Feature

INCREASED SCRUTINY of Small Business Subcontracting Requirements

BY W. BARRON A. AVERY

WHILE MANY CONSTRUCTION contractors are doubtlessly familiar with the small business subcontracting community, few are nearly as familiar with their legal obligation to use that community's services on federal prime contracts and certain state and local construction contracts. As the federal government's crusade to combat waste, fraud, and abuse expands, contractor compliance with these obligations is coming under increasing scrutiny, with severe financial—and possibly even criminal—ramifications for those caught in the crosshairs. Construction contractors who do not currently employ robust compliance measures should make the effort to do so soon, lest they find themselves the target of the government's next investigation.

Below is a discussion of select subcontracting requirements imposed on federal contractors with a focus on the unique requirements for federal construction contractors, two case studies of how the government's increased enforcement poses new business risks to those contractors, and conclusions for surety professionals and their contractors.

A. Subcontracting Requirements are More Specific Than You Realize. The federal government has a stated policy of leveraging its position as the world's largest single consumer of goods and services to support small business enterprises. In addition to well-known programs administered by the Small Business Administration (SBA) in accordance with this policy, the government has also promulgated a variety of programs requiring prime contractors to support this goal through their subcontracting decisions. The Federal Acquisition Regulation (FAR), for example, requires virtually all contractors to "carry out" the policy of promoting small businesses by awarding subcontracts to small businesses "to the fullest extent consistent with efficient contract performance" and by prioritizing prompt payments to small business subcontractors. Additionally, for contracts above certain thresholds—$1.5 million in the case of most construction contracts—the FAR requires contractors to submit detailed subcontracting plans, including small business subcontracting goals and procedures the contractor will undertake to meet those goals.

Of greater concern to construction contractors, however, is the U.S. Department of Transportation's (DOT) Disadvantaged Business Enterprise (DBE) program, along with similar programs administered by other federal and state agencies. The regulations governing DBE programs are more detailed than those found in the FAR, creating more pitfalls for contractors not paying close attention to their obligations. Additionally, because the federal DBE program covers state and local projects assisted by federal funds, construction contractors are faced with the unique risk of facing federal consequences for their non-federal contracts.

The DOT DBE program, for example, requires states receiving federal financial assistance to develop their own goals and procedures for encouraging small business subcontracting on local construction contracts. However, DOT still prescribes strict requirements that each state program must meet, with one such requirement proving especially complicated to local officials and construction contractors alike. To prevent contractors from undermining the purpose of the program through the use of pass-through entities, DOT's

regulations provide that only a DBE performing a "commercially useful function" may be counted toward the program's goals. DOT's regulations provide limited guidance as to what constitutes a "commercially useful function." Two of the factors DOT has identified as amounting to a commercially useful function include whether and to what extent the DBE independently manages its portion of the work, and whether the payments to the DBE are disproportionate to similar contracts with non-DBE entities. However, the determination of whether a DBE is performing a "commercially useful function" is still a subjective one. Moreover, there are few opportunities to appeal a determination that the DBE is not performing a "commercially useful function." This uncertainty, combined with lack of recourse, amplifies the need for contractors to be sure they are allocating DBE funds legitimately.

B. Compliance Failures Can Be Costly. Although the federal DBE programs are administered by participating states on a day-to-day basis, the federal government is increasingly engaged in policing the program for malfeasance and has an array of tools at its disposal for punishing misconduct. Contractors failing to observe program requirements risk severe financial ramifications in the form of fines as well as debarment from future federal and local contracts. Two examples from just the past year highlight not only the size, but also the relevance of these risks.

In June 2015, a former officer of RMD Holdings, Ltd d/b/a Nationwide Fence and Supply Co. (Nationwide) paid $358,707 to settle allegations that he personally violated DBE requirements in certain federally funded construction projects on which he served as a project manager. This personal liability came on top of $1.75 million paid by the company itself to settle allegations arising from the same circumstances. Nationwide claimed that a DBE company provided materials on federally funded projects. In reality, Nationwide had contracted with non-DBE material suppliers and directed the DBE company to them to make it appear as if the DBE company was furnishing materials. As part of these settlements, Nationwide and the former officer agreed to enter into administrative settlements and a three-year compliance agreement with DOT.

Just a few months later, in November 2015, Yonkers Contracting agreed to pay $2.6 million for violating the DBE program on a contract for a federally funded construction project. As part of the contract, the New York State DOT required an 8.03 percent DBE participation commitment, 31 percent of which was supposed to be completed by Global Marine Supply Co. through the supply of required steel. However, Global Marine simply resold steel obtained from a third-party supplier at a 1 percent markup with Yonkers' knowledge and consent. As Yonkers admitted as part of the settlement, this arrangement used Global Marine as a mere "pass through" entity of the sort prohibited by DOT regulations.

The recency of these settlements, when considered in light of their scale, should demonstrate the need for construction contractors to re-evaluate their subcontracting practices and to ensure that these practices are consistent with the relevant small business contracting rules.

C. Conclusions for Surety Professionals and Their Contractors. As seen above, the importance of compliance with federal subcontracting requirements is only increasing in today's environment. Construction contractors not already emphasizing small business contracting as an element of their compliance procedures run the risk of crippling financial penalties and would be well advised to re-evaluate their existing procedures before it is too late. Such re-evaluations should occur with an eye towards the following elements:

- Ensuring that relevant contract personnel are fully apprised of the particular requirements imposed on their contract(s);
- Maintaining an internal database of available DBE subcontractors to solicit for work;
- Avoiding the risk of pass-through transactions through development of an internal compliance checklist that addresses red flags, such as the use of joint employees, work beyond the DBE's capacity, and the use of joint/two-party checks for payment;
- Regularly comparing DBE contract pricing with non-DBE contracts to identify possible compliance breaches; and
- Updating internal practices to make modifications as needed.

With these measures, construction contractors can reduce their compliance risk in connection with federal small business subcontracting requirements.

W. Barron A. Avery is an attorney at Baker & Hostetler, LLP in Washington, DC, where he specializes in federal government contract law, including bid protests, claims litigation, regulatory compliance counseling, and investigative matters. Avery can be reached at 202.861.1705 or wavery@bakerlaw.com.
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Be sure to read Avery's next article in the Fall 2016 edition of *Surety Bond Quarterly* on the effect of Equal Employment Opportunity requirements in federal contracting.