contractor get full DBE participation credit for all trucks and drivers (assuming the DBE is responsible for the management and supervision of the entire trucking operation). On the other hand, if the DBE leased four (4) trucks and drivers from a non-DBE firm on the same contract, then the DBE and prime contractor would still only receive full DBE participation credit for six (6) trucks and drivers total.[41]

In any event, all leases must indicate that the DBE has exclusive use of and control over the truck. Leased trucks must also display the name and identification number of the DBE.[42]

However, the DBE cannot lease trucks from the prime contractor or its affiliate in any event. Otherwise, these trucks cannot count towards DBE participation goals.[43]

[37] 49 CFR 26.55 (d); DOT Official Questions and Answers 49 CFR Part 26. April 15, 2016, p. 44 DBE Truckers, pp. 51-52 DBE Truckers as Regular Dealers at https://www.transportation.gov/sites/dot.gov/files/docs/Official%20Questions%20and%20Answers%204-15-16.pdf.

[38] 49 CFR 26.55 (d)(4).

[39] 49 CFR 26.55 (d)(6).

[40] 49 CFR 26.55 (d)(5); *See* DOT Official Questions and Answers 49 CFR Part 26. April 15, 2016, p. 44 at https://www.transportation.gov/sites/dot.gov/files/docs/Official%20Questions%20and%20Answers%204-15-16.pdf. [A recipient can choose either of these options. If it chooses the second option, the recipient must obtain the written consent of the appropriate DOT operating administration (e.g., the Federal Highway Administration for a state highway agency) before implementing that option. Whatever option a recipient chooses should be clearly stated in its DBE program].

[41] 49 CFR 26.55 (d)(5). In this case, the DBE and prime contractor would receive DBE participation credit only for the fee or commission it receives on the seventh (7th) truck. However, the DBE must obtain written consent from DOT to get this credit.

[42] 49 CFR 26.55 (d)(7). The leased truck can work for others during the term of the lease with the consent of the DBE, so long as the lease gives the DBE absolute priority for use of the leased truck.

[43] 49 CFR 26.55 (a)(1)[Count the entire amount of that portion of a construction contract ... that is performed by the DBE's own forces. Include the cost of supplies and materials obtained by the DBE for the work of the contract, including supplies purchased or equipment

Under the discussion of DBE Suppliers above, we noted that 49 CFR 26.55 (e)(2)(ii)(B) states that:

> a person may be a regular dealer in such bulk items as petroleum products, steel, cement, gravel, stone, or asphalt without owning, operating, or maintaining a place of business as provided in this paragraph (e)(2)(ii) if the person both owns and operates distribution equipment for the products. Any supplementing of regular dealers' own distribution equipment shall be by a long-term lease agreement and not on an ad hoc or contract-by-contract basis.

This is an opportunity for a DBE trucker that owns one of more of its own trucks. Legitimate DBE participation credit is available for the trucking services provided by a DBE trucker that owns its own truck or additional trucks on a long-term lease agreement.[44] DBE participation credit is also available for sixty percent (60%) of the cost of bulk items as petroleum products, steel, cement, gravel, stone, or asphalt delivered by that DBE trucker.

DBE REGULATION IN OTHER FEDERAL AND STATE AGENCIES

All federal and most state and local government agencies have DBE participation goals or requirements. Almost all federal, state or local government agencies have procedures for certifying Disadvantaged Business Enterprises, requiring qualification as a "small business" owned at least 51% and actually controlled by a socially disadvantaged and economically disadvantaged person.

However, fairly few federal, state or local government agencies have rules further defining valid DBE participation, with a commercially useful function (CUF) or similar requirement.

This does seem to be changing. More federal and particularly state statutes and regulations are adopting standards similar to the federal DOT commercially useful function regulation. The Environmental Protection Agency has adopted modified DOT commercially useful function regulations. The state of Maryland has passed very similar regulations for any state executive branch procurement. Virginia regulations state that any entity must perform a CUF in order to be a certified DBE.

MWAA & WMATA

In 1966, Congress created the Washington Metropolitan Area Transit Authority (WMATA) by approving an interstate compact between the Commonwealth of Virginia, the State of Maryland and the District of Columbia. WMATA operates a system of underground and surface trains traveling to and from points in Virginia, Maryland and Washington, DC.[45] WMATA has its own DBE Program Manual,[46] which states that WMATA follows the federal DOT DBE regulations,[47] as recipient of federal money[48] and acknowledges the federal DOT CUF standards.[49] WMATA uses the certification standards of the DOT regulation to determine eligibility to participate as a DBE in DOT-assisted contracts. WMATA will count DBE participation towards goals as provided in the DOT regulations.

The Metropolitan Washington Airport Authority (MWAA) is a regional public entity established by an interstate compact, approved by the United States Congress in 1986,[50] created for the purpose of "acquiring, operating, maintaining, developing, promoting and protecting Ronald Reagan Washington National Airport and Washington Dulles International Airport."[51] WMAA has established a DBE program in accordance with the federal DOT

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leased by the DBE (except supplies and equipment the DBE subcontractor purchases or leases from the prime contractor or its affiliate)].

[44] DOT Official Questions and Answers 49 CFR Part 26. April 15, 2016, pp. 51-52 at https://www.transportation.gov/sites/dot.gov/files/docs/Official%20Questions%20and%20Answers%204-15-16.pdf. [A lease for trucks or other distribution equipment cannot be an ad hoc deal specific to the particular contract or distribution task. The leased equipment should be used over an extended period of time to serve a variety of customers and/or contracts].

[45] *Dant v. District of Columbia*, 829 F.2d 69, 71 (D.C. Cir. 1987) *citing Washington Metropolitan Area Transit Authority Compact*, Pub. L. No. 89-774, 80 Stat. 1324 (1966), amended by Pub. L. No. 94-306, 90 Stat. 672 (1976) (authorizing creation of WMATA police force).

[46] https://www.wmata.com/business/procurement_and_contracting/WMATA%20Procurement%20Procedures%20Manual.pdf.

[47] 49 CFR 26.

[48] *See* WMATA DBE Program Manual at page 1.

[49] *See* WMATA DBE Program Manual at pages 25-26.

[50] *See* 49 U.S.C. §49101 *et seq.*

[51] Va. Code Anno. Code §5.1-156 (Michie 1950).

regulations. WMAA has received federal financial assistance from the DOT, and as a condition of receiving this assistance, WMAA has signed an assurance that it will comply with the DOT DBE regulations.[52]

Environmental Protection Agency

The Environmental Protection Agency has adopted commercially useful function regulations that borrow to some extent from the DOT regulations.[53]

The DBE[54] must first attempt to be certified by SBA, DOT or an Indian Tribal Government, state Government, local Government or independent private organization. Such certifications shall be considered acceptable for establishing DBE status under EPA's DBE Program.[55] An entity may only apply to EPA for DBE certification if it is unable to obtain such outside certification.

A DBE joint venture receives DBE participation credit only for the portion of the dollar amount of the joint venture attributable to the DBE. If a DBE's risk of loss, control or management responsibilities is not commensurate with its share of the profit, the EPA may direct an adjustment in the percentage of DBE participation credit.[56]

Recipients under EPA's DBE Program may not count expenditures to a DBE that acts merely as a broker or passive conduit of funds, without performing, managing, or supervising the work of its contract or subcontract in a manner consistent with normal business practices. If 50% or more of the total dollar amount of a DBE's prime contract is subcontracted to a non-DBE, the DBE prime contractor will be presumed to be a broker, with no DBE participation credit.

However, the EPA regulations do not use the DOT four pillars (the DBE must be responsible for negotiating price, determining quality and quantity, ordering the material, installing materials and paying for the material). This certainly means that the four pillars cannot be a safe harbor for EPA projects. There is also no discussion of DBE manufacturers or "regular dealers" with respect to material purchases, so these cannot be safe harbors for EPA projects either. In fact, there is no discussion of counting the cost of materials towards DBE participation goals at all. There is discussion of "project procurement costs," which presumably includes the cost of materials. The EPA regulations use only the no "broker or passive conduit of funds" standard, which may come to the same result as DOT regulations.

Like under DOT regulations, there are special rules for DBE truckers, who count as DBE participation only if the DBE trucker/hauler is performing a commercially useful function. The DBE must be responsible for the management and supervision of the entire trucking/hauling operation for which it is responsible on a particular contract, and there cannot be a contrived arrangement for the purpose of meeting DBE objectives. The DBE must itself own and operate at least one fully licensed, insured and operational truck used on the contract.[57]

Maryland

Maryland's Office of Minority Business Enterprise (OMBE), within the Maryland Department of Transportation (MDOT), is the state's official MBE/DBE certification agency. Applicant firms may apply online for MDOT certification.[58] Firms certified as MBEs may participate as MBE contractors on Maryland State contracts with MBE/DBE participation goals, and businesses certified as DBE contractors may participate as DBEs on U.S. Department of

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[52] *See* WMAA DBE Policy Statement at http://www.mwaa.com/sites/default/files/metropolitan_washington_airports_authority_disadvantaged_business_enterprise_policy_statement.pdf.

[53] 40 CFR 33.503.

[54] Termed Minority Business Enterprise (MBE) or Women's Business Enterprise (WBE) in EPA Regulations.

[55] SBA 8(a) or DOT certification is sufficient. Certification by an Indian Tribal Government, State Government, local Government or independent private organization must be in accordance with EPA's 8% or 10% statute as applicable. Any certification must meet EPA's U.S. citizenship requirement under §33.202 or §33.203.

EPA's DBE Program is primarily based on two statutes. Public Law 102–389, 42 U.S.C. 4370d, provides for an 8% objective for awarding contracts under EPA financial assistance agreements to business concerns or other organizations owned or controlled by socially and economically disadvantaged individuals, including HBCUs and women ("EPA's 8% statute"). Title X of the Clean Air Act Amendments of 1990, 42 U.S.C. 7601 note, provides for a 10% objective for awarding contracts under EPA financial assistance agreements for research relating to such amendments to business concerns or other organizations owned and controlled by socially and economically disadvantaged individuals ("EPA's 10% statute").

[56] 40 CFR 33.503(c).

[57] 40 CFR 33.503(f).

[58] The online application is available at https://mbe.mdot.maryland.gov/apply/.

Transportation-assisted contracts administered by the Maryland State Highway Administration, Maryland Aviation Administration and Maryland Transit Administration.[59]

To be eligible for certification as an MBE and/or DBE, the applicant firm must be at least 51% owned and controlled by a socially and economically disadvantaged individual(s).[60] Under Maryland law, there are several groups that are presumed to be disadvantaged, including African Americans, Native Americans, Asians, Hispanics, women, and physically or mentally disabled individuals, though individuals not of those groups are eligible for certification by establishing their social and economic disadvantage.[61]

Maryland law will not allow certification for "front" or "pass through" DBE firms. Ownership and control by disadvantaged individuals must be "real, substantial, and continuing and shall go beyond the pro-forma ownership of the firm as reflected in its ownership documents."[62] MDOT determines on a case-by-case basis whether an applying firm is owned and controlled by disadvantaged individuals. After applying with OMBE, the department will conduct an investigation and determine the applicant's eligibility for certification.

Maryland public projects fall into one of four categories with respect to CUF regulation:

1. Maryland public transportation projects in which federal funding makes the federal DOT commercially useful function (CUF) standards applicable.
2. Any Maryland Department of Public Works contracts using state funds, including Maryland county school projects.
3. Maryland state executive branch public procurement on which COMAR 21.11.03.12-1 applies.
4. Limited number of Maryland public procurement projects, mostly county projects, to which NO commercially useful function (CUF) standards applicable.

The Maryland Department of Transportation (MDOT) has essentially adopted the federal DOT commercially useful function (CUF) standards for its projects,[63] whether or not a full funding and grant agreement with the federal DOT makes the federal procurement regulations applicable. Accordingly, on any Maryland public transportation project,[64] either the federal DOT regulations or the MDOT CUF standards,[65] or both, will apply.

The state of Maryland has also passed regulations very similar to the DOT standards for most state public procurement, including non-transportation projects. Maryland has an MBE Program Manual,[66] developed by the Maryland Department of Transportation (MDOT), which acts as the chief DBE agency for Maryland. DBEs are generally referred to as MBEs in Maryland statutes

The Maryland MBE Program Manual is incorporated into and is a part of the Maryland state COMAR regulations.[67] It contains CUF requirements which largely mirror those found in the federal DOT regulations, stating in part:

> Any participating DBE/MBE must serve a commercially useful function on a contract and not function as a broker, unless certified as a broker (insurance, real estate, etc.). A firm is considered to perform a commercially useful function when it executes a distinct element of work by actually

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[59] *See* Maryland Federal DBE Program Manual (March 2015) at page 7.

[60] *See* Maryland MBE Program Manual (July 2014) at page 21.

[61] *See* COMAR 21.11.03.03 (B)(14).

[62] *See* Maryland MBE Program Manual (July 2014) at pages 21-23.

[63] http://www.mdot.maryland.gov/Office%20of%20Minority%20Business%20Enterprise/Resources_Information/03.2015%20MD%20MBE%20Federal%20DBE%20Program%20Manual%206-2012%20revised%203-2015.pdf. Maryland Federal DBE Program Manual (March 2015) at pp.68-72.

[64] The Maryland Federal DBE Program Manual states in its introduction that "included within MDOT are the following six Administrations: Maryland Aviation Administration, Maryland State Highway Administration, Maryland Port Administration, Maryland Motor Vehicle Administration, Maryland Transit Administration and the Maryland Transportation Authority (an independent agency that is subject to MDOT policies regarding the DBE Program)."

[65] http://www.mdot.maryland.gov/Office%20of%20Minority%20Business%20Enterprise/Resources_Information/4.8.15%20MBE%20Manual%202014%20Amendments.pdf. Maryland MBE Program Manual. *See* February 2009 & July 2014 Amendments, at p. 105.

[66] Authorized by Md. Code Ann., St. Fin. & Proc., §14-301.

[67] COMAR 11.01.10.01 [Incorporation by Reference: The Maryland Minority Business Enterprise Program Manual, formerly known as The Maryland Minority Business Enterprise/Federal Disadvantaged Business Enterprise Program (Maryland Department of Transportation, November 1999), as amended February 2009 and July 2014, is incorporated by reference].

