Government contract requirements on Disadvantaged Business Enterprises

By Richard Arnholt, Esq., Bass, Berry & Sims PLC

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The Infrastructure Investment and Jobs Act (IIJA) is a historic investment, allocating $550 billion to build, repair, and improve our nation's roads, bridges, airports, railways, and other transportation systems. In just the last year, the federal government, largely through state or local municipalities, has awarded roughly $200 billion in contracts through more than 20,000 projects across all 50 states. While the legislation aims to enhance industrial competitiveness and foster a more resilient and efficient economy, the funding provides a generational opportunity for contractors to bid and win large construction contracts.

As Sherwin-Williams learned in a recent False Claims Act (FCA) settlement, the influx of money does carry conditions and it is important prime contractors, subcontractors, and Disadvantaged Business Enterprises (DBEs) understand and comply with the responsibilities that accompany the successful award of a contract.

DBE requirements

Most notably, the IIJA places an emphasis on the use of DBEs, requiring 10% of all funding for surface transportation projects, public transportation programs, highway safety research, and development to be earmarked for DBE firms. DBEs are for-profit businesses which are at least 51% owned and controlled by socially *and* economically disadvantaged individuals. Interestingly, the federal Department of Transportation relies on state determinations and certifications of DBE status.

Many contracts awarded using federal IIJA funding will require the prime contractor to commit to a goal of subcontracting a certain amount of money to DBE firms which must perform a "commercially useful function." The regulations at 49 C.F.R. 26.55(c) state, "A DBE 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."

A DBE's compliance is determined based on 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.

There is a presumption that the DBE is not performing a "commercially useful function" when it performs less than 30% of the contract's total cost with its workforce. The "commercially useful function" requirement is meant to ensure DBEs are not used as a "pass through" business or "extra participant" but are in fact gaining the experience necessary to develop real capabilities to compete for, and successfully perform, contracts in the future. Unfortunately for Sherwin-Williams, the type of scheme which the regulations were designed to mitigate cost the paint company $1 million.

Sherwin-Williams FCA settlement

On March 2, Sherwin-Williams Company, the Cleveland-based supplier of paint and other paint-related supplies, settled FCA allegations based on an alleged scheme to use a DBE as a pass-through business.

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In April 2011, the Pennsylvania Department of Transportation (PENNDOT), awarded a $42.7 million contract to Hercules-Vimas, a joint venture based in Pennsylvania. The contract was primarily federally funded with 80% of the money coming from the federal Department of Transportation (DOT) through the Federal Highway Administration (FHWA) and included a subcontracting goal of 8% to a DBE firm.

Vertech, a DBE certified by PENNDOT, was selected and Hercules-Vimas certified that the DBE would supply $3.1 million in materials and supplies. According to the government, this never happened.

Instead, Hercules-Vimas allegedly negotiated prices and placed orders with Sherwin-Williams sales associates directly and Sherwin-Williams supplied the materials to the job site even though it was not a party to the contract. The paint company allegedly submitted invoices to Vertech for the materials with the understanding that Vertech would then submit invoices to Hercules-Vimas with a 1.75% markup representing Vertech's profit.

The government alleged that Vertech did not perform a "commercially useful function" and took the position that this activity contravened the intention of the requirement. (It is important to note that Sherwin-Williams denies the allegations).

Principals at both Vertech and Hercules-Vimas pleaded guilty to criminal charges for their roles in 2016 and 2017, respectively. Hercules-Vimas also agreed to pay $310,000 to resolve its own FCA investigation. Sherwin-Williams agreed to pay $1 million to settle its investigation and agreed to implement a compliance program focused on preventing "fraud, false statements, and misuse of government funds." U.S. Attorney's Office, Eastern District of Pennsylvania, Press Release, "Sherwin-Williams to Pay $1 Million to Resolve Alleged False Claims Act Violations Arising from Bridge Painting Project," March 2, 2023.

Proposed change to DBE rule

The method of determining whether a DBE is performing "a commercially useful function" is poised to change. As discussed in greater detail above, a DBE is generally required to perform roughly 30% of the work with its own workforce to be considered compliant with the regulations. In practice, that calculation largely depends on the type of work. For example, for DBEs performing on construction contracts DOT only counts the work performed by their workforce, while for professional and consulting services DOT counts the fee charged by the DBE as credit toward the goal.

Additionally, DOT counts 60% of the cost of materials and supplies provided by regular dealers, but DOT counts 100% of the cost of labor and supplies purchased or leased by a DBE subcontractor performing a distinct element of the work with its own workforce under a contract. It is crucial prime contractors and DBEs understand how the government counts credit to ensure they are complying with the relevant regulations.

The proposed rule, published at 87 Fed. Reg. 43620, would tweak the counting formula. First, the rule would eliminate the current bar on drop shipping — the practice of selling products the seller never keeps in stock. Under the proposed rule, "drop shippers" would be allowed to receive credit for 40% of the cost of materials.

The proposed rule will also cap the total credit a DBE can receive from prime contractor expenditures at 50%, decreasing the limit from 60% of expenditures from non-manufacturer suppliers. This change reflects a long standing concern that prime contractors could meet the DBE contract goal solely from supply contracts with DBEs limiting opportunities for DBEs performing different work.

Lastly, industry leaders consistently sought clarity as to the definition of "manufacturer" for purposes of calculating "commercially useful function" credit. Importantly, "manufacturers" are awarded 100% credit of supply and materials costs toward a contract goal. The proposed rule defines a DBE as a manufacturer when "it owns or leases and operates a factory or establishment that produces the materials, supplies, articles, or equipment required under the contract."

Going forward

The False Claims Act, originally enacted during the Civil War, is a popular tool used by federal prosecutors to penalize contractors submitting "false claims" to the government. The FCA allows the government to impose both civil and criminal penalties and even allows private citizens to bring suits against contractors on behalf of the government allowing successful claimants to receive a portion of the monetary penalty imposed. In just Fiscal Year 2021 alone, the Department of Justice obtained over $5.6 billion in penalties using the FCA.

While the IIJA presents an immense opportunity in the government contracting space for prime contractors, subcontractors, and especially DBEs, large and small contractors alike should be aware that the DBE program is governed by a number of regulations that have real teeth. DBEs cannot be used as "pass through" businesses and must perform "commercially useful functions." The regulations must be strictly complied with or entities risk running afoul of the FCA. Contractors should also review the changes in the proposed rule and pay close attention for the issuance of a final rule as it will likely come in the thick of IIJA project awards.

About the author

Richard Arnholt is a member at **Bass, Berry & Sims PLC** in Washington, D.C. He advises companies on the complex rules applicable to contracting with federal and state governments. He focuses on risk mitigation through implementation and upgrades to ethics and compliance programs as well as response to government allegations of procurement fraud or misconduct. He can be reached at rarnholt@bassberry.com.

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