

DBE Compliance When the DBE is not Compliant

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Federal, state and local government projects have various programs designed to maximize contracting opportunities for Disadvantaged Business Enterprises (DBEs). By way of example, United States Department of Transportation projects often require at least 10% of funds authorized for certain highway projects be allocated to work performed by DBEs. This means the contractor must ensure at least 10% of the work is performed by a certified DBE. The rules and regulations vary depending on the state and/or local government funding the project, and they are often well advertised or otherwise made known by the owner before the project commences. Usually, at the beginning of the project, the owner and contractor ensure certified DBEs are retained to perform commercially useful functions at least to the extent of the required percentage for the project. However, contractors often get into trouble when they forget to ensure compliance if issues arise with the DBEs in the middle of the project. Sometimes, in the mind of the contractor, the severity of the issues caused by the DBE overshadow the severity of the repercussions for failing to maintain DBE compliance – *THIS IS A FATAL MISTAKE*.

The Reality of the Consequences:

The consequences of failing to maintain DBE compliance are severe. For example, in January, a fine of over \$3.2 million was levied against a Connecticut electrical contractor for DBE violations on state public transportation projects. The electrical contractor, after being awarded multiple contracts by the Connecticut Department of Transportation which included DBE requirements, set up “Company No. 1” and awarded a subcontract to Company No. 1 to fulfill those DBE requirements. The electrical contractor terminated multiple employees and then re-hired them under Company No. 1. The electrical contractor, which was not a certified DBE, controlled those employees hired by Company No. 1, provided Company No. 1 with the equipment needed to perform its scope of awarded work, and negotiated for Company No. 1 the materials it ordered. The court determined no commercially useful function was being

performed by Company No. 1, and it cost the electrical contractor at least \$3.2 million in fines, not to mention attorneys' fees and costs to defend the claims.

It's also hard to continue working and obtaining new contracts when sitting in jail. This is the lesson some who have violated DBE requirements have learned the hard way. In 2014, the president of a contractor was sentenced to 84 months imprisonment and was ordered to pay fines for his role in failing to follow DBE requirements. Although his circumstances involved 15 years of fraud and abuses of DBE programs, his losses should not go without acting as a warning.

To add another layer, it's often not even the contractor as the bad actor that ends up in trouble when its subcontractors are the parties utilizing their own DBE suppliers or contractors to fulfill the DBE requirements of the project, which lower-tier subcontractors don't actually perform commercially useful functions. The contractor certifies DBE compliance and gets busted under the False Claims Act. Simply, don't forget to monitor the status of lower-tier subcontractors if you are relying on those subcontractors/suppliers to fulfill your DBE requirements for the project.

Starting Strong with DBEs Performing Commercially Useful Functions:

Due diligence of which entities are fulfilling the DBE requirements on the front end is a crucial component to ensuring compliance. To be eligible for DBE participation goals on a particular project, a qualified DBE must perform a "commercially useful function." A DBE generally performs a commercially useful function when it:

- Is responsible for the execution of a distinct scope of the work of a contract;
- Carries out its responsibilities by actually performing, managing, and supervising the scope of work involved; and
- Furnishes its own supervision, labor, tools, equipment, materials, and supplies necessary to perform that distinct scope of the contract work.

If the DBE's role is limited to that of an extra participant, meaning it is a mere pass-through or a front, through which funds are merely passed in order to obtain the appearance of DBE participation in a contract, a commercially useful function is not being performed. When a DBE does not perform a commercially useful function, all parties involved, including the upstream and downstream parties, may be subject to governmental investigations, substantial monetary penalties, and even jail time. Again, most responsible contractors will ensure this is addressed before the project commences, typically at the time of awarding contracts for the various scopes. However, this compliance must continue throughout the project.

Finishing Strong Even When a DBE Must be Replaced During the Project:

Even the diligent and often well-meaning contractor runs into issues when faced with a non-compliant or non-performing DBE in the middle of the project. This can arise when either the DBE is defaulting on its obligations or the DBE is found to not be performing a commercially useful function. The contractor might tend to look to its contract with the DBE for the termination provisions for cause or convenience and those procedures for providing notice and cure periods. Nevertheless, the contractor may still be breaking the law. The contractor remains under the DBE guidelines and restrictions from the beginning until the end of the project. It is vital that a contractor always adhere to DBE guidelines and work in conjunction with the public entity responsible for the project when terminating or replacing any

DBE or even a portion of their scope of work. As a rule of thumb, a contractor's legal and/or statutory obligations are more stringent upstream than the more favorable contractual obligations it inserts in its contracts downstream.

DBEs can be replaced for typically three (3) reasons: decertification of the DBE, voluntary replacement, or involuntary replacement. When replacing a DBE, always work hand in hand with the owner's representatives such as the Area Engineer's Office, Contract Compliance Officer, or other official designated by the public owner. And always remember to act with a "Good Faith Effort" to comply with your DBE obligations because your actions will likely be viewed with more scrutiny than on non-DBE projects.

"Replacement" or "substitution" generally means a full or partial reduction in the amount of work subcontracted to a committed (meaning under contract) DBE. Typically, a replacement will require a "good cause" to exist, and typically your contracting body has a formal list of good causes within its DBE program. Examples might include when the DBE becomes insolvent, the DBE is not a responsible subcontractor and has demonstrated such on the project, the DBE refuses to meet non-discriminatory requirements of the contractor such as bonding requirements, or otherwise. Even if good cause exists to replace a DBE, there often are many steps required to complete the replacement beyond the steps required in the contract – for example, the North Carolina Department of Transportation generally sets out twenty-six (26) steps required for DBE replacement. Typically required steps include notice to the DBE and a response period, notification to the owner, potential meetings between the DBE, owner, and contractor to review and determine if replacement is appropriate, and certain forms must be submitted and approved to the owner. Even if all of these steps are followed, it should go without question that all documents showing compliance with the requirements should be preserved.

Simple awareness and communication are likely the best ways to remain diligent in your DBE obligations and avoid investigations, fines, and possible criminal penalties.

Nexsen Pruet's Construction Practice stands ready to help if you experience any issues related to DBE compliance. Our group has served as attorneys for the construction industry throughout North and South Carolina for years. The group is one of the leading construction practices in the Carolinas, with experience in all areas of the industry. If you have any additional questions, please feel free to reach out to Brett M. Becker, Esq., at (336)-387-5150.