> performing, managing and supervising the work involved and/or[68] negotiating the cost of, arranging and accepting delivery of, and paying for the materials or supplies required for the work of its contract. A contractor may count toward its DBE/MBE goal 60 percent of its expenditures for materials and supplies required under the contract and obtained from a DBE/MBE regular dealer, and 100 percent of such expenditures to a DBE/MBE manufacturer.[69]

These MBE Program Manual CUF provisions are not identical to the federal regulations, but they generally state the same public policy standards and goals. It does have a definition of regular dealer:

> A firm that owns, operates, or maintains a store, warehouse, or other establishment in which the materials or supplies required for the performance of the contract are bought, kept in stock, and regularly sold to the public in the usual course of business. To be a regular dealer, the firm must engage in, as its principal business, and in its own name, the purchase and sale of the products in question. A regular dealer in such bulk items as cement, gravel, stone and petroleum need not keep such products in stock, if it owns or operates distribution equipment. Brokers and packagers shall not be regarded as manufacturers or regular dealer within the meaning of this section.
>
> A Regular Dealer must be engaged in selling the product in question to the public. This is important in distinguishing a regular dealer, which has a regular trade with a variety of customers, from a firm which performs supply-like functions on an ad hoc basis, for only one or two contractors with whom it has a special relationship. A business that simply transfers title of a product from manufacturer to ultimate purchaser (e.g., broker or sales representative who reinvoices a product from the producing company to the recipient or contractor) or a firm that puts a product in a container for delivery would not be considered a Regular Dealer.
>
> A supplier of bulk goods may qualify as a regular dealer if it either maintains an inventory or owns or operates distribution equipment. With respect to the distribution equipment (e.g., a fleet of trucks), the term "operates" is intended to cover a situation in which the supplier leases the equipment on a regular basis for its entire business. It is not intended to cover a situation in which the firm simply

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[68] The only difference between the Maryland MBE Manual quoted here and the Maryland Federal DBE Manual (which just restates the 49 CFR 26.55(c)(1) regulations) is this "and/or." In the Federal regulations there is no "or," so the four pillars are mandatory and not optional for determining CUF.

This part of the Maryland MBE Program Manual can be read to say that a traditional non-DBE supplier is safe selling to a DBE that EITHER "executes a distinct element of work by actually performing, managing and supervising the work involved" OR is "negotiating the cost of, arranging and accepting delivery of, and paying for the materials or supplies." Of course, we do not know if a judge would agree with this. The next sentence says "A contractor may count toward its DBE/MBE goal 60 percent of its expenditures for materials and supplies required under the contract and obtained from a DBE/MBE regular dealer, and 100 percent of such expenditures to a DBE/MBE manufacturer." This MAY be saying that the ONLY way to get credit for materials is if they are sold by a regular dealer or a manufacturer, which may be the result under the federal DOT regulations.

The quoted CUF definition appears on page 105 of the Maryland MBE Program Manual, in a section called "Contractor Compliance Process." It appears to be the authoritative definition, as this section is all about how the use of DBEs will actually be monitored, and what the contractor has to submit each month regarding the participation of the DBEs. However, the MBE Manual discusses the CUF in other places that do not contain "and/or" distinction.

Page 6 ("Explanation of Terms"): COMMERCIALLY USEFUL FUNCTION: Work performed by a DBE/MBE in a particular transaction can be counted towards goals only if the Administration determines that it involves a commercially useful function. A certified business is considered to perform a commercially useful function when it is responsible for the execution of a distinct element of the work of a contract and carries out its responsibilities by actually performing, managing and supervising the work involved. That is, in light of industry practices and other relevant considerations, the DBE/MBE must have a necessary and useful role in the transaction of a kind for which there is a market outside the context of the DBE/MBE Program. The firm's role cannot be a superfluous step added in an attempt to obtain credit goals.

Page 36: With regard to the purchase of materials, the DBE/MBE must perform a commercially useful function'. A certified business is considered to perform a commercially useful function when it is responsible for execution of a distinct element of the work of a contract and carries out its responsibilities by actually performing, managing and supervising the work involved.

These definitions do not have the "and/or" distinction. They both seem to say that the DBE must be responsible for the execution of a distinct element of the work of a contract and carry out its responsibilities by actually performing, managing and supervising the work involved. They may say that traditional material supplier is only safe if selling to a DBE subcontractor, which may be the result under DOT regulations.

[69] *See* Maryland MBE Program Manual (July 2014) at pages 6, 36 & 105-115.

provides drivers for trucks owned or leased by another party, (e.g., a prime contractor) or leases such a party's trucks on an ad hoc basis for a specific job.[70]

These CUF requirements would apply on any Maryland Department of Public Works contracts using state funds, including Maryland county school projects. "The Board of Public Works is authorized to adopt regulations and procedures for the school construction program, and both the county governments and all of the educational agencies, including the county school boards, are expressly made subject to those regulations."[71] Maryland state Board of Public Works' regulations state: "[t]he State's minority business enterprise program applies to procurements conducted in accordance with this chapter that the State funds in whole or part."[72]

The Maryland state code also states that the Board of Public Works shall require local school systems to adopt procedures consistent with the minority business enterprise policies of the State.[73] Most or all counties have done so. Of course, any county could also make their minority business enterprise policies applicable to any school project, whether or not funded by the state, or simply applicable to any county procurement. Accordingly, we would have to check county regulation in any particular case. CUF requirements may apply to any county contract.

The state of Maryland has also passed CUF regulations that apply to Maryland state executive branch public procurement,[74] that are somewhat different from both the federal DOT regulations and the Maryland Board of Public Works' regulations. They read in part as follows:

Counting Minority Business Enterprise Participation.

A. General. When a certified MBE participates in a contract, the procurement agency shall consider ... this regulation in determining whether and the extent to which the certified MBE's participation may be counted toward the MBE participation goals.
B. Commercially Useful Function. A procurement agency may count participation of a certified MBE contractor toward MBE goals only if the certified MBE is performing a commercially useful function on that contract.
   (1) Commercially Useful Function.
   (a) A certified MBE performs a commercially useful function when it is responsible:
   (i) For execution of the work of the contract and is carrying out its responsibilities by actually performing, managing, and supervising the work involved; and
   (ii) With respect to materials and supplies used on the contract, for negotiating price, determining quality and quantity, ordering the material, and installing (where applicable) and paying for the material itself ... .
   (2) A certified MBE 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 MBE participation. In deciding whether a certified MBE is such an extra participant, the procurement agency may examine similar transactions, particularly those in which MBEs do not participate.
   (3) A certified MBE is presumed not to perform a commercially useful function if it does not perform or exercise responsibility for at least 30 percent of the total dollar value of its contract with its own work force, or the certified MBE subcontracts a greater portion of the work of a contract than would be expected on the basis of industry practice for the type of work involved. A procurement agency may, however, upon evaluation of the work involved and industry practices, decide that the certified MBE is performing a commercially useful function.[75]

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[70] Maryland MBE Program Manual (July 2014) at page 16, in the Explanation of Terms.

[71] Maryland State Code Education §5-301(h); *Chesapeake Charter, Inc. v. Anne Arundel County Bd. of Educ*., 358 Md. 129, 141, 747 A.2d 625, 631 (2000), ftn.5.

[72] COMAR 23.03.03.06(D).

[73] Maryland State Code Education §5-301(d)(3)(v).

[74] COMAR 21.11.03.12-1. An internet search for Maryland state executive branch will provide a list of those agencies http://msa.maryland.gov/msa/mdmanual/08conoff/html/01exec.html.

[75] COMAR 21.11.03.12-1. This regulation does not have the "and/or" distinction. It says "and," like the federal DOT regulations.

A significant difference is that this Maryland executive branch regulation states that "a procurement agency may, however, upon evaluation of the work involved and industry practices, decide that the certified MBE is performing a commercially useful function." This may mean that a contracting officer, or at least the procuring agency, can determine that a DBE performs a sufficient CUF no matter what the facts are or the regulation says. This is different from the federal CUF regulation, which states that decisions on commercially useful function matters are subject to review by the concerned operating administration, but are not administratively appealable to DOT.[76]

These regulations contain the requirement that "procurement agencies" only count DBE participation to the extent the DBE performed a CUF.[77] These DBE policies apply to "every procurement of supplies, services, maintenance, construction, construction-related services, architectural services and engineering services by a procurement agency."[78] A procurement agency is defined as a part of the Executive Branch.

These Maryland state executive branch regulations probably apply to some "county" projects, although they do not apply to county procurement generally. However, the Maryland Board of Public Works regulations are substantially the same. It may not really matter which applies, if the Board of Public Works administers the project.

The Maryland Supreme Court has decided that the COMAR *bidding* regulations do *not* apply to a county school procurement of bus operations supplies and services.[79] It is tempting to conclude from this that the Maryland state executive branch COMAR simply does not apply to county procurement. However, the Maryland Supreme Court decision came to this result in part because county school bus operations are less than one-half funded and are not regulated by the Maryland state. The Maryland state executive branch COMAR may apply to county procurement that is more than one-half funded and/or highly regulated by a Maryland state executive branch agency.

Virginia

The Virginia Small Business and Supplier Diversity Department is the DBE certifying agency in Virginia.[80] The Department administers both the state certification program, known as the Small, Woman-Owned, and Minority (SWaM) business program, as well as the federal USDOT DBE program for Virginia. Applications for certification to these programs can be found online.[81] Certification under the state's federal DBE program automatically gives certified status under the SWaM program. Certification under the state's federal DBE program also allows businesses to participate in federally-assisted Virginia Department of Transportation highway projects, as well as federally-assisted rail, airport, seaport and public transit projects in Virginia.[82]

A business applying for SWaM certification is eligible if at least 51% of the business is owned by women or minority individuals, or if the business is "small," as defined in the Virginia Code.[83] In addition, to be eligible, one or more of the small, minority or woman owners must "control both the management and daily business operations."[84] "Control" is defined as the power to direct the operation and management of a business and actually do so in day-to-day operations.[85] Certification as a SWaM also requires that the business perform a "commercially useful function"

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[76] 49 CFR 26.55 (c)(5). Even this federal DOT administration review may be applicable only to the "30% rule." 49 CFR 26.55 (c)(3), (4) & (5) together read:

(3) If a DBE does not perform or exercise responsibility for at least 30 percent of the total cost of its contract with its own work force, or the DBE subcontracts a greater portion of the work of a contract than would be expected on the basis of normal industry practice for the type of work involved, you must presume that it is not performing a commercially useful function.

(4) When a DBE is presumed not to be performing a commercially useful function as provided in paragraph (c)(3) of this section, the DBE may present evidence to rebut this presumption. You may determine that the firm is performing a commercially useful function given the type of work involved and normal industry practices.

(5) Your decisions on commercially useful function matters are subject to review by the concerned operating administration, but are not administratively appealable to DOT.

[77] COMAR 21.11.03.12-1.

[78] COMAR 21.11.03.02.

[79] *Charter, Inc. v. Anne Arundel County Bd. of Educ.*, 358 Md. 129, 747 A.2d 625 (2000).

[80] Va. Code Anno. §2.2-16403 (Michie 1950) Statutory Authority.

[81] *See* http://www.dmbe.virginia.gov/swamcert.html (state SWaM program), and http://www.dmbe.virginia.gov/dbecert.html (federal DBE program).

[82] *See* the online FAQ page at http://www.dmbe.virginia.gov/faq.html. "The SWaM Procurement Initiative is a Commonwealth of Virginia program, while the Disadvantaged Business Enterprise ("DBE") Program is a federal certification program under the U.S. Department of Transportation. The DBE Program focuses on federally-funded projects through the Virginia Department of Transportation (VDOT), and also includes rail, airport and seaport projects, as well as public transit projects."

[83] Code Anno. §2.2-1604 (Michie 1950).

[84] Code Anno. §2.2-1604 (Michie 1950).

[85] 7VAC13-20-10; 7VAC13-20-110.

(CUF), as described below.[86] The state will consider "all the facts in the record" to determine whether the business is owned and controlled by the small, women or minority individuals.[87]

A business can be certified as a DBE in Virginia if the business has been certified by another local, state, private sector or federal certification program. The Virginia Administrative Code states:

> "The department may at its discretion evaluate any local, state, private sector or federal certification program to determine whether it meets the minimum eligibility, ownership and control requirements for certification of small, women- and minority-owned businesses as set forth in this chapter."[88]

Once certified, the Department is required to give notice of any initial decision to review the business to verify its continued eligibility as a small, women-owned, or minority-owned business.[89] The Department may revoke the certification of a business that it finds no longer qualifies as a small, women-owned, or minority-owned business.[90] The business does have the opportunity to request an informal fact-finding proceeding, within 10 days after the Department issues its notice of revocation or denial of recertification.[91] There are rigorous conditions on such a request.[92]

The legal standard that a complaining business must meet in order to have an adverse decision reconsidered is difficult:

> "A decision of the department will only be reconsidered if the complainant can demonstrate that a material mistake of fact formed the basis for the department's review of the application or other relevant record, or if the department's decision was not in accordance with applicable laws or regulations."[93]

The Virginia Department of Transportation (VDOT) has essentially adopted the federal USDOT CUF standards.[94] VDOT now aggressively investigates CUF violations, as well as "front companies," control and profit issues. Accordingly, on any Virginia public transportation project, either the federal DOT regulations or the VDOT CUF standards, or both, will apply.

The 2016 VDOT Road and Bridge Compiled Specifications do also state:

> 107.15—Use of Small, Women-Owned, and Minority-Owned Businesses (SWaMs). It is the policy of the Department that Small, Women-Owned and Minority-Owned Businesses (SWaMs) shall have the maximum opportunity to participate in the performance of the Contract. The Contractor is encouraged to take necessary and reasonable steps to ensure that SWaMs have the maximum opportunity to compete for and perform work on the Contract, including participation in any subsequent subcontracts. Any SWaMs used by the Contractor, including the Contractor himself, shall perform a commercially useful function, as defined in 7VAC10-21-220.[95]

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[86] 7VAC13-20-110(3)(d).

[87] 7VAC13-20-90(A).

[88] 7VAC13-20-170.

[89] 7VAC13-20-210.

[90] 7VAC13-20-200.

[91] *See* re: 7VAC13-20-230.

[92] 7VAC13-20-230(B) [Any request for an informal fact-finding proceeding ... must be submitted in writing to the Department within 10 days of the date on which the notice of denial of recertification or the notice of revocation was sent by the Department. The request for an informal fact-finding proceeding shall include a clear, brief summary of all factual errors and legal grounds upon which the complainant intends to rely. Within 30 days of the receipt of a timely request for an informal fact-finding proceeding, the Department shall issue a notice stating the date and time of the informal fact-finding proceeding. The informal fact-finding proceeding will not be scheduled less than seven and not more than 45 days from the date of the notice. Within 60 days from the date on which the informal fact-finding proceeding was held, the Department shall issue a notice, in writing, stating the final decision of the Department].

[93] 7VAC13-20-230.

[94] Disadvantaged Business Enterprise Program Statement of Commitment dated January 30, 2015, which states that VDOT receives federal financial assistance from the United States Department of Transportation (USDOT) and, as a condition of receiving this assistance, VDOT signed an assurance that it will comply with 49 CFR Part 26. *Also see e.g.,* http://www.vdot.virginia.gov/business/civil_rights_commercially_useful_function.asp.

[95] 2016 VDOT Road and Bridge Compiled Specifications, Section 107.15 [7VAC10-21-220 is now 7VAC13-20-110].

