



Prosecutors root out fraud in disadvantaged business enterprise construction contracting | by Stephen M. Phillips

Federal and state prosecutors have been increasing efforts throughout the U.S. to prosecute fraud in minority business enterprise programs, particularly in the construction industry. Large, well-established general contractors and specialty subcontractors have been the targets of investigations resulting in numerous substantial settlement payments and criminal penalties in some cases. U.S. attorneys are on the lookout for fraud in disadvantaged business enterprise (DBE) programs.

In November 2014, a New York grand jury completed an investigation concluding there was widespread fraud and abuse in construction contracting for minority- and women-owned business enterprises in New York City.

The grand jury found there was evidence of “systemic criminal conduct” by several individuals and corporations in the construction industry. The minority- and women-owned businesses were not performing the work or providing the materials required under their contracts and did not have the capacity to do so. Invoices and billing documents were created to make it appear the companies did the work when, in fact, money merely passed through a minority- or women-owned business to another firm not owned by a minority or woman.

The New York grand jury’s findings are similar to the conclusions of other audits and investigations conducted by federal and local officials of similar programs. There is a widely held view fraud and abuse in minority- and women-owned business programs is widespread, pervasive and has gone on for many years.

DBE PROGRAMS

The federal government, most states and many local governments have adopted DBE, minority business enterprise, women-owned business enterprise, and minority- and women-owned enterprise programs. Although the names, acronyms and specific regulations governing these programs may vary, their objectives, structure and operations are similar. For purposes of this article, the DBE designation refers generically to these types of programs.

Started in the 1980s, DBE programs were intended to increase the participation of minority- and women-owned businesses in industries in which they have been historically underrepresented and remedy past discrimination by providing business opportunities to them. The goal is to allow businesses owned and controlled by socially and economically disadvantaged individuals to grow and prosper through their participation in government-funded contracts.

The U.S. Department of Transportation (DOT) established its DBE program in 1980. The DOT DBE program has been widely followed by other agencies. Pursuant to a statutory provision in effect since 1983, at least 10 percent of federal funds authorized for highway and transit financial assistance programs are to be awarded to DBE contractors. The DOT DBE regulations apply to state and local government agencies that receive federal funds. DOT grant recipients are required to establish a DBE program that sets established percentage goals for projects receiving DOT funding. General contractors working on DOT-funded projects must make good faith efforts to meet DBE goals.

Although the qualification criteria typically are established in federal regulations, actual certification of a company as a DBE is done at the local or regional level. To become a certified DBE, a business must meet the following criteria:

- At least 51 percent of the business must be owned and controlled by a socially and economically disadvantaged individual or individuals.
- The socially and economically disadvantaged owner must control the company's daily management and operations.
- The company must be an independent business whose viability does not depend on its relationship with other firms.
- The company must employ its own workforce and equipment necessary to perform its work.
- The company must be able to meet its financial obligations.

Businesses owned and controlled by minorities are presumed to meet the socially and economically disadvantaged criterion. Minority group members are defined as U.S. citizens who are Asian, black, Hispanic, Native American; Asian-Indians whose origins are from India, Pakistan and Bangladesh; and Asian-Pacific citizens whose origins are from Japan, China, Indonesia, Malaysia, Taiwan, Korea, Vietnam, Laos, Cambodia, the Philippines, Thailand, Samoa and Guam.

Once certified as a DBE and retained for a construction project, the DBE must perform a "commercially useful function." Otherwise, the DBE and contractors who may have retained or contracted with the DBE may find themselves subject to prosecution for fraud.

Per DOT regulations, which are followed by many agencies, a DBE construction contractor performs a commercially useful function "when it is responsible for execution of the work of the contract and is carrying out its responsibilities by actually performing, managing, and supervising the work involved."

With regard to materials, the DBE must be responsible "for negotiating price, determining quality and quantity, ordering the material, and installing (where applicable) and paying for the material itself."

The regulations state explicitly that 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." The DBE must have the labor, equipment, financial resources and expertise to perform the work. The DBE is to perform work with its own workforce and have an active role in negotiating price and ordering materials.

FRAUDULENT WAYS

The most common instance of DBE fraud is using a certified DBE as a pass-through. The DBE is retained as a subcontractor so the project appears to satisfy DBE goals. However, the DBE does not actually perform work or services but acts as a front for which it receives a fee, typically a small percentage of the subcontract amount. In this scenario, invoicing may be done through a DBE to give the appearance the DBE performed the work and was being paid even if the work and most of the money actually went to a non-DBE. Another example of DBE fraud is a contractor claiming to use a DBE to perform work or provide materials when the contractor actually used a firm that was not owned by minorities or women.

U.S. attorneys bring claims for alleged DBE fraud under the federal False Claims Act. However, a suit against a contractor or business for DBE fraud also can be initiated by a private citizen, including employees and former employees, under the False Claims Act's whistleblower provision.

After a False Claims Act suit is filed by a private citizen, it may be sealed pending a review and decision by the Department of Justice (DOJ), which may decide to intervene and assume responsibility for the claim's prosecution. The

individual who initiated the suit is entitled to recover 15 to 30 percent of the government's funds in addition to reimbursement of attorneys' fees. The whistleblower provision provides individuals who have knowledge of DBE fraud with a strong financial incentive to file suit.

Contractors who commit DBE fraud are subject to potential civil and criminal penalties, prison terms, debarment, restitution and forfeiture. In one case, the



Third Circuit U.S. Court of Appeals upheld a U.S. district court ruling that the loss amount for purposes of sentencing the president of a fraudulent DBE firm was the entire amount of the DBE contract regardless of the actual costs that were incurred to perform the work. The loss amount is a factor that may be considered when determining criminal sentencing under federal sentencing guidelines.

NEW YORK

New York state and New York City have established programs intended to provide business opportunities to minority- and women-owned businesses. The state's goal has been to award 30 percent of work on applicable contracts to DBEs, and the city's goal is to have 37 percent of city construction work performed by DBEs. In its November 2014 report, the New York grand jury found fraud was rampant in the DBE contracting process, especially in the construction industry.

The U.S. attorney for the Southern District of New York and New York's district attorney have cracked down on DBE fraud in the construction industry in New York during the past five years.

In March 2011, Skanska USA Civil Northeast Inc., Whitestone, N.Y., a unit of global giant Swedish contractor Skanska AB, agreed to pay \$19.6 million to settle a federal investigation pertaining to DBE fraud in connection with numerous New York public construction projects where Skanska USA Civil Northeast retained a fraudulent DBE subcontractor.

On numerous public construction projects, including several Metropolitan Transit Authority (MTA) projects, the new World Trade Center transportation hub and a terminal project at John F. Kennedy International Airport, where Skanska USA Civil Northeast was the general contractor, the company subcontracted during a period extending 15 years with Environmental Energy Associates LLC (EEA), Ridgefield, N.J. EEA was a certified DBE but did not have the labor, equipment and finances to do the work.

According to charges brought against EEA, Skanska USA Civil Northeast effectively self-performed the work that had been subcontracted to EEA. Skanska USA Civil Northeast employees allegedly were placed on EEA

certified payrolls, helping create the appearance EEA had done commercially useful work.

EEA's owners were indicted and plead guilty in connection with one \$5.2 million MTA project. In return for the \$19.6 settlement, Skanska USA Civil Northeast reached an agreement with the U.S. attorney that the company would not be prosecuted for credits it claimed for use of minority, women and disadvantaged businesses since January 1997. Of the \$19.6 million, half went to DOT and half to MTA, representing money Skanska USA Civil Northeast had paid EEA as a subcontractor on various New York public construction projects.

In another case brought by the U.S. attorney for the Southern District of New York involving EEA and the construction of the World Trade Center transportation hub project, a subcontractor, Moretrench American Corp., Rockaway, N.J., admitted to violating DBE regulations and agreed to pay a \$3 million fine to the U.S. and \$50,000 to the Port Authority of New York and New Jersey for its investigative costs.