Otherwise, Virginia general regulations applicable to all Virginia public procurement state only that any entity must perform a CUF in order to be a certified DBE.[96] This regulation seems to speak only to the qualification for certification as a DBE and not whether that DBE contract will count towards DBE participation goals as USDOT regulations do. It is a part of Title 7, Chapter 20 Regulations to Govern the Certification of Small, Women-Owned, and Minority-Owned Businesses. It is entitled "Control" and states that governance, operation, management and independence are all factors that will be examined in determining who controls an applicant's business.

This regulation does conclude by stating:

c. An agent, broker, dealer or manufacturer's representative, unless it is the standard for the industry, generally does not qualify for certification.
d. A business that adds no material value or does not perform a commercially useful function in the provision of the products or services being supplied or has no ownership, financial responsibility, legal liability, or does not possess or handle the item being procured with its own employees, equipment, or facilities generally does not qualify for certification, unless the business structure is the standard in the industry.[97]

Pennsylvania

There are five DBE "third-party certifying" programs for Pennsylvania state projects, including: the Women's Business Enterprise Council; the National Minority Supplier Development Council; the United States Department of Veteran Affairs; the United States Small Business Administration and the Pennsylvania Unified Certification Program.[98] Firms that certify with one of these programs may also qualify as a "Small Diverse Business" with the Pennsylvania Department of General Services' Bureau of Diversity, Inclusion & Small Business Opportunities (BDISBO), if the business meets specific size and gross sales revenue requirements.[99] Small and diverse firms should utilize the services offered by the BDISBO to take advantage of non-transportation related Pennsylvania state contracting opportunities.

In order to participate as a DBE on Pennsylvania Department of Transportation (PennDOT) projects that are NOT federally funded, firms must also be recognized by PennDOT as a "Diverse Business," with a somewhat different definition than BDISBO's.[100] PennDOT's Diverse Business Program defines a diverse business as "a disadvantaged business, minority-owned or women-owned business or service-disabled veteran-owned or veteran-owned small business that has been certified by a third-party certifying organization" (one of the programs described above).[101]

The PennDOT Diverse Business Participation statute is fairly broad and does create goals for DBE or diverse business participation. It requires all bidders to use "Good Faith Efforts" to solicit subcontractors that are diverse businesses, but does not include a CUF or similar standard. This applies only to non-federally funded state transportation projects. It applies to subcontracted work only. It does not apply to material suppliers or general contractor self-performed work.

Firms seeking DBE status for federal DOT-assisted projects must certify with the Pennsylvania Unified Certification Program (PAUCP), to participate on any Federal Highway Administration, Federal Transit Administration, or Federal Aviation Administration funded project.[102] Firms must submit applications for PAUCP certification directly to one of five participating state agencies. These include PennDOT, the City of Philadelphia International Airport, the Pennsylvania Port Authority of Pittsburgh, the Allegheny County Department of MBE/WBE/DBE and the Southeastern Pennsylvania Transportation Authority.[103] When a firm obtains certification through any one of these

[96] 7VAC13-20-110. Control.

[97] 7VAC13-20-110(3)(c) & (d).

[98] The PAUCP is the sole DBE certifying entity in Pennsylvania for all projects involving federal funds. Certification through that Program, however, also satisfies the requirements for being a diverse business for participating on non-federally funded PennDOT projects.

[99] For more information on the BDISBO, *see*: http://www.dgs.pa.gov/Businesses/Minority,%20Women%20and%20Veteran%20Businesses/Pages/default.aspx#.V3FihSgrLIU.

[100] *See* 74 Pa.C.S. §303.

[101] A Diverse Business must be an ECMS Business Partner [PennDOT's Engineering and Construction Management System]. They may also need to be pre-qualified. *See* 74 Pa.C.S. §303. *See also* PennDOT's FAQ on Section 303 at: http://www.penndot.gov/about-us/EqualEmployment/Documents/Diverse%20Business%20FAQs.pdf.

[102] *See* the Pennsylvania Department of Transportation's DBE program website for more information: http://www.penndot.gov/about-us/EqualEmployment/Pages/Disadvantaged-Business-Enterprise.aspx#.V2hiDCgrLIU.

[103] To apply for certification on federal projects in Pennsylvania, go to: https://www.paucp.com/Default.aspx.

agencies, that certification will allow the firm to participate on other federal DOT-assisted construction projects in Pennsylvania. If the PennDOT project is federally funded, the federal DOT CUF standards will apply.[104]

With respect to a CUF or other "quality of participation" standard, Pennsylvania statutes and regulations do not seem to add anything beyond what federal law provides.[105] Any specific requirements of a CUF standard would either come from local municipal law (like Philadelphia), federal law or are administered though contract provisions.

City of Philadelphia

Philadelphia has unusually well-developed CUF standards and requirements. Section 17-600 of the Philadelphia Code also applies to any project (except a single-family residential project or projects under $250,000) that requires a grant of financial assistance, or an ordinance of Council, or an action of the Zoning Board of Adjustment to proceed. This would probably include most commercial and larger residential projects. Section 17-600 requires an Economic Opportunity Plan that provides meaningful and representative opportunities for DBEs to participate in all phases of the project or contract and an appropriately diverse workforce in all phases of the project or contract with regard to minority, female and disabled persons.

The prime contractor in such a project must use its best efforts to include in their subcontracts an enforceable requirement that each subcontractor participant abide by the provisions of the Economic Opportunity Plan.

Executive Order 03-12 applies to all City public procurement contracts. While it is largely an enabling document, the Executive Order contains a definition of "Commercially Useful Function," which usually reappears in the "Project Manual" as follows:

> **Commercially Useful Function (CUF).** For contractors and subcontractors, [a DBE] performs a Commercially Useful Function when it performs a distinct element of a City Contract ... which is worthy of the dollar amount of the [DBE's] contract and the [DBE] carries out its responsibilities by managing and supervising the work involved and actually selfperforming at least twenty percent (20%) of the work of the contract with its own workforce.
>
> For suppliers, [a DBE] performs a Commercially Useful Function when it is responsible for sourcing the material, negotiating price, determining quality and quantity, ordering the material and paying for it from its own funds. Commercial usefulness will be evaluated and determined by the OEO on a bid-by-bid basis as informed by prevailing industry standards and the [DBE's] NAICS Codes and may require, without limitation, evidence of a warehouse, distribution equipment and certified payroll records.

This Executive Order does state that bidders must make "Good Faith Efforts" to identify and use DBEs that perform CUFs, but does NOT seem to state anywhere that other participants (like a non-DBE supplier) need to meet this definition of CUF at any particular time or the penalty if they do not.

Accordingly, in Philadelphia, a DBE contractor or subcontractor must perform a distinct element of a City Contract that is commensurate with the dollar amount of the DBE's contract. The DBE must carry out its responsibilities by managing and supervising the work involved. This is similar to the DOT standard. Much of the other DOT wording is missing or different, however. In Philadelphia, the DBE must actually selfperform at least twenty percent (20%) of the work of the contract with its own workforce, rather than the 30% requirement in the DOT regulations. There is no explicit statement prohibiting an "extra participant through which funds are passed in order to obtain the appearance of DBE participation." There are no special provisions for DBE truckers.

This Executive Order states explicitly that for suppliers a DBE performs a commercially useful function when it is responsible for sourcing the material, negotiating price, determining quality and quantity, ordering the material and paying for it from its own funds. There are no special provisions for material supplier manufacturers or "regular dealers." Accordingly, the four pillars appear to be the rule, and the only rule, for DBE Suppliers in Philadelphia. This

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[104] 62 Pa.C.S. §2108 states that where a project uses federal funds, the agency must follow federal requirements. *See* PennDOT's website for more information on the DBE Program at: http://www.penndot.gov/about-us/EqualEmployment/Pages/Disadvantaged-Business-Enterprise.aspx#.Vz9EvvkrLDc.

[105] 74 Pa.C.S. §303.

is a significant difference with the DOT regulations that may not allow for a DBE Supplier, other than manufacturers or "regular dealers."

The Section 17-600 Economic Opportunity Plan and the Executive Order 03-12 definition of "Commercially Useful Function" would normally be included in the "Project Manual" included in most City public procurement. This would be a part of the contract between the City and any general contractor.

The Economic Opportunity Plan, Executive Order and Project Manual seem to apply only to first tier subcontractors, although a non-DBE subcontractor or supplier may be in that position at times. "Conduit" clauses in a subcontract or purchase order that say a non-DBE subcontractor or supplier is bound to the general contract may also be a concern. In other words, these CUF provisions in the Economic Opportunity Plan, the Executive Order and the Project Manual for the project may be incorporated in any subcontract in these two ways. It is not clear how or when this would apply to or impact a non-DBE supplier, since these statutes and the Economic Opportunity plans on their face speak only to whether a bidder should prevail in a contract bid and whether that bidder or contractor is later complying with its contract terms with the City.

District of Columbia

The District of Columbia has a very active and aggressive disadvantaged local small business enterprise preference system, with extra protections for local businesses.

Qualified local businesses are referred to as a "Certified Business Enterprise"[106] (CBE) under the D.C. Code. There are several different types of CBEs, including;

1. Small business enterprise[107]
2. Local business enterprise[108]
3. Disadvantaged business enterprise[109]

The rules generally provide preferences in City procurement to individual and corporate residents of the City that are subject to City tax and licensure requirements.[110] The Department of Small and Local Business Development (Department)[111] establishes rules for: (1) A bid preference mechanism for CBEs; (2) A set-aside program for small business enterprises; and (3) A set-aside program for CBEs.[112] Each City agency has the goal of procuring and contracting 50% of its expendable budget to qualified small business enterprises. However, if the agency determines in writing that there are not at least two qualified small business enterprises, the agency may use any qualified CBEs to fulfill those requirements.[113]

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[106] DC Code §2-218.02(1D) Definitions.

[107] DC Code §2-218.02(16) Definitions & DC Code §2-218.32. A business enterprise shall be eligible for certification as a small business enterprise if the business enterprise: (1) Is a local business enterprise; (2) Is independently owned, operated and controlled; and (3) (A) Is certified by the United States Small Business Administration as a small business concern or meets the definition of a small business concern under the Small Business Act ... or (B) Has had averaged annualized gross receipts for the three years preceding certification not exceeding [certain limits].

[108] DC Code §2-218.02(12) Definitions & DC Code §2-218.31. A business enterprise shall be eligible for certification as a local business enterprise if the business enterprise: (1) Has its principal office located physically in the District of Columbia; (2) Requires that its chief executive officer and the highest level managerial employees of the business enterprise perform their managerial functions in their principal office located in the District; (2A) Can demonstrate one of the following: (A) More than 50% of the employees of the business enterprise are residents of the District; (B) The owners of more than 50% of the business enterprise are residents of the District; or (C) (i) More than 50% of the assets of the business enterprise, excluding bank accounts, are located in the District; and (ii) More than 50% of the business enterprise's gross receipts are District gross receipts; and (3) Can demonstrate [that the business enterprise is licensed or taxed pursuant to the DC Code].

[109] DC Code §2-218.02(5) Definitions & DC Code §2-218.33. A business enterprise shall be eligible for certification as a disadvantaged business enterprise if the business enterprise is: (1) Owned, operated, and controlled by economically disadvantaged individuals; and (2) Is a local business enterprise.

[110] There are also preferential designations for local business enterprises with principal offices located in an enterprise zone in DC Code §2-218.37 [principal offices are located in an enterprise zone as defined by DC Code §2-218.02]; Veteran-owned business enterprises in DC Code §2-218.38 [a local business enterprise not less than 51% owned and operated by one or more veterans]; and Local manufacturing business enterprises in DC Code §2-218.39 [a local manufacturing business enterprise makes a product through a process involving raw materials, components, or assemblies, usually on a large scale, with different operations divided among different workers; and manufactures only in the District of Columbia].

[111] Department of Small and Local Business Development is established by DC Code §2-218.11.

[112] DC Code §2-218.42. *See* the point system for bid and proposal preferences in DC Code §2-218.43.

[113] DC Code §2-218.41(a) & (a-1).

Each agency must set also aside contracts of $250,000 or less for qualified small business enterprises.[114] However, if an agency determines in writing that there are not at least two qualified small business enterprises that can provide the services or goods for the contract, the agency may use any qualified CBE. Also, an agency can issue the contract in the open market, if the agency determines in writing that the bids set aside for a small or certified business enterprise are believed to be 12% or more above the likely price on the open market.[115]

A joint venture is eligible for certification as a certified joint venture only for a specific solicitation.[116] In other words, there are no "standing" certified joint ventures in the City. A certified joint venture should receive preference points or price reductions in solicitations only if a CBE owns a majority interest in the joint venture. If the certified joint venture is formed to serve as a general contractor on a project (A) Any bond for the project must be provided by the CBE, and the CBE participant shall be solely and individually liable as the principal to the surety for at least 51% of each claim asserted under the bond; (B) The individual primarily responsible for project decisions, such as the project executive, must be provided by the CBE; and (C) At least 50% of the staff that the joint venture will devote to the project will be provided by the CBE.[117]

Each government-assisted construction and non-construction contract in which a CBE is selected and is granted points or a price reduction or is selected through a set-aside program shall include a requirement that the CBE perform at least 35% of the contracting effort with its own organization and resources. If the CBE subcontracts work, 35% of the subcontracted effort shall be with CBEs.[118] If the project is $1 million or less, the CBE must perform at least 50% of the contracting effort with its own organization and resources.[119] If a certified joint venture is selected and is granted points or a price reduction or is selected through a set-aside program, the CBE must perform at least 50% of the contracting effort with its own organization and resources. If the certified joint venture subcontracts work, 35% of the subcontracted effort must be with CBEs.[120]

"Government-assisted" is fairly broadly defined as a contract executed on behalf of the City that involves City funds or that the City administers in accordance with a federal grant or otherwise; a project that receives a loan or grant from a City agency; a project that receives bonds or notes issued by a City agency, including tax increment financing or industrial revenue bonds; a project that receives City tax exemptions or abatements; or a development project that involves property sold or leased by the City.[121]

Whether or not a certified CBE is the successful bidder as general contractor on a City contract, all construction contracts for government-assisted projects in excess of $250,000 have CBE subcontracting requirements.[122]

§2-218.46. Performance and subcontracting requirements for construction and non-construction contracts; subcontracting plans.

(a) (1) All ... contracts for government-assisted projects in excess of $250,000 shall include the following requirements unless a waiver has been approved in accordance with §2-218.51:

(A) At least 35% of the dollar volume of the contract shall be subcontracted to small business enterprises; or

(B) If there are insufficient qualified small business enterprises to completely fulfill the requirement of subparagraph (A) of this paragraph, then the subcontracting requirement may be satisfied by subcontracting 35% of the dollar volume to any qualified certified business enterprises; provided, that all reasonable efforts shall be made to ensure that qualified small business enterprises are significant participants in the overall subcontracting work.