Moretrench American, which provides geotechnical construction and engineering services, was hired as a subcontractor and was required by contract to obtain 17 percent DBE participation for the World Trade Center transportation hub project.

Similar to Skanska USA Civil Northeast, Moretrench American retained EEA as a subcontractor to meet DBE goals by operating the project's dewatering system. However, EEA operated as a shell company. Moretrench American hired the pump operators, supervised the job site and assembled biweekly payrolls. To give the appearance EEA was performing a commercially useful function, Moretrench American employees already working on the site were put on EEA's payroll, which was assembled by Moretrench American employees. EEA received a markup on the payrolls as compensation for use of its DBE certification.

In December 2014, DOJ announced RMD Holdings Ltd., Chesterfield, Mich., d/b/a Nationwide Fence and Supply Co., agreed to pay \$1.75 million to settle allegations that RMD Holdings had violated DBE requirements on numerous federally funded projects in Kentucky, Indiana,



Illinois, Georgia and New York, including LaGuardia Airport.

RMD Holdings was a subcontractor on a construction project at the LaGuardia Airport Central Terminal building. For the LaGuardia Airport Central Terminal project, DOT set the DBE participation goal at 17 percent of the project's cost, or about \$1.8 million. The prime contractor retained a subcontractor to install the bollard structural steel, and that subcontractor hired RMD Holdings as a sub-subcontractor. The contract required RMD Holdings to provide materials provided by a DBE. RMD Holdings represented to the upstream subcontractor that it would use a DBE, MS Construction Co., Staten Island, N.Y., to supply about \$1 million in bollard structural steel.

RMD Holdings provided its upstream subcontractor with invoices and other documentation purportedly from MS Construction so the upstream subcontractor could claim credit toward its DBE contract requirements. RMD Holdings knew MS Construction was not actually supplying the steel, which was supplied by several third-party suppliers, none of which was a DBE. RMD Holdings paid MS Construction a percentage of the amount paid to the actual steel suppliers to use MS Construction's DBE status to earn DBE credit for the prime contractor.

Per the settlement agreement, RMD Holdings admitted one of its employees caused false certifications to be submitted to DOT. RMD Holdings engaged in similar fraudulent practices on other projects in Georgia, Indiana and Kentucky.

ILLINOIS

While prosecutors in New York have been particularly active in investigating DBE fraud, similar efforts have been underway in many other parts of the U.S., as well.

In a case initiated by the Illinois attorney general, the former president of Core Construction Services of Illinois, Morton, Stephen Roeschley, plead guilty in May 2014 to using a minority-owned business firm, BJB Enterprises, Peoria, Ill., as a front to be awarded the construction contract for phase-two restoration of the Illinois Capitol in Springfield.

Roeschley told the Illinois Capital Development

Board that Core Construction Services of Illinois would employ BJB Enterprises to satisfy Illinois' requirement that a portion of the work be performed by a DBE. An investigation by the Illinois attorney general found BJB



Enterprises did not do any work or provide any materials for the project. Roeschley sustained a felony conviction, was sentenced to 30 months of probation and ordered to pay \$800,000 in restitution to the state.

In another Illinois case, James McHugh Construction Co., a large Chicago-area contractor, agreed in May 2014 to a \$12 million settlement arising from alleged violations of DBE program regulations in connection

with James McHugh Construction's work on highways and for the Chicago Transit Authority.

The case was initiated by a project manager of a subcontractor to James McHugh Construction on three construction sites. In this case, the subcontractor's project manager received more than \$2 million. By agreeing to the settlement, James McHugh Construction avoided being debarred from performing government contracts. In addition to the \$12 million settlement, the company agreed to donate \$2 million to support Chicago's DBE programs.

SCHEMES INVOLVING SUPPLIERS

DBE fraud in connection with construction projects is not limited to contractors and subcontractors. Manufacturers and suppliers also have been included in DBE fraud investigations and prosecutions.

DOT regulations require a DBE supplier to be responsible "for negotiating price, determining quality and quantity, ordering the material and installing (where applicable) and paying for the material itself." The regulations are clear that a DBE supplier cannot serve merely as a pass-through. A DBE supplier performs a commercially useful function if it performs tasks such as identifying the source of the materials to be provided for the job, negotiating pricing, making sure the quality and quantity of materials purchased meet contract requirements, paying for the materials with its own funds, and arranging for and scheduling delivery and invoicing.

Per DOT regulations, a supplier who qualifies as a

“regular dealer” can earn a DBE credit equal to 60 percent of the value of the materials supplied to a project. DOT regulations provide that a DBE, which qualifies as a “regular dealer,” must be an established, regular business that engages as its principal business and under its own name in the purchase, sale or lease of products of the same general character as those involved in the contract and for which DBE credit is sought. In addition, a DBE “regular dealer” must maintain a store, warehouse or other establishment where the products are bought, stocked, sold or leased to the public in the regular course of business.

If a DBE serves in a limited role as a broker, DBE credit is limited to the amount of the fee or commission the DBE broker receives. To earn a DBE credit based on the value of materials, DOT regulations require the supplier qualify as a “regular dealer.”

In August 2012, the U.S. attorney for the Western District of New York in Buffalo reached a civil settlement with Lafarge North America Inc., a national manufacturer of construction materials with locations throughout North America. Lafarge North America agreed to pay \$950,000 to the U.S. without admitting liability.

The government alleged Lafarge North America had fraudulently obtained subcontracts between June 2001 and March 2006 on eight partially federal funded highway construction projects in the Buffalo area that were to go to DBEs.

Rayford Enterprises Inc. d/b/a Rayford Concrete Products, Buffalo, a certified DBE construction company, was awarded highway construction subcontracts partially funded by the Federal Highway Administration. Rayford Enterprises obtained the contracts by representing it was a DBE manufacturer of concrete. In reality, according to the government’s complaint, Rayford Enterprises was not a concrete manufacturer and did not have a concrete batching plant or other equipment to manufacture concrete. Rather, Rayford Enterprises contracted with Lafarge North America to perform all the concrete work on the projects. The owner of Rayford Enterprises, Oscar Rayford, plead guilty to mail fraud charges and forfeited \$1.8 million.



The U.S. attorney alleged Rayford Enterprises had an agreement with Lafarge North America, which was not a DBE, to manufacture and deliver concrete for these projects. The claim against Lafarge North America was that it fraudulently obtained subcontracts that were supposed to be performed by DBEs.

BEWARE

Suppliers must be diligent and avoid participating in fraudulent DBE schemes when a non-DBE supplier sells materials on paper to a certified DBE who invoices an upstream contractor and adds a fee. A supplier who knowingly participates in a scheme with a DBE that the supplier knows is just a pass-through is likely to be included in an investigation of DBE fraud.

Additionally, suppliers cannot be “willfully blind” to such schemes. Similar to all DBE contractors, a DBE supplier must perform a commercially useful function. Prosecutors may pursue a claim against a non-DBE supplier based on a willful blindness theory if the evidence shows the supplier intentionally avoided learning the truth and chose deliberately to be ignorant of the facts surrounding a transaction.

Government prosecutors know the DBE and similar programs are rife with abuse and fraud and have been devoting resources to identify, investigate and prosecute cases of fraud in public construction projects. Contractors and suppliers who perform government contract work calling for DBE participation should be vigilant in making sure they are not party to DBE fraud. If you are asked to retain a DBE subcontractor or supplier or serve as subcontractor to a DBE, make reasonable inquiries to ensure the DBE is not a mere pass-through but actually is performing a commercially useful function. You should examine your practices with regard to DBE program requirements and

implement an effective monitoring and enforcement program to ensure your operations comply with applicable DBE regulations. 📌🔍

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