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[114] DC Code §2-218.44 & 45.

[115] DC Code §2-218.44 & 45.

[116] DC Code §2-218.39a(a) (2015).

[117] DC Code §2-218.39a(h) (2015).

[118] DC Code §2-218.46(b)(1)(A).

[119] DC Code §2-218.46(c).

[120] DC Code §2-218.46(b)(2)(A).

[121] DC Code §2-218.02(9A) Definitions.

[122] DC Code §2-218.46. Under DC Code §2-218.51 these subcontracting requirements may be waived only in writing by the Director if there is insufficient market capacity for the goods or services that comprise the project and such lack of capacity leaves the contractor commercially incapable of achieving the subcontracting requirements at a project level.

If a CBE is utilized to meet these subcontracting requirements, then that CBE subcontractor must perform at least 35% of the contracting effort with its own organization and resources.[123]

Bids or proposals responding to any City solicitation must include a subcontracting plan that includes the name and address of each subcontractor; a current certification number of the small or certified business enterprise; the scope of work to be performed by each subcontractor; and the price to be paid to each subcontractor. This subcontracting plan must be provided before the City accepts the submission of the bid or proposal.[124]

The D.C. Code does define commercially useful function, borrowing from the federal DOT terminology:

> For the purposes of this subchapter, the term:
> "Commercially useful function" means work performed by a certified business enterprise in a particular transaction that, consistent with industry practices and other relevant considerations, has a necessary and useful role in the transaction. The certified business enterprise shall be responsible for the execution of the work of the contract and carry out its responsibility by actually performing, managing, and supervising the work involved. The certified business enterprise shall be responsible, with respect to materials and supplies used on the contract, for negotiating price, determining quality and quantity, ordering the materials and installing (where applicable) and paying for the material itself.[125]

However, the CUF term is used only one other place in the D.C. Code:

> The Department, in coordination with the agency contracting officer, shall have the authority, in reviewing participation by certified business enterprises, to disregard participation by a certified business enterprise when that certified business enterprise serves no commercially useful function in the performance of a contract.[126]

This seems to create a discretionary standard for the Department,[127] which has the authority, but not the duty to disregard DBE participation if the DBE serves no commercially useful function in the performance of a contract. The D.C. definition of CUF is from the DOT regulations, requiring actual performance and the four pillars. However, the discretionary nature of the statute means that any number of factors could determine how it is applied in a specific situation.

Private Projects

More private owners are including DBE participation goals in general contracts voluntarily in an effort to achieve public policy goals and act as good corporate citizens. Such DBE participation would be a matter of private contract, not any regulatory scheme. The level or type of DBE participation required, therefore, can only be determined by a review of the applicable general contract provisions. A failure to comply would be a matter only of contract breach and damages for those in privity of contract. Conduit clauses in subcontracts may impact in this regard.

Private projects often require some type of public funding or at least zoning, site plan or other governmental approvals to proceed. Government agencies sometimes require DBE participation for such governmental approvals.[128] It is possible that a private owner could, or be required to, agree that an existing DBE participation regulatory regime would apply to the project. If this occurred, then an existing regulatory framework could determine the level or

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[123] DC Code §2-218.46(b-1). Under DC Code §2-218.64, no bidder may identify a small or certified business enterprise in a bid or proposal unless it has obtained authorization from the small or certified business enterprise to identify the small or certified business enterprise in its bid or proposal; has notified the small or certified business enterprise before execution of the contract of its inclusion in the bid or proposal; and uses the small or certified business enterprise in the performance of the contract.

[124] DC Code §2-218.46(d)(1)-(3). Under DC Code §2-218.46(d-1) a design-build project is not required to identify specific subcontractors before performing preconstruction services, but a detailed subcontracting plan must be submitted before entering into a guaranteed maximum price or authorization to commence construction.

[125] DC Code §2-218.02(1G) Definitions.

[126] DC Code §2-218.13(e) Functions of the Department.

[127] Department of Small and Local Business Development, established by DC Code §2-218.11.

[128] *See e.g.*, National Harbor project in Prince George's County, Maryland.

type of DBE participation required and it would be necessary to review that regulatory regime. Failure to comply, however, would still seem to be only a contractual breach and not regulatory or criminal.

ENFORCEMENT OF DBE AND CUF REGULATION

The industry has been waiting to see promotion of public policy objectives through regulations and enforcement. We now see enforcement, at least on DOT projects that have more developed DBE and CUF regulations. U.S. Department of Transportation regulations apply only on federal transportation projects. However, more state and federal government agencies are adopting similar regulations.[129] The vast majority of investigations and penalties have come from DOT projects. It is not clear at this point whether state and local governments will ever actively initiate CUF investigations or enforcement actions. The risk is there, however, and the costs could be significant for suppliers and contractors.

On the DOT Inspector General website (http://www.oig.dot.gov./) you can find recent DBE enforcement actions on DOT projects. Most or all of these defendants had a contract with the government or were one tier removed. Most of these defendants were contractually required to make certifications to the government regarding the DBE participation. Accordingly, these cases involve a breach of contract or outright fraud on the government.

Historically, common violations have involved false or illegitimate DBE contractors set up or controlled by non-DBE contractors. A traditional contractor may set up an employee or relative to "own" a DBE contractor, which then works primarily for the non-DBE contractor that set it up. There is no *per se* violation in a close working relationship between two contractors. The issues, however, are control, independence, management and profits of the DBE. In other words, does the DBE contractor truly own, control and manage its contracting business?

The DBE may act as a general contractor and the non-DBE contractor acts as the primary subcontractor. The roles can be reversed, where the non-DBE is a general contractor that then feeds significant subcontracting work to the DBE contractor. The equipment used by the DBE contractor may be owned by the non-DBE. The employees supervising and performing work for the DBE may be former or current employees of the non-DBE contractor. These are all "red flags" that will attract investigator interest. The DBE must be responsible for the performance, management and supervision of a distinct element of the work, in accordance with normal industry practice.

An Internet search for "red flags for DBE participation on DOT projects" will yield a detailed list of "red flags" published by the Federal Highway Administration to assist state highway administrators in identifying probable or possible fraud in creation and control of DBE contractors.

DBE participants, general contractors and subcontractors have received jail time, probation and large fines in such DBE control and profit fraud cases. These cases also often discussed the lack of a CUF by the DBE, when the DBE is not actually performing, managing and supervising its work. However, more recent enforcement actions have been brought against more remote material suppliers that participated in transactions involving DBEs that did not perform a CUF.

Commercially useful function regulations usually discuss the basis upon which a contracting officer decides whether certain DBE participation qualifies for credit under the goals for the contract. However, DOT regulations have been interpreted by a few U.S. Attorneys' offices as allowing at least civil fines against remote suppliers, who have no contract with the government and did not certify compliance with DBE or CUF requirements, but that knowingly participate in a transaction that circumvents or violates these CUF standards.

The problem is that if you look at the federal DOT regulations 49 CFR §26.55, it is entitled "How is DBE participation counted toward goals." The entire regulation speaks only to whether any particular transaction within a contract should count towards DBE participation goals. The penalty for violation seems clear in the regulation: a loss of DBE participation credit to the general contractor and DBE. However, based on this regulation, a national pipe supplier recently agreed to pay a $4,950,000 fine to settle an investigation as discussed below.

It is important to understand that this case was resolved in a settlement agreement between the government and the supplier, so there was no "court decision." This is not a legal precedent and we do not know how a court would have ruled on these facts. There are still doubts about whether this regulation could apply to a third tier supplier that did not contract directly with a government entity and did not expressly certify anything to any government entity.

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[129] *See e.g.*, Maryland State Fin. & Proc. §14-303 and COMAR 21.11.03.12-1; Maryland State Code Education §5-301(h) and COMAR 23.03.03.06(D); Maryland Minority Business Enterprise Program Manual (July 2014) at pages 6, 36 & 105-115 and COMAR 11.01.10.01; Philadelphia Code §17-600.

If the prosecutor in that case was correct about that regulation and *if* a court would agree, then you could come to the same result based on other state statutes and regulations. This is the situation under Virginia, Maryland, Pennsylvania and District of Columbia statutes and regulations. They do not apply on their face to remote non-DBE subcontractors and suppliers, but suppliers are very nervous about facing investigations.

CUF Violations under DOT and EPA Regulations

A national supplier of construction materials (Supplier) agreed in 2015 to pay a fine of $4,945,000 to the United States for participating in transactions in which a certified Disadvantaged Business Enterprise (DBE) acted "merely as a pass through" and did not perform a "commercially useful function."[130]

The settled case involved a series of transactions on multiple projects by both the DOT and EPA. This resulted in a settlement agreement (Settlement Agreement) between the government and the Supplier, so there was no "court decision." This is not a legal precedent and we do not know how a court would have ruled on these facts. Nonetheless, we know how federal prosecutors view conduct that is very common in the marketplace by suppliers, DBEs, subcontractors and general contractors. The use of pass through "paper pushers" or "brokers" that participate "in name only" for a 2% or 3% markup will result in investigations and prosecutions.

The Settlement Agreement confirms that the Supplier "did not contract directly with a government entity...." The Supplier did not "certify—nor was it required to certify—to any government entity that it had or would comply with DBE regulations in connection with those contracts and projects. Nevertheless, the United States contended that ... [the Supplier] was subject to the DBE requirements because [it] transacted business with a company that had itself contracted with a government entity to perform work on a project that was funded by DOT or EPA, and the DOT Regulations and EPA Regulations apply both to contractors in privity with government entities and to downstream contractors that are not."

Under the DOT regulation, the DBE must be responsible for negotiating price, determining quality and quantity, ordering the material and paying for the material to perform a CUF with respect to the materials (the four pillars). The Settlement Agreement states that "various prime contractors represented falsely that [the DBE] had performed a commercially useful function by negotiating price and other terms of sale when, in reality, the prime contractors had negotiated terms with [the Supplier] and used [the DBE] merely as a pass through. [The DBE] collected invoices from [the Supplier]; transferred the information from those invoices to [the DBE's] own invoices and added a markup; and passed [the DBE] invoices on to the prime contractors. The prime contractors then represented falsely to federal, state and/or local contract-letting authorities that [the DBE] supplied materials that, in reality, [the Supplier] supplied. In this connection, [the Supplier's] conduct enabled various prime contractors to certify falsely that materials were supplied by [the DBE] when the parties—i.e., [the Supplier, the DBE], and the prime contractors—knew that was not the case, resulting in the submission to government entities of false or fraudulent claims for payment from federal funds."

Contractors historically have had greater CUF concerns than suppliers. The majority of investigations and penalties in the past involved entities that had contracts directly with the government or one tier removed. It is significant that this Supplier did not contract directly with a government entity and was not required to certify any compliance with DBE regulations. The U.S. Attorney's office contended the traditional supplier was subject to the DBE requirements because it transacted business with a DBE Supplier and contractor that then contracted with the government. In other words, on projects funded by DOT or EPA, the DOT and EPA regulations apply to downstream contractors and suppliers that are not in privity of contract with the government.

It is also significant that the Settlement Agreement states that the DBE in this case was a DOT certified "Regular Dealer" in the materials purchased. This emphasizes again that CUF requires a "transactional analysis." A DBE must perform a CUF in every transaction. Proper certification does not mean that the DBE performance qualifies for DBE participation credit. Similarly, the fact that a DBE owns warehouses and trucks or has many employees may mean that the DBE is capable of performing a CUF. However, the proper analysis must look at the role the DBE played in this particular transaction.

However, the result in the $4,950,000 fine case is curious, since there is no apparent CUF requirement in the definition of a regular dealer and no requirement that the regular dealer negotiate the price of the material. There is also no apparent prohibition against a regular dealer acting as an "extra participant in a transaction, contract or

[130] https://www.oig.dot.gov/library-item/32633.

project, through which funds are passed in order to obtain the appearance of DBE participation."[131] Both of these requirements appear only in the discussion of expenditures to a DBE contractor, discussed above.[132] It is difficult to see how this certified regular dealer DBE, the general contractor and the traditional non-DBE supplier were in violation of DOT regulations just because the regular dealer DBE did not negotiate the price and acted merely as a pass through.

Apparently, no charges have been brought at this point against the now defunct DBE supplier or the general contractor. However, investigations and settlements have occurred with other contractors that used the same DBE as a pass through.[133]

DOT Investigations have also occurred for violation of CUF rules in Pennsylvania.[134] In that case, the individual owner of a certified DBE company was sentenced to 12 months' probation and ordered to pay a $10,000 fine in the U.S. District Court in Philadelphia. The DBE paint supplier served as a pass through and did not provide a CUF. The general contractor negotiated contracts and ordered materials directly with non-DBE suppliers. The DBE supplier was paid a fee of 1.75 percent of the face value of the supply invoices. Apparently, no charges have been brought at this point against the remote non-DBE supplier or the general contractor.

False Claims Act

A very special feature of the $4,950,000 fine DOT enforcement action is that it did involve a relatively passive third tier supplier. DOT enforcement actions had otherwise historically involved parties that had contracts with the government or one tier removed. The defendant typically was in breach of a contract with the government and/or had made a false certification to the government. These actions also often involved a far more "active" type of fraud in which the defendant set up a "sham" DBE company, for example.

This $4,950,000 fine DOT enforcement action was brought under the federal civil "False Claims Act" (FCA).[135] The government agreed that the remote supplier had no contract with the government, had never agreed to comply with DBE regulations, and had never certified anything to the government regarding DBE compliance. It was not an attempt to prove criminal activity by the supplier.

Under 31 U.S. Code §3729, any person who knowingly presents, or causes to be presented, or conspires to present a false or fraudulent claim for payment or approval to the government or knowingly makes, uses, or causes to be made or used, a false record or statement material to a false or fraudulent claim is subject to a civil penalty of not less than $5,000 and not more than $10,000 for each instance of a false claim.[136] The defendant is also liable for three times the government's actual damage as a result.[137]

The $4,950,000 fine DOT enforcement action simply involved a lot of invoices on multiple projects. The point is that this civil false claims act violation does not need to involve an active fraud. Anyone who knowingly participates, including remote subcontractors and suppliers, is at risk of a False Claims Act prosecution.

"Knowledge" is a key factor in any False Claim Act prosecution. There is no violation unless the defendant "knowingly presents, or causes to be presented, [or conspires to present] a false or fraudulent claim for payment."

There is no affirmative obligation to investigate the role that any DBE will play in a project. Risk arises, however, when knowledge is undeniably "dumped" upon you. This occurs most commonly when a non-DBE supplier and their customer communicate about a project for months, trade quotes and purchase orders, transfer technical data and shop drawings. The DBE Supplier is then injected into the contract tiers shortly before a project begins. All parties know at this point that this DBE is not performing a CUF.

There are still doubts about whether this CUF regulation could apply to a third tier supplier that did not contract directly with a government entity and did not expressly certify anything to any government entity. A false claim under the FCA can be factually false or legally false. In a factually false claim, the contractor falsely represents what goods or services it provided to the government. In a legally false claim, however, the contractor knowingly

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[131] 49 CFR 26.55 (c)(2).

[132] 49 CFR 26.55 (c)(1) – (2).

[133] https://www.oig.dot.gov/library-item/33774; https://www.oig.dot.gov/library-item/33605; https://www.oig.dot.gov/library-item/33436.

[134] https://www.oig.dot.gov/library-item/33773.

[135] 31 U.S.C.A. §3279, *et seq*.

[136] Subject to inflation increases under 31 U.S.C.A. §3279(a)(1)(G).

[137] The issue of damages can be difficult. *Wall v. Circle C. Constr., L.L.C.*, 697 F.3d 345 (6th Cir. 2012).

and falsely certifies that it has complied with a contract requirement, statute, or regulation that is a precondition for payment.

False certifications can be express or implied. The implied certification theory is controversial because it finds a false statement in a claim or invoice when there is no express certification of compliance and the claim itself otherwise is accurate.[138] In other words, the government got the goods and services it paid for. However, the contractor failed to disclose that it violated a contract provision, statute or regulation. According to this implied certification theory, when a claim for payment fails to disclose a violation of a material statutory, regulatory, or contractual requirement, this is a misrepresentation that renders the claim "false or fraudulent" under the False Claims Act. This arguably turns routine contract disputes into false claims.

As discussed above, a national supplier of construction materials (Supplier) had agreed to pay a fine of $4,945,000 to the United States for participating in transactions in which a certified DBE acted "merely as a pass through" and did not perform a "commercially useful function" under USDOT regulations.

There was no "court decision" in that case, since it resulted in a settlement agreement. This was not a legal precedent and we do not know how a court would have ruled on these facts. The settlement agreement did not use the term "implied certification," although the United States did state that the Supplier violated the U.S. False Claims Act. However, the prosecutor must have been operating on the theory that the Supplier's invoices impliedly certified that the transaction complied with all statutory, regulatory or contractual requirements, including the DBE CUF requirements.

A U.S. Supreme Court decision and decisions in some Circuit Courts (one level below the U.S. Supreme Court) cast doubt on whether courts would agree with the United States' position in that $4,945,000 penalty case.[139] The Supreme Court case is *Universal Health Servs. v. United States ex rel. Escobar*, 136 S. Ct. 1989, 195 L. Ed. 2d 348 (U.S. 2016).

The Supreme Court decided that:

> [L]iability can attach when the defendant submits a claim for payment *that makes specific representations* about the goods or services provided, but knowingly fails to disclose the defendant's noncompliance with a statutory, regulatory, or contractual requirement. In these circumstances, liability may attach if the omission renders those representations misleading.[140]

The defendant in *Universal Health Servs.* submitted mental health service invoices for Medicaid reimbursement. Those invoices contained codes signifying that the services were provided by properly licensed mental health professionals, which was false.

If we look only at the quoted language above from the Supreme Court, we would decide that False Claim Act violations can occur only if there is a claim for payment that makes *specific representations*, but the claimant knowingly fails to disclose noncompliance with a statutory, regulatory, or contractual requirements, which render *those representations misleading*.

The settlement agreement in the $4,945,000 construction material supplier case confirmed that the Supplier "did not contract directly with a government entity for any of the federally-funded contracts." Neither did the Supplier "certify—nor was it required to certify—to any government entity that it had or would comply with DBE regulations in connection with those contracts and projects."

"[The DBE] collected invoices from [the Supplier]; transferred the information from those invoices to [the DBE's] own invoices and added a markup; and passed [the DBE] invoices on to the prime contractors. *The prime contractors* then represented falsely to federal, state and/or local contract-letting authorities that [the DBE] supplied materials that, in reality, [the Supplier] supplied. In this connection, [the Supplier's] conduct *enabled various prime*

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[138] As noted by the U.S. Supreme Court, the Circuit Courts are split on the implied certification theory. The Seventh Circuit has rejected this theory, reasoning that only express (or affirmative) falsehoods can render a claim "false or fraudulent" under the FCA. *United States v. Sanford-Brown, Ltd.*, 788 F. 3d 696, 711-712 (7th Cir. 2015). Other Circuit Courts have accepted the theory, but limit its application to cases where defendants fail to disclose violations of expressly designated conditions of payment. *See e.g.*, *Mikes. v. Strauss*, 274 F.3d 687 (2nd Cir. 2011). Yet others hold that conditions of payment need not be expressly designated as such to be a basis for False Claims Act liability. *See e.g.*, *United States v. Science Applications Int'l Corp.*, 626 F. 3d 1257, 1269 (CADC 2010) (SAIC). *Universal Health Servs. v. United States ex rel. Escobar*, 136 S. Ct. 1989, 1998-99, 195 L. Ed. 2d 348, 360-61 (U.S. 2016).

[139] A full copy of the opinion can be seen at https://www.law.cornell.edu/supct/pdf/15-7.pdf.

[140] [Emphasis Added] *Universal Health Servs. v. United States ex rel. Escobar,* 136 S. Ct. 1989, 195 L. Ed. 2d 348, 357 (U.S. 2016).

contractors to certify falsely that materials were supplied by [the DBE] when the parties–i.e., [the Supplier, the DBE], and the prime contractors—knew that was not the case, resulting in the submission to government entities of false or fraudulent claims for payment from federal funds." The invoices from the Supplier contained no representation or discussion of DBE regulations or whether the DBE had performed a CUF. These invoices presumably only described the materials furnished.

It is possible that *Universal Health Servs*. means that this conduct can no longer constitute a False Claims Act violation. However, life is never that simple in the legal business. The Supreme Court also stated in the *Universal Health Servs.* case that:

> We need not resolve whether all claims for payment implicitly represent that the billing party is legally entitled to payment. The claims in this case do more than merely demand payment. They fall squarely within the rule that half-truths—representations that state the truth only so far as it goes, while omitting critical qualifying information—can be actionable misrepresentations.

In other words, the claimant in *Universal Health Servs*. made *specific representations* AND *knowingly* failed to disclose noncompliance with a statutory, regulatory, or contractual requirement, *which rendered those representations misleading*. Therefore the U.S. Supreme Court did not have to decide whether ALL claims for payment implicitly represent that the billing party is legally entitled to payment.

The *Universal Health Servs.* case certainly implies that a construction material supplier that did not contract directly with a government entity[141] and did not certify or make any statement regarding compliance with DBE regulations cannot be liable for a False Claims Act violation. However, the door is still cracked open for this argument.

Cases since *Universal Health Servs*. discussed "materiality." In other words, not all implied certifications or even misrepresentations are "material" (important to the government). The court will often look to the reaction if the government is aware of the representations. If the government allowed the vendor to continue performance and paid the vendor, it indicates that the government did not consider the infraction material. Even the government's designation of compliance as a condition of payment alone is insufficient to establish materiality.[142] On the other hand compliance can be material, even if it is not made a condition of payment. The vendor's own actions in covering up the noncompliance can establish materiality.[143]

The statute of limitations on the federal False Claims Act is at least six (6) years.[144] Accordingly, it could be a long time before you learn the cost of behavior on projects today. Investigators are also free to broaden investigations into all projects in which you have participated in the last six years once an investigation begins.

Whistleblowers are also a concern, since they can file civil False Claim Act complaints.[145] The government then has the option to take over the case. In any event, the whistleblower can share in the eventual proceeds of the action.

Any private citizen[146] can file a False Claims Act lawsuit for the benefit of the government in order to recover damages for the false claims submitted. The lawsuit is initially under "seal," which means that only the government will know about it for a period of sixty (60) days.[147] The government has the right to review this lawsuit and the supporting evidence during this period of time and decide whether the government will "intervene" and take over

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[141] In its discussion of the history of the False Claims Act, the U.S. Supreme Court stated that ... Congress has repeatedly amended the Act, but its focus remains on those who present or directly induce the submission of false or fraudulent claims. *See* 31 U. S. C. §3729(a) (imposing civil liability on "any person who ... knowingly presents, or causes to be presented, a false or fraudulent claim for payment or approval"). A "claim" now includes direct requests to the Government for payment as well as reimbursement requests made to the recipients of federal funds under federal benefits programs. *See* §3729(b)(2)(A). The Act's scienter requirement defines "knowing" and "knowingly" to mean that a person has "actual knowledge of the information," "acts in deliberate ignorance of the truth or falsity of the information," or "acts in reckless disregard of the truth or falsity of the information." §3729(b)(1)(A). And the Act defines "material" to mean "having a natural tendency to influence, or be capable of influencing, the payment or receipt of money or property." §3729(b)(4). *Universal Health Servs. v. United States ex rel. Escobar*, 136 S. Ct. 1989, 1997, 195 L. Ed. 2d 348, 358 (U.S. 2016) [Emphasis added].

[142] *Abbott v. BP Exploration & Production, Inc.*, 851 F.3d 384, 387 (5th Cir. 2017); *Kelly v. Serco, Inc*., 846 F.3d 325 (9th Cir. 2017).

[143] *Badar v. Triple Canopy, Inc*., 857 F.3d 174, 178 (4th Cir. 2017); *See also Beauchamp v. Academi Training Center, Inc*., 220 F.Supp. 3d 676 (E.D.Va. 2016).

[144] 31 U.S.C.A. §3279, *et seq*. Virginia's False Claims Act is at Va. Code Anno. §8.01-216.1, *et seq*. (Michie 1950) and Maryland's False Claims Act became effective June 1, 2015. Maryland State Code Gen. Prov. §8-101 *et seq*.

[145] Often referred to as "*qui tam*" lawsuit provisions.

[146] Often referred to as a "relator" or "private attorney general."

[147] This sixty (60)-day period can, and usually is, extended.

prosecution. If the government does not take over the case, the private individual can continue litigation of the case. In either event, the defendant is then served with the lawsuit.

If the government takes over the case and recovers through a settlement or a trial, the whistleblower is entitled to 15 percent to 25 percent of the recovery, determined by the judge. If the government does not take over the case and it is pursued by the private citizen team, the whistleblower reward is between 25 and 30 percent of the recovery. Regardless, this can be a great deal of money, often with a limited initial effort by the whistleblower. Accordingly, any businesses engaging in risky CUF compliance behavior need to be concerned with competitors believing you are taking unfair advantage, disgruntled employees or simply lawyers trying to drum up some work while protecting DBE programs.

Most states have also adopted a False Claims Act that is usually very similar to the federal False Claims Act.[148]

Enforcement of CUF Regulations by Other Federal and State Government Agencies

There are still doubts about whether the CUF regulations could apply, and result in penalties, to a remote third tier subcontractor or supplier that did not contract directly with a government entity and did not certify anything to any government entity. There is no doubt, however, how federal prosecutors view conduct that is very common in the marketplace by suppliers, DBEs, subcontractors and general contractors. The use of pass through extra participants through which funds are passed in order to obtain the appearance of DBE participation will result in investigations and prosecutions for contractors and suppliers that knowingly participate.

Note that the DOT regulation is entitled: "Title 49: Transportation Part 26—Participation by Disadvantaged Business Enterprises in Department of Transportation Financial Assistance Programs, Subpart C—Goals, Good Faith Efforts, and Counting §26.55. How is DBE participation counted toward goals?"

The entire regulation speaks only to whether the participation counts towards DBE goals. On its face, it is difficult to see how this can result in a False Claims Act penalty to a remote non-DBE subcontractor or supplier. This was sufficient, however, to result in a False Claims Act investigation by the U.S. Attorney's office in the Southern District of New York of a non-DBE supplier that "knew" that the DBE was not performing a CUF. The supplier paid a $4,950,000 penalty rather than risk prosecution.

If this "worked" under the DOT and EPA regulations, it is impossible to say that it would not come to the same result under other state statutes or regulation. There is very little history of enforcement of CUF regulation by state prosecutors. In fact, there is very little history of enforcement of CUF regulation against remote subcontractors or suppliers by federal prosecutors outside of New York. The temptation may be difficult or impossible to resist for other federal and state prosecutors, however. The prosecution of white collar crime is a part of a prosecutor's job. CUF violations do thwart public policy objectives of DBE participation and the development of DBE small businesses.

Large regional and national material suppliers may be a particularly attractive target if they consistently decide to agree to pay large fines rather than risk the results of a prosecution. This may be an opportunity for prosecutors to do their job, protect the public and public policy at no taxpayer expense.

No federal agencies other than DOT and EPA have CUF regulations at this time. Only time will tell, but presumably this means there cannot be a False Claim Act violation for remote contractors and suppliers that knowingly participate in a transaction in which the DBE performs no CUF. It will always be possible, of course, for a remote contractor and supplier to participate in a fraud upon the government. A fraud would generally require a misrepresentation which is relied upon to the government's detriment. Accordingly, it is always important to speak the truth. Do not opine or state as fact matters that you do not know to be true regarding compliance with regulations, certification or anything else.

Where does this otherwise leave remote contractors and suppliers working on state procurement projects for agencies that do have a CUF requirement? It should make a difference how those CUF statutes or regulations are

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[148] 31 U.S.C.A. §3279, *et seq*. Virginia's False Claims Act is at Va. Code Anno. §8.01-216.1, *et seq*. (Michie 1950), and Maryland's False Claims Act which became effective June 1, 2015 is at Maryland State Code Gen. Prov. §8-101 *et seq.*, and the District of Columbia's False Claims Act is at DC Code Section 2-381.01, *et seq*.

The Commonwealth of Pennsylvania does not have a general False Claims Act, although it has been recently been debated in the legislature. It does have Penn Code 18 P.S. 4107.2(a)(4) which a "false claims" type of criminal statute. It states that "a person commits a felony of the third degree if, in the course of business, he ... fraudulently obtains public moneys reserved for or allocated or available to minority business enterprises or women's business enterprises. The City of Philadelphia does have a False Claims ordinance, codified at Philadelphia Code Ch. 19-3600. It reads similarly to the federal False Claims Act, except that it does allow criminal, as well as civil penalties.

worded. For example, the settlement agreement in the $4,950,000 penalty case recited repeatedly that the DBE Suppliers had not negotiated the price for the material (one of the four pillars in the DOT regulation) and had acted "merely as a pass through." These standards do not appear in all CUF statutes or regulations.

The Maryland CUF regulations are the most similar to the federal DOT regulations and the most likely to come to the same result as the DOT enforcement actions, if Maryland state prosecutors ever engage in enforcement actions on CUF regulations.

The Virginia regulation applicable to non-transportation projects seems to speak only to whether a DBE should be certified.[149] This again makes it clear that the DBE can lose certification and that a general contractor can be in breach of its contract with the government if any DBE is not performing a CUF. What does this mean for a remote supplier that did not contract directly with a government entity and did not certify anything to any government entity?

The D.C. Code seems to create a discretionary standard for the Department,[150] which has the authority, but not the duty to disregard DBE participation if the DBE serves no commercially useful function in the performance of a contract. The D.C. actual performance definition of CUF is from the DOT regulations and the four pillars from the DOT regulations are included. However, the operation of the statute seems to be discretionary. Even the government agency does not have to enforce it. Can this create compliance risk for a traditional material supplier? It is a little hard to see how it can, when the statute is discretionary and the penalty is stated in the statute as the disregard of participation by a DBE.

The Philadelphia Code and Executive Order have a well developed concept of a CUF standard, but it is not clear how or when this would apply to a non-DBE subcontractor or supplier. These provisions speak only to whether a bidder should prevail in a contract bid, whether that bidder or contractor is later complying with its contract terms with the City and whether any particular transaction within a contract should count towards DBE participation goals. It may be easy to conclude that this cannot impact a non-DBE subcontractor or supplier (as long as the CUF standard is not in a non-DBE supplier's contract). However, the same can be said of the federal DOT regulation.

The Philadelphia Executive Order states explicitly that for suppliers a DBE performs a commercially useful function when it is responsible for sourcing the material, negotiating price, determining quality and quantity, ordering the material and paying for it from its own funds. There are no special provisions for material supplier manufacturers or "regular dealers." Accordingly, the four pillars appear to be the rule, and the only rule, for DBE Suppliers in Philadelphia. This is a significant difference with the DOT regulations that may not allow for a DBE Supplier, other than manufacturers or "regular dealers." A non-DBE material supplier may be in complete compliance in Philadelphia as long as they ensure that their DBE Supplier customers are performing the four pillars.

The City of Philadelphia is ready to prosecute DBE fraud. These cases appear to have been civil only and not criminal.[151] They were also resolved by a settlement agreement. Arguably, they involved a more active fraud and did involve only general contractors and first tier subcontractors. However, it may still be possible to say that the use of DBE Supplier "paper pushers" or "brokers" that participate "in name only" for a 2% or 3% markup is also colluding to make it appear that the DBE Supplier had provided materials for a government-funded project when the DBE Supplier is really paid only for the use of its name and minority certification.

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[149] 7VAC10-21-220. Control. Va. Code Anno. §2.2-1403 (Michie 1950) Statutory Authority.

[150] DC Code §2-218.02(1G) (2015) & DC Code §2-218.13(e) (2015).

[151] A Philadelphia case was Prison Health Services, Inc. (PHS), which used a pass-through DBE to circumvent the City's DBE requirements. This investigation found that PHS contravened the City's policies by subcontracting with JHK Inc., d.b.a. American Safety & First Aid (JHK), a pass-through DBE that provided no commercially acceptable function (presumably the same as a commercially useful function). PHS also submitted paperwork that inflated JHK's role to represent compliance with the City's policies. JHK did not receive the 40% that PHS represented on the documentation provided to the City. Instead, JHK received a check each month from PHS for less than 1% of the contract price, simply for the use of its name on City contracting documents. This case was also resolved with a settlement agreement, that provided that PHS will pay $1.85 million to the City and will incorporate new internal policies to ensure that it complies with the City's Anti-Discrimination Policies on future contracts with the City.

Another relevant Philadelphia case involved William Betz Jr. Inc., a local Philadelphia heating and plumbing supply company. Betz, JHS and Sons Supply Company and UGI HVAC Inc. colluded to make it appear that JHS, a City-certified minority vendor, had provided equipment and supplies for a government-funded weatherization project when JHS was paid only for the use of its name and minority certification. Betz agreed to pay the City $128,000 and refrain from performing work for the City and bidding on City contracts for 24 months. On storefront signage and on key sales-related documents distributed to its customers, Betz must also disclose that it is prohibited from selling supplies to companies that plan to use those goods in work performed under contract with the City.

Avoiding CUF Investigations & Penalties

The remote traditional supplier $4,950,000 penalty case certainly generated much attention in the construction industry. Traditional suppliers are now very concerned with the best practices and procedures to avoid similar criminal investigations and penalties.

The simplest response is that the DBE Supplier must be involved in the project from the earliest communication between the traditional non-DBE supplier and their customer on a project with a CUF. Historically, it has been very common that the non-DBE supplier communicates with their customer about the project for months, trade quotes and purchase orders, transfer technical data and shop drawings. The DBE Supplier is injected into the contract tiers shortly before a project begins.

However, if this is a transportation project, EPA, Maryland State executive branch procurement[152] or another project with a CUF requirement, we now all understand that this non-DBE supplier cannot sell material to this DBE Supplier. The well is poisoned. The only way for the supplier and customer to avoid risk of fines is to sell the product directly to the non-DBE customer or refrain from selling the product at all. The only other possibility is for the non-DBE customer to get new bids from new DBE suppliers, who will then get pricing information from the non-DBE supplier.

If the non-DBE customer has already determined the material it wants to buy and has already negotiated the price, there is no way to "fix" this and no way that the DBE Supplier can perform a CUF within the meaning of these regulations. These were exactly the facts that resulted in the $4,950,000 fine paid.

Contractors must identify their DBE Suppliers at an earlier stage of the project. It is already common that contractors need to identify their DBEs at the contract bid stage. This just needs to be done earlier, so that the DBE Supplier is the entity negotiating price, determining quality and quantity and ordering the material from the traditional non-DBE supplier. We all understand that it can be difficult to identify competent DBEs to perform these functions. However, this problem is constant. Non-DBE suppliers and their customers have this problem whether the DBE Supplier becomes involved at the bid stage or the day before the project begins. There is no obvious prohibition against including all parties in all communications. What is critical is that the DBE is involved in all communications and is the entity actually negotiating price, determining quality and quantity, ordering the material and later paying for the material.

As discussed above, the four pillars or touchstones may not be a "safe harbor" for contractors, DBEs and traditional non-DBE suppliers. Even if the DBE is responsible for negotiating price, determining quality and quantity, ordering the material and paying for the material, it may still be possible to say that the DBE is an "extra participant in a transaction, contract or project, through which funds are passed in order to obtain the appearance of DBE participation." The vast majority of investigations have also resulted in settlement agreements with the U.S. Attorney's office. Accordingly, we do not have many "court decisions." We do not know how a court would have ruled on these facts.

Remember that CUF compliance requires a "transactional analysis." A DBE must perform a CUF in every transaction. Proper certification as a DBE does not mean that the DBE performance qualifies for DBE participation credit. Similarly, the fact that a DBE owns warehouses and trucks or has many employees may mean that the DBE is capable of performing a CUF. However, the proper analysis must look at the role the DBE played in this particular transaction.

Only time will tell whether it is possible to ever use DBE Suppliers under the DOT regulations that are not manufacturers or "regular dealers." It is possible that contractors will eventually have to use DBE subcontractors (rather than DBE Suppliers) to achieve their DBE participation goals. This may be the correct interpretation of at least the DOT regulations and this may be the eventual result of prosecutions and court case law. Since we do not have much case law, however, the eventual result is very difficult to predict. We must at least make sure DBEs are responsible for negotiating price, determining quality and quantity, ordering the material and paying for the material. A traditional supplier may only be "safe" if they are selling materials to a certified "regular dealer" or to a subcontractor that performed a portion of the contract with its own forces and that actually negotiated the price, determined the quality and quantity, ordered the material and paid for the material.

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[152] 49 CFR (Code of Federal Regulations) for DOT and 26.55 (c)(2) and 40 CFR 33.503 for EPA; Maryland State Fin. & Proc. §14-303 and COMAR 21.11.03.12-1; Maryland State Code Education §5-301(h) and COMAR 23.03.03.06(D); Maryland Minority Business Enterprise Program Manual (July 2014) at pages 6, 36 & 105-115 and COMAR 11.01.10.01.

It may behoove traditional suppliers and their customers to promote the development of DBE contractors and suppliers and enter into informal or formal mentor protégé arrangements. This may help solve the problem of identifying competent DBEs. This may also help achieve the public policy goals of competition and the development of viable contractors in the marketplace owned by traditionally disadvantaged groups. An objective of DBE participation goals in contracting is actual participation by the DBE, so that they obtain the experience necessary to become viable actors in the market.

Enforcement Conclusions

Many players in the construction industry have concluded that they will never deal with a DBE again, unless the DBE performs a commercially useful function within the DOT regulation definition. Many contractors and suppliers are unaware of or are simply ignoring CUF regulations. These are probably both bad policies. One is a conscious decision to cut your business off from profitable work. The second in some cases violates the law and leaves you vulnerable to significant penalties. It is possible to capture more work, without taking on more risk. However, this requires some education and training for employees.

Contractors and suppliers need sales staff and/or credit staff and/or management that can differentiate one project from another, determine whether CUF regulations apply to that project and evaluate options to perform work within those CUF regulations. As discussed in other chapters, we have always been strong advocates for evaluating projects before pricing or bidding.[153] Will you be a secured creditor in this project or unsecured. Is the job bonded? Will you have effective mechanic's lien rights at a reasonable cost? Your profit and your pricing is in part a function of your risk of default and risk of taking a complete loss. A very similar process, and probably the same employees, can be utilized to evaluate the CUF risk.

The first question is whether this is public work or private. If it is public work, there is a good chance that the job is bonded and you have little risk of noncollection. Find out if the job is bonded and get a copy of the bond. Also find out if there are DBE participation requirements on this project. If this is a private project, it may still be bonded and you probably have mechanic's lien rights. You want to know this. However, any DBE participation requirements on this project are probably only contractual in nature and not regulatory. You certainly need to know the terms of your contract, but otherwise you probably have little risk of CUF violations.

If this is public work with DBE participation requirements, who is the owner? What federal or state agency is doing this project? Does that agency have CUF regulations? Almost all federal and state public agency procurement has rules requiring DBE participation and certification as a DBE. However, few agencies have rules requiring quality control of that participation, with CUF or similar standards. We have discussed above all known CUF regulation for federal, Virginia, Maryland, Pennsylvania and District of Columbia projects. You need to be aware of any CUF rules for all state and local governments where you do business. If there are no such CUF rules, you may need to make sure that the DBE is certified to act as a DBE for this particular agency and for this particular labor and material. You will also always get in trouble for committing a direct fraud on the government. However, a contractor or supplier cannot get in trouble for violating CUF standards if there are no CUF standards.

If there are CUF rules, you could decide that your DBE partner must perform a commercially useful function within the DOT regulation definition. No matter what the federal or state agency, you are probably on safe ground complying with DOT CUF regulations. This will best insure that you and your company will not be the subject of an investigation or prosecution. It will also help achieve laudable public policy objectives.

A more aggressive approach would focus on whether there is any history of investigation or prosecution of CUF regulations by the public agency involved in your project. Federal DOT and EPA certainly have a history of CUF investigation or prosecution, at least in the Southern District of New York. It is a fairly safe bet that this will spread to other federal U.S. Attorney offices eventually, unless we get intervening case law from a high federal court. You should be familiar with and follow CUF standards as defined in the DOT regulations on federal DOT and EPA projects.

Most states, even if they have CUF rules, have no history of investigation or prosecution of CUF regulations. This makes a decision more difficult. We do not even have court case law establishing that the federal DOT investigations or prosecutions of CUF regulations have been well founded. There is still doubt about this. It is even harder to evaluate the risk when the state or local agency regulation is worded differently that the DOT regulations. On the other hand, if federal DOT investigations were well founded, then there is some risk of the same result under other

[153] *See* chapter, Credit Management.

state and local agency rules. The statute of limitations is at least six (6) years under most False Claims Act statutes. It will be at least six years from today before you know for a certainty whether your actions today will be a problem.

Accordingly, the decision is basically an evaluation of your level of corporate risk tolerance. You can evaluate whether there is a risk of "losing" a CUF violation case. You may want to see if any court or at least any agency has decided that the applicable CUF rules can result in violations for companies playing your role in the construction project. You can hope that your company will not be the first to face an investigation in your locality. It is a very different objective, however, to make sure that your company is never even the subject of an investigation, much less a prosecution or "losing" a CUF violation case. This requires a much more conservative approach. In this case, you should be familiar with any CUF or similar "quality of participation" rules applicable to each project. If there are rules, follow the CUF standards as defined in the DOT regulations on federal DOT and EPA projects.

PAYMENT PROTECTION FOR TRADITIONAL SUBS AND SUPPLIERS

Construction material suppliers are often asked to sell materials to a "DBE Supplier," who will then resell the materials to an "End User," who then has a subcontract with a general contractor. Sometimes the End User is the general contractor. End Users often do not want to allow a DBE to perform labor functions on the construction site. The labor is often the source of much subcontractor profit and they do not want to share these economics. Sometimes there are quality, coordination or scheduling concerns in having the DBE perform on-site labor functions. Contractors can get large DBE participation credits, because the material portion of subcontracts are usually in a large dollar amount. If the DBE Supplier has no actual project presence, the End Users do not need to fear default by the DBE Supplier, resulting in delays or defective work. In any event, End Users frequently wish to increase the amount of the DBE participation on a project by purchasing material from a DBE Supplier.

Traditional non-DBE material suppliers sometimes must pay some or all of the two or three percent markup that a broker DBE Supplier will get. Traditional non-DBE material suppliers should be even more concerned with the risk of default and risk of non-collection in such a transaction. By definition, DBE Suppliers are small, disadvantaged companies that are financially weak. They do not have large warehouse space, large trucking fleets or strong relationships with major manufacturers. Accordingly, DBE Suppliers will almost always need to buy the needed material from a more traditional local construction material supplier. The end result is that the DBE Supplier's involvement on the project is "in name only." The End User chooses the material to purchase, negotiates the price and then tells the material supplier that the sale must be structured through a qualified DBE Supplier. The DBE Supplier is only a "broker" or "paper pusher," that performs no real economic function.

In this scenario, taxpayers are paying 2% or 3% more for the construction materials in the project and do not achieve the public policy objective that disadvantaged groups gain actual experience in government contracting. Of course, this arrangement also does not meet SBA or Department of Transportation standards and definitions. Regardless, this is often the landscape that traditional construction material suppliers face. Their concern is primarily making sure they get paid for their materials. The End Users' objective is often to make sure the construction material suppliers take the risk of default or insolvency of the DBE Supplier.

The Negotiating Range

The challenge is to structure transactions to satisfy governmental owners and get "DBE participation points" for general contractors, while still leaving non-DBE subcontractors and 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-DBE 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 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.[154]

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.[155] 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 DBE participation 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 contractors 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 more remote 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 and usually provide no protection to a "supplier to a supplier." Mechanic's lien statutes often have a similar limitation, extending only to second or third tier subcontractor. 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 DBE participation, 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 material. This would satisfy the supplier's credit concerns, but it would also decrease the dollar amount of the DBE's contract and could decrease the DBE participation credit for the DBE 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. A direct sale to the general contractor 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. For all these reasons, a general contractor may not agree to a direct sale.

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. It appears that such a guaranty would not decrease the DBE participation 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. A general contractor guaranty should always be considered, but is not always possible.

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[154] An exception would be Pennsylvania. *See* chapter, Performance and Payment Bonds, section Pennsylvania.

[155] An exception would be Maryland. *See* chapter, Mechanic's Liens in Maryland, section Defense of Payment: Owner's Responsibility for Payment to Subcontractors.

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 some or all subcontractors to provide payment bonds. 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 Performance and 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 now 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 rider (endorsement or amendment) to the payment bond is the easiest way to fix this problem. Whoever provided the bond (bond principal) and the surety can agree to extend bond rights to a specific supplier on a project, sometimes without any additional premium. A supplier in any industry can also 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. As explained in the chapter on Performance and Payment Bonds, 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 also need to pay a premium to obtain the bond. However, a general contractor, its surety and a supplier would be free to draft a private (not legally required) 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.[156] 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. There are no mechanic's lien rights on most public procurement projects, so the use of mechanic's lien rights in DBE transactions will be limited. The possibilities of mechanic's lien rights will occur, however, especially with the increased use of public-private partnerships and other mechanisms. Some private owners also agree to require DBE participation and mechanic's lien rights may exist on those projects.

As explained in the chapters on Mechanic's Liens, 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 a 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.

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[156] *See* chapter, Performance & Payment Bonds, section on Private Bonds and section on Bond Forms.

As also explained in the chapters on Mechanic's Liens, 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 a 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.[157] 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

The insertion of a DBE into the contract hierarchy may eliminate a supplier's mechanic's lien or payment bond rights, because of "defense of payment" or remoteness issues. There may be a temptation to "solve" this problem by having the DBE "assign" its mechanic's lien or payment bond rights to the supplier.

The most obvious observation is that an assignment of the DBE's mechanic's lien or payment bond rights will not solve anything if the DBE is not owed any money on the project. If the DBE was paid or the DBE defaulted on its contract, then the DBE also has no mechanic's lien or payment bond rights. Any supplier with an assignment of lien or bond rights from the DBE 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 or payment bond rights could solve remoteness issues, by bringing the supplier one tier closer to the owner and general contractor. However, it is often questionable whether lien and bond rights can be assigned.

There are more potential assignment problems with mechanic's lien rights than with bond rights. In addition to problems when *the DBE* is not owed money, any supplier with an assignment of mechanic's lien rights has no enforceable rights on the project if *the DBE's customer* on the project has been paid in a "defense of payment" state. In other words, even if the DBE is owed money, the DBE will have no lien rights if upstream contractors have been paid in a "defense of payment" state.

In Virginia[158] and Maryland, 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 Pennsylvania,[159] because the question has never come up in a recorded case. 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.[160] However, some states prohibit the assignment of mechanic's lien rights on public policy grounds.

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[157] *See e.g.*, Maryland. *See* chapter, Mechanic's Liens in Maryland, section on Remote Suppliers and Subcontractors and section on Defense of Payment: Owner's Responsibility for Payment to Subcontractors.

[158] Va. Code Anno. §8.01-13 (Michie 1950); Va. Code Anno. §43-65 (Michie 1950) [Protection of assignees, transferees or endorsees of debts secured by mechanics' or crop liens. Whenever any debt secured on real estate or personal property by a mechanics' or crop lien has been assigned, transferred, or endorsed to another, in whole or in part by the original payee thereof, such payee, assignee, transferee, or endorsee may cause a memorandum or statement of the assignment to such assignee, transferee, or endorsee to be recorded, which memorandum or statement shall be signed by the assignor, transferrer, or endorser, or his duly authorized agent or attorney, and when so signed and the signature thereto attested by the clerk in whose office such encumbrance is recorded the same shall operate as a notice of such assignment and transfer. Such assignment, transfer, or endorsement shall reference the book and page where the original debt secured on real estate or personal property is recorded ...] This statute at least allows assignment of a recorded mechanic's lien.

[159] *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).

[160] *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."].

The state legislature has granted mechanic's lien rights to certain classes of labor and material suppliers.[161] The limitations of these rights cannot be circumvented by private contract. The mechanic's lien rights are "personal" to the claimant that supplied labor or material.[162]

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.[163] 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.[164] 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.[165] 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.[166]

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 on how the bond form is worded. Any owner and general contractor would be free to agree in the bond that rights would be nonassignable. They can also agree to add a defense of payment feature or add other limitations to the bond. This would further complicate the issue.

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. In the event of default, 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

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

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

[163] *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).

[164] *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]; *Iaege 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 materialman 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].

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

[166] *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).

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. It is just an agreement with the DBE that the creditor can file and control the DBE's lien or bond legal actions brought in the DBE's name. 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.

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 the federal DOT will deny minority participation points if the joint check agreement circumvents actual participation policies.

The Federal Highway Administration published "Guidance on the Use of Joint Checks under the DBE Program" in 2006, applicable to any federal aid transportation project.[167] This has now apparently been replaced with the Official Questions and Answers (Q&A's) Disadvantaged Business Enterprise Program Regulation (49 CFR 26) dated April 15, 2016.[168] The 2006 "Guidance" was removed from the DOT website in 2015. However, the new Official Questions and Answers make it clear that this policy has changed very little and is still in effect.[169]

Joint checks are not prohibited,[170] but are subject to conditions and are a "red flag" calling for further scrutiny. A written joint check agreement is required among the parties, including the non-DBE suppliers, providing full and prompt disclosure of the expected use of joint checks. The agreement should contain all information concerning the parties' obligations and consequences or remedies if the agreement is not fulfilled or a breach occurs. 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;[171] the state transportation agency must approve the practice before it is used; and the state agency must monitor the practice to avoid abuse.[172]

The concern is the "4 Pillars" in the DOT regulations.[173] By "paying for the material itself," the regulation means that the DBE's own funds are used to pay for the material. It is not appropriate for the funds to come from the general contractor. However, the Official Answers also state that accounts receivable to the DBE from the general contractor for the costs of materials purchased by the DBE from the non-DBE supplier may be regarded as "the DBE's own funds." If a DBE can show that it has been in control of the funds provided in the joint check and has determined when the non-DBE supplier has fulfilled its responsibilities under the contract, then the DBE is paying the non-DBE supplier with its own funds.[174]

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[167] *See* Federal Highway Administration Guidance on Use of Joint Checks under the DBE Program, dated August 30, 2006.

[168] DOT Official Questions and Answers 49 CFR Part 26. April 15, 2016, pp. 46-50 at https://www.transportation.gov/sites/dot.gov/files/docs/Official%20Questions%20and%20Answers%204-15-16.pdf.

[169] However, *see* the MD MBE Federal DBE Program Manual 6-2012 revised 3-2015 at pp.68-72, which explicitly endorses the USDOT Guidance on the Use of Joint Checks dated August 30, 2006 and goes as far as to say that Joint Checks are "prohibited." Accordingly, this Guidance is still applicable for Maryland DOT projects.
http://www.mdot.maryland.gov/Office%20of%20Minority%20Business%20Enterprise/Resources_Information/03.2015%20MD%20MBE%20Federal%20DBE%20Program%20Manual%206-2012%20revised%203-2015.pdf.

[170] DOT Official Questions and Answers 49 CFR Part 26. April 15, 2016, pp. 46-47 states that the "text of the DBE rule does not mention the use of joint checks. Consequently, the rule does not prohibit prime contractors and subcontractors from using joint checks" and "[h]istorically, what has led to problems is not so much the use of joint checks in itself, but concealment or a lack of honesty concerning their use."

[171] If joint checks are available to a DBE subcontractor, they should be made available to all subcontractors (DBEs and non-DBEs). DOT Official Questions and Answers 49 CFR Part 26. April 15, 2016, p. 49.

[172] *See e.g.* Maryland Minority Business Enterprise Program Manual (June 2012, revised March 2015) at page 71 of 97. With respect to the use of joint checks by the prime contractor, MDOT follows USDOT Guidance on Use of Joint Checks Under the DBE Program dated August 30, 2006. Double-payee checks are prohibited except for purchase of supplies and materials. Two-part checks are allowable only in the following situation:

a. The other party acts solely as a guarantor,
b. The funds do not come from the other party,
c. It is a commonly recognized way of doing business, and
d. Must be approved in advance by the Administration's DBE Compliance Officer.

[173] To receive DBE credit for performing a commercially useful function with respect to obtaining materials and supplies, a DBE "must also be responsible for negotiating price, determining quality and quantity, ordering the material, and installing (where applicable) and paying for the material itself." DOT Official Questions and Answers 49 CFR Part 26. April 15, 2016, p. 47 and 49 CFR 26.55(c)(1)).

[174] The state DOT should review this documentation before deciding whether to give DBE credit for the material. DOT Official Questions and Answers 49 CFR Part 26. April 15, 2016, pp. 47-48.

The DBE must retain final decision-making responsibility concerning the purchase of materials, even when joint checks are involved. The relationship between the DBE and its non-DBE suppliers should be established independently of and without interference by the general contractor.[175]

The conclusions we can draw is that these rules do not prohibit the use of joint checks, they only created administrative hurdles. It is necessary to get agency preapproval for the use of a joint check agreement and this is often cumbersome for general contractors and suppliers. The general contractor must release the joint check to the DBE and the DBE must then deliver it to the non-DBE supplier.

We can also conclude that a payment guaranty from a general contractor has no impact on DBE participation credit. It is a preferred mechanism, at least for federal highway projects. A "pass through" DBE broker should never get DBE participation credit. We also learn that many players in the industry "use the rules" for their own purposes. Suppliers are often told "joint check agreements are not allowed under the DBE rules," when they really mean "we do not want to do that." It is important to learn the skill of asking "what rule requires that?" The person you are speaking with will often not be able to show you such a rule.

As explained in the chapter on Contract Terms and Preserving Rights, section on Joint Check Agreements, there are also risks to a creditor in any joint check agreement. Most importantly, it may not help if a check is never written. If the DBE defaults on its contract and the general contractor does not owe any payment, the supplier may 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. A joint check agreement is just a type of contract and it all depends on how that contract is worded.

As is also discussed in the chapter on Contract Terms and Preserving Rights, 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. Both parties would also want to make sure that the joint check agreement had explicit trust agreement provisions.[176] The general contractor wants to avoid the risk of double payment and the supplier wants to make sure it is not a general unsecured creditor.

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 may modify the general contract to say that payment will be made jointly to the general contractor and the supplier.[177] 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.[178] A supplier may be able to make a similar arrangement, however, with the Assignment of Claims Act.

The bottom line for DBE participation compliance is that there may not be any rules restricting the use of joint check agreements with most government agencies. There are rules for only DOT projects, but those rules do not prohibit the use of joint checks, they only create administrative hurdles.

Trust or Escrow Arrangement

It is possible to create an escrow or trust payment agreement for the benefit of the general contractor, the DBE and the supplier. This arrangement has been approved or even proposed in the past by some federal government procuring agencies without impacting minority participation points to the general contractor. Any government owner, private owner or general contractor could agree to this arrangement. 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.

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[175] DOT Official Questions and Answers 49 CFR Part 26. April 15, 2016, p. 49.

[176] *M&T Elec. Contrs., Inc. v. Capital Lighting & Supply, Inc. (In re M&T Elec. Contrs., Inc.)*, 267 B.R. 434, 480 (Bankr. D.D.C. 2001).

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

[178] *Winter v. Floorpro, Inc*., 570 F.2d 1367 (Fed. Cir. 2008); *D & H Distributing Co. v. United States*, 102 F.3d 542 (Fed. Cir. 1996).

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.

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. As explained in the chapter on Trust Funds Laws and Agreements, 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 not work if the DBE is a general contractor, with a contract directly with the government. The government will not normally sign an escrow or trust agreement. It is possible that the government may 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.

Bank signature cards and resolutions do not provide protection. Most obviously, the bank is not even signing it. The resolution contains no agreement by the bank to do anything. It tells the bank who is authorized to deal with the account. This is a safe haven for the bank. They know that if they are dealing with one of the listed persons, they are safe. There is a difference between saying "Client is authorized" and saying "ONLY Client is authorized," or "the bank agrees that they will only let Client have access to this account," which most resolutions do not say.

It is possible to have a Bank Agreement signed by the Bank that contains some commitment about the procedure for payments into the account, when the bank will disburse and who is authorized to approve disbursement. This is a variation of the Escrow Agreement idea. The bank will certainly charge higher fees for the administrative cost and potential liability to the bank. An escrow account with this law firm may be less expensive.

A cheaper alternative may be an account with a check debit freeze, so that checks cannot be written. The account would receive and distribute funds via Automatic Clearing House, with the supplier having two signatures and the DBE having one signature. The account requires dual approval to distribute funds (one person initiate and one person approve via online password through the bank's website). This option will also usually cost about the same as a bank agreement or Escrow Agreement. A disadvantage is that the bank is not signing anything and it contains no agreement by the bank to do anything. You may have no recourse against the bank. There is still a risk that the DBE will be able to withdraw funds in some manner, assuming that the account is in the name of the DBE.

There is also some question whether any of these trust or escrow arrangements might violate the DOT commercially useful function requirement that the DBE must "pay" for the material.[179] This is one of the four pillars cited by the federal DOT in their Guidance on joint check agreements.

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.[180] 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,[181] 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

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[179] 49 CFR 26.55 (c)(1).

[180] 31 U.S.C. §3727 and 41 U.S.C. §15.

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

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.[182] 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.[183] Some courts have held that any bank assignee must show that it loaned money for the performance of the government contract.[184]

However, the government can accept an assignment, even if the assignment was legally invalid under the Assignment of Claims Act.[185] This would be similar to the government agreeing to a joint check or other arrangement. The government could 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.[186] 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

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.

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

[183] *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. *See Holmes Envtl. v. Suntrust Banks (In re Holmes Envtl., Inc.)*, 287 B.R. 363 (Bankr. E.D. Va. 2002).

[184] *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).

[185] *Delmarva Power & Light Co. v. United States*, 542 F.3d 889, 893 (Fed. Cir. 2008); *Tuftco Corp. v. United States*, 222 Ct. Cl. 277 (Ct. Cl. 1980); *United States v. Russell Elec. Co*., 250 F. Supp. 2 (S.D.N.Y. 1965).

[186] *Kawa v. United States*, 77 Fed.Cl. 294 (2007).

CONCLUSIONS

Conclusions for General Contractors, Subcontractors and Other End Users

Dealing with Disadvantaged Business Enterprises is an opportunity to obtain more contracts 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.

DBE Contractors and general contractors or other end users are currently at risk of civil or criminal penalties for circumventing DBE rules, especially on Department of Transportation projects.[187] We can expect to see increased enforcement of DOT commercially useful function regulations. We can also expect to see more jurisdictions and agencies adopt commercially useful function regulations.[188] It is a bad idea to control or operate an entity that will appear to be a DBE when it is not, or to help a DBE appear to perform a commercially useful function when it does not. The future will bring more jail time, penalties or debarments for such activities. It is a far better strategy to help legitimate DBE contractors gain the experience and financial strength necessary to become strong subcontracting partners.

You must know your regulatory regime. Each federal, state and local government agency has a different regulatory system for DBE participation. Whatever the "rules" were on the last project may have no relevance for the rules on the next project. You must determine the rules before you bid on any project, in order to submit a responsive bid.

You must also determine whether there is a commercially useful function (CUF) or similar rule for this agency. It is possible to decide as a matter of corporate policy that you will not deal with any DBE unless they are performing a CUF. This will certainly reduce your risk of any CUF investigation and reduce the need for other management on this issue. It will also promote the public policy goals of promoting the development of experienced and financially strong DBE partners. These may be sufficient moral grounds for the decision. However, it may be more profitable to ignore the CUF issue on projects that have no CUF rules.

Those CUF rules are now limited to the Department of Transportation (DOT) and Environmental Protection Agency (EPA) in the federal arena. State and local government rules vary widely across the nation. In the Mid-Atlantic states, the CUF concerns may be limited to Maryland and the City of Philadelphia. Virginia and the District of Columbia may be a concern. It all depends on whether those rules could be interpreted as presenting potential False Claims Act liability for general and subcontractors and whether these jurisdictions will ever prosecute CUF violations. The complete lack of case law history makes this a very difficult prediction.

You should confirm that your DBE partner has the proper certification for this project. Generally, each state, federal and local government agency has its own certification procedure. However, you may be able to confirm that your owner agency will "adopt" or accept certifications from other agencies, particularly from the federal Small Business Administration (SBA) and your state Department of Transportation. In addition to certification generally, you must confirm that your DBE partner is certified for the particular type of construction labor or material they will supply. Certification is usually for particular NAICS codes.[189] A firm may be certified in a NAICS code related to performing supplier functions.[190]

Remember that determining whether a CUF has been or will be performed requires a "transactional analysis." A DBE must perform a CUF in every transaction. Proper certification does not mean that the DBE performance qualifies for DBE participation credit. Similarly, the fact that a DBE owns warehouses and trucks or has many employees may mean that the DBE is capable of performing a CUF. You must make sure that your DBE partner is performing a CUF in this particular transaction.

If your project has a CUF, it may make a difference how those CUF rules are worded. If your contract is with the DOT or one of the jurisdictions that has adopted similar rules, you must at least make sure that your DBE partner is performing the four pillars. The DBE Supplier or subcontractor must be involved in the project from the earliest communications between you, any non-DBE subcontractors and any non-DBE supplier. The DBE must actually

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[187] *See* summaries of DOT enforcement actions for DBE fraud at https://www.oig.dot.gov/oversight-areas/contract-grant-fraud.

[188] *See e.g.*, DC Code Section 2-218.02 & DC Code Section 2-218.13.

[189] 49 CFR 26.71(n); DOT Official Questions and Answers 49 CFR Part 26. April 15, 2016, pp. 25-28 and 44-46 at https://www.transportation.gov/sites/dot.gov/files/docs/Official%20Questions%20and%20Answers%204-15-16.pdf.

[190] DOT Official Questions and Answers 49 CFR Part 26. April 15, 2016, p. 50 at https://www.transportation.gov/sites/dot.gov/files/docs/Official%20Questions%20and%20Answers%204-15-16.pdf.

perform, manage and supervise the work. With respect to materials, the DBE must negotiate the price, determine the quality and quantity, order the material and pay for the material.

Complying with the four pillars or touchstones may not be a "safe harbor," however. Only time will tell whether it is possible to ever use DBE Suppliers that are not manufacturers or "regular dealers." It is possible that contractors will eventually have to use DBE subcontractors to achieve their DBE participation goals. A general contractor or other End User may only be "safe" if materials counting towards DBE participation goals are purchased from a DBE manufacturer, from a certified "regular dealer," or by a subcontractor that performed a portion of the contract with its own forces and that actually negotiated the price, determined the quality and quantity, ordered the material and paid for the material.

Once you know your regulatory regime, you can also usually find published statements of policy and the "red flags" that the regulatory agency is looking for to initiate investigations. Make sure none, or as few as possible, of these red flags will exist in your contemplated project. Once you know your regulatory regime, policy and red flags, make sure that your documentation for this project match and that your staff understand all three. Above all, do not rewrite history. It is all too frequent that the general contractor, a subcontractor or a supplier realize after months of performance that the invoices or other documentation do not reflect the CUF rules that should have been followed. It is a particularly bad idea to "reinvoice" months of deliveries. This looks like fraud and is a huge red flag. Whether or not there are CUF rules on a project and whether or not you are at risk of a CUF violation, it is still possible to participate in a fraud upon the government.

General Contractors and suppliers have a joint interest in developing relationships with good DBE subcontractors and helping them develop good practices. Tension with non-DBE suppliers over security or other assurance of payments is not entirely avoidable. However, these risks can be managed as you should already manage bonded projects. A willingness to take some increased risk and employ administrative controls to avoid that risk will increase competition between suppliers and result in better pricing for general contractors.

Active policing of subcontractors and suppliers is necessary on all projects, whether or not they involve DBE participation. Careful monitoring of lien and bond waivers is the most obvious example. Require all subcontractors and suppliers to provide and update lists of their lower tier suppliers. Your subcontracts should prohibit the use of unauthorized subcontractors and suppliers. Do not pay your subcontractors if they cannot provide waivers from those lower tier suppliers for previous payments. There is nothing wrong with communicating with subcontractors' lower tier suppliers regarding the status of payment and compliance with subcontract payment provisions.

Many payment procedures discussed above present no additional risk to general contractors or other end users. They only reduce the chance of malfeasance by a DBE contractor. Escrow, trust, joint check and similar arrangements add additional administrative costs, but most of these arrangements are as beneficial to a general contractor as they are to a supplier in avoiding risk. A good payment procedure simply avoids problems neither of you need. A general contractor wants a non-DBE supplier to have the right to step in and perform if the DBE defaults. This may result in a loss of DBE participation, but will get the project done. Once you have agreed to some type of payment procedure, you must make sure your personnel follow the procedure. Again, this is simply good contract administration to avoid problems.

Conclusions for Material Suppliers

Dealing with Disadvantaged Business Enterprises is 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.

The first step is to know your regulatory regime. Each federal, state and local government agency has a different regulatory system for DBE participation. Whatever the "rules" were on the last project may have no relevance for the rules on the next project. This makes an even bigger difference to general contractors that are trying to submit responsive bids to each government agency.

Material suppliers' concern is generally more limited to whether there is a commercially useful function (CUF) or similar rule for this agency. It is possible to decide as a matter of corporate policy that you will not deal with any DBE unless they are performing a CUF. This will certainly reduce your risk of any CUF investigation and reduce the need for other management on this issue. It will also promote the public policy goals of promoting the development of experienced and financially strong DBE partners. These may be sufficient moral grounds for the decision. However, it will put your company at a competition disadvantage, at least to some extent. Some of your competitors will

certainly take a more aggressive approach and will have both more business and more risk as a result. Perhaps more importantly, you will be turning away business on projects that have no CUF risk, because there are no CUF rules.

Otherwise, someone in your risk management department has to be able to distinguish between a DOT project and a private subdivision infrastructure project. It is already the best practice to qualify each project, in addition to qualifying each customer. As discussed in the chapters on mechanic's liens, bonds and trust funds, a supplier that has the benefit of these types of security rights have lower costs on a project, because of the lower risk of taking a loss. You can be more aggressive in pricing or providing favorable terms if you have a lower chance of loss. Someone in your organization should focus on this payment security position before making pricing decisions. Most public new construction projects will have payment bond rights, for example. If you already have a risk manager focusing on the project owner and security rights, that risk manager should also focus on whether this owner is a public agency with CUF rules.

Those CUF rules are now limited to the Department of Transportation (DOT) and Environmental Protection Agency (EPA) in the federal arena. State and local government rules vary widely across the nation. In the Mid-Atlantic states, the CUF concerns may be limited to Maryland and the City of Philadelphia. Virginia and the District of Columbia may be a concern. It all depends on whether those rules could be interpreted as presenting potential False Claims Act liability for remote suppliers that have no contract with the government and whether these jurisdictions will ever prosecute CUF violations. The complete lack of case law history makes this a very difficult prediction. However, there is some risk. It basically comes down to whether you want to maximize your market share and protect against competition or you want to make sure it is never possible you will be the subject of an investigation, whether or not a prosecution could succeed.

Once you know your regulatory regime, you can also usually easily find on the Internet published statements of policy and the "red flags" that agency is looking for to initiate investigations. Determine whether any of these red flags exist in your contemplated project.

You should confirm that your DBE partner has the proper certification for this project. Generally, each state, federal and local government agency has its own certification procedure. However, you may be able to confirm that your owner agency will "adopt" or accept certifications from other agencies, particularly from the federal Small Business Administration (SBA) and your state Department of Transportation.

In addition to certification generally, you must confirm that your DBE partner is certified for the particular type of construction labor or material they will supply. Certification is usually for particular NAIC or division codes.[191]

Remember that determining whether a CUF has been or will be performed requires a "transactional analysis." A DBE must perform a CUF in every transaction. Proper certification does not mean that the DBE performance qualifies for DBE participation credit. Similarly, the fact that a DBE owns warehouses and trucks or has many employees may mean that the DBE is capable of performing a CUF. You must make sure that your DBE partner is performing a CUF in this particular transaction.

If your project has a CUF, it may make a difference how those CUF rules are worded. If you are dealing with the DOT rules or one of the jurisdictions that has adopted similar rules, you must at least make sure that your DBE partner is performing the four pillars. The DBE Supplier or subcontractor must be involved in the project from the earliest communications between the traditional supplier and the End User. The DBE must at least actually negotiate the price, determine the quality and quantity, order the material and pay for the material.

Complying with the four pillars or touchstones may not be a "safe harbor," however. Only time will tell whether it is possible to ever use DBE Suppliers under the regulations that are not manufacturers or "regular dealers." It is possible that contractors will eventually have to use DBE subcontractors to achieve their DBE participation goals. A traditional supplier may only be "safe" if you are selling to a subcontractor with an on-site presence that actually negotiated the price, determined the quality and quantity, ordered the material and paid for the material or you are selling to a certified "regular dealer."

Once you know your regulatory regime, policy and red flags, make sure that your documentation for this project match and that your sales staff understand all three. Above all, do not rewrite history. It is all too frequent that the general contractor, a subcontractor or a supplier realize after months of performance that the invoices or other documentation do not reflect the CUF rules that should have been followed. Particularly if you are a supplier that has not been told that there were DBE participation rules on this project and you are now being told to "reinvoice"

[191] 49 CFR 26.71(n); DOT Official Questions and Answers 49 CFR Part 26. April 15, 2016, pp. 25-28 and 44-46 at https://www.transportation.gov/sites/dot.gov/files/docs/Official%20Questions%20and%20Answers%204-15-16.pdf.

months of deliveries, this looks like fraud and is a huge red flag. Whether or not there are CUF rules on a project and whether or not you are at risk of a CUF violation, it is still possible to participate in a fraud upon the government.

Payment Security Conclusions for Material Suppliers

Contract Rights

A construction material supplier needs two things in a transaction with a financially weak DBE customer:

1. *Third Party Recourse.* Somebody other than the DBE must be liable to you for your materials, by using one of the mechanisms described above. You often get third party recourse through a payment bond (recourse against the End User and surety), through a guarantee from the End User, or sometimes though a joint check agreement or other agreement (depending on how it is worded).
2. *Payment Procedure.* A mechanism or procedure to make sure that the money gets where it is supposed to go. You get that through an escrow agreement with this firm, a collection and disbursement agreement with a bank, or sometimes though a joint check or other agreement (depending on how it is worded).

You need the Third Party Recourse, just to make sure that the End User carefully follows the Payment Procedure to make sure that the money gets where it is supposed to go. If the End User uses the agreed Payment Procedure, they will never have liability.

If you have an agreement only with the DBE and no enforceable agreement with the End User, End User and DBE are free to make whatever agreement they want later. You will ship. You will then hope the general contractor or End User issues a joint check and you get the check. You need to be able to say the End User is in breach of contract with you if they do not follow the agreed Payment Procedure.

If you have no bond rights and no lien rights, you are an entirely unsecured creditor. If the general contractor or End User or DBE do not follow the agreed Payment Procedure, your only recourse is against DBE.

Security Rights

In most of your construction industry transactions, you are used to having security rights in the form of mechanic's lien or bond rights. The general contractor and End User want to change the contractual relationships in order to get DBE participation credit, but the insertion of the DBE has eliminated your security rights by making you too far removed. A "supplier to a supplier" will not normally have bond rights.

1. You must get the general contractor and/or End User to help put things back the way they were before they decided to insert the DBE in the transaction. If the general contractor has decided to take this job, with DBE participation rules, they decided to be working on a project that would have payment security issues for material vendors.
2. A rider (endorsement or amendment) to the payment bond would fix this. Whoever provided the bond and the surety can agree to extend bond rights to you on this project.
3. A guarantee from the End User would only put you in the same position as if you had a contract directly with them (without the DBE) and in the same position as if you had rights on the payment bond (except that you would still not have rights against the surety).
4. An assignment of lien and bond rights from the DBE may help fix this, but you would not have lien rights if the DBE has been paid (the End User did not follow the Payment Procedure). Again you need third party recourse.
5. An assignment of lien and bond rights from the End User may help fix this, but you would not have lien rights if the End User has been paid. You may still need third party recourse.

Contract with DBE

You certainly want a contract with the DBE. You want to make sure the DBE has an obligation to perform. There are cases in which the DBE just stops performing, stops invoicing the general contractor and stops processing change orders. Sometimes this is the result of incompetence or insolvency and sometimes it is because the DBE

wants leverage to get an increase in DBE compensation. It is important to have affirmative obligations in the DBE to perform their limited functions and your right to step in to do it for them if they fail.

In the event of default of performance by the DBE, you want an assignment of the DBE's contract with the End User so that you can step in and perform. This benefits the End User and general contractor by making sure the project is completed in a timely manner. You also want an assignment of the DBE's lien and bond rights in the event of their default. You should get the DBE to agree to the Payment Procedure, by joint check agreement, escrow agreement, or banking agreement.

Contract with End User

You want some type of Agreement with the general contractor or other End User that they commit to use the Payment Procedure. This can be done in the form of a joint check agreement or a payment agreement or a change to the payment terms of the DBE's contract with the End User (but then you must also be identified as a third party beneficiary of that contract).

You should get a guarantee of payment from the End User, if possible. You are only asking to have the same rights as if you were selling to the End User without the intervention of the DBE. If you have a standing credit agreement with the End User, they might agree that credit agreement applies to these sales to the DBE. You also want an assignment of the End User's lien and bond Rights in the event of their default.