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FEATURE

Working with socially or economically disadvantaged business enterprises provides opportunities for new business on government projects, but these opportunities come with additional risks. Many of these entities do not have the ability to pay the material supplier until they are paid, so exercising extreme due diligence to maximize the opportunity and minimize the risk is warranted.

In addition, rules that govern these programs vary from comprehensive guidelines to few or no requirements. Albeit, that's a moving target as more federal and state agencies are adding regulations, said James Fullerton, Esq., a partner in the law firm of Fullerton & Knowles, P.C. And with more regulations comes the potential for increased enforcement efforts. Enforcement appears to be already taking root. In the past six months, two alleged New York violations were settled with fines near \$5 million.

Most public procurement contracts have participation goals or requirements for disadvantaged groups. Under the U.S. Department of Transportation (DOT), which has the most comprehensive requirements, and some other agencies, the disadvantaged contractor must perform a commercially useful function (CUF) that helps participants develop into financially strong contractors. It cannot be an extra participant in

Socially or Economically Disadvantaged Businesses Bring Opportunity and Risks

By Diana Mota



PROTECTING

a transaction, contract or project, through which funds are passed in order to obtain the appearance of disadvantaged business enterprise (DBE) participation. The contractor must perform, manage and supervise the work. For example, with respect to materials, the contractor must (a) negotiate price; (b) determine quality and quantity; (c) order and install the material, where applicable; and (d) pay for the material, which Fullerton refers to as the four pillars or touchstones of these projects.

As more cases make the headlines, it becomes increasingly apparent that credit professionals need to know more and do more to help their firms avoid hefty fines, said Chris Ring, of NACM's Secured Transaction Services. They have to understand what the potential problems and risks are. Learning about the challenges associated with these endeavors can help credit managers develop a plan to minimize their firms' exposure to nonpayment and violations that could result in substantial fines.

Problems and Challenges

A variety of programs exist, including minority business enterprises (MBEs), small minority business enterprises (SBEs) or DBEs. Each comes with its own requirements and rules. A lot of confusion, misinformation and inconsistencies surround these programs, Fullerton said. "There's a lot of uncertainty about what a violation is and what it isn't; what breaks the rules and what doesn't." (For the purposes of this article, the entities will be referred to as DBEs.)

Having an entity that performs the four pillars, however, does not guarantee a "safe harbor" from violations. On some projects, the disadvantaged business must perform or exercise responsibility for a certain percentage of the contract value. Otherwise there is a presumption that it did not perform a commercially useful role, Fullerton said. However, it's not clear how DBE suppliers would meet this requirement, he noted.

Challenges include finding businesses that are qualified to perform the work. They often lack the training, experience or resources required for the job. Many companies on either side of the DBE equation hesitate using them because of an elevated risk of default or negative impact on project schedules. Concerns such as these have led some of the parties in these projects to circumvent the rules.

It's common, though risky, for the general contractor (GC) and traditional suppliers to communicate between themselves about a project, leaving the disadvantaged contractor out of the loop, Fullerton said. In essence, the GC uses the disadvantaged contractor as a paper pusher, broker or pass through that participates in name only. For example, the disadvantaged supplier "purchases" materials from a traditional supplier and then resells these materials to the GC or other end user. It marks up the traditional supplier's invoices 2% or 3% and then re-invoices the end user. "That's extremely common in the marketplace, but that can result in fines and penalties," Fullerton said. This goes against the spirit of the program's intent and can lead to legal trouble for everyone involved, Ring said. Participants, GCs and subcontractors have received jail time, probation and large fines. Most of the cases have involved outright fraud by either the GC or use of a fake DBE that had contracts with the government directly or that were one tier removed.



YOUR COMPANY

In a recent case, however, a supplier with national reach was held accused of participating in a false claim to the federal government. The supplier agreed to pay a \$4.95 million fine to settle the investigation by the U.S. Attorney's office for the Northern District of New York under the federal False Claims Act. The supplier acknowledged that it knowingly participated in transactions in which the DBE acted merely as a pass through and did not perform a commercially useful function on DOT and EPA projects. The traditional supplier didn't have a government contract nor was it required to certify compliance with DBE regulations, Fullerton noted, but the attorney's office maintained that downstream suppliers were subject to the same requirements because they transacted business with a DBE supplier and contractor that then contracted with the government. The takeaway here is that if traditional suppliers are aware that one of the other parties is committing a fraud, they need to walk away from the deal or they could be found guilty of collusion, Ring said. "This case was a wakeup call. Every material supplier has to think about this. It adds a huge level of due diligence."

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Settlement agreements are not legal precedents, however, Fullerton said. "There's no case law," he said. "That's how we typically learn what this all means. All we have are the regulations. We don't know what a court would have done with that case." Though, it is clear how federal prosecutors view such conduct "that is very common in the marketplace by suppliers, DBEs, subcontractors and general contractors," he noted. The national supplier perceived enough of a risk that it paid the fine to avoid prosecution and minimize bad press, Fullerton added. The fine doesn't go into the U.S. treasury, Fullerton pointed out. "The prosecutors' office keeps it so there's a strong incentive for prosecutors to investigate these cases." States and local governments are struggling to make money so fines such as these could become attractive, Ring agreed.

In addition, the statute of limitations on the federal False Claims Act is at least six years. "Accordingly, it could be a long time before you learn the cost of behavior on projects today," Fullerton said. "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, which have included legitimate DBEs or former employees, can file civil False Claim Act complaints, and the government then has the option to take over the case.

What Credit Professionals Have to Say

"No one has seen a playbook or set of regulations on how to handle these projects" from the creditor's perspective, one

credit manager said. Available information focuses on the DBE. "It doesn't outline the dos and don'ts of a vendor," he added. "Program goals are developed to help them, but the way they go about it isn't advantageous for us. We're trying to figure out how to protect ourselves."

"There's no real way of telling if the company is legit," another credit analyst said. "Many times they don't have an office." When she receives the credit application, "We have no idea up front that it's a DBE. We usually figure it out because there's very little to verify. They wouldn't normally qualify for a line of credit." The analyst noted, "Many of them work under the GC because they don't qualify for a bond." "We need to treat them the same as other customers," the credit manager explained. "Yet, they don't have the credit history; they don't have the financial wherewithal; they don't have the experience."

The credit manager agreed. "In a way, [government agencies] are asking vendors to be DBE cops to make sure they have a warehouse of materials and boots on the ground. How are we supposed to be the police? We're relying on our customers and many of them don't understand." Creditors don't have a lot of security. "At least when we sell directly to the GC, we have lien rights," he said. "Unless there's a bond on the job, we have no security. The DBE doesn't really have a lot of skin in the game."

The analyst finds that most of the minority entities she works with don't process the paperwork so she now sends the invoices directly to the GC. Payment is typically slow, she added. "It often takes 90 days total." Her firm uses a joint-check process where the DBE receives, endorses and then mails a check from the GC to her company. "We don't have a comfort level that check will come to us," she said. "They get their cut and make zero effort to get us paid." Their recourse to date has been to call the general contractor who intervenes on her company's behalf. Joint checks add some level of security, the credit manager said, "but some general contractors don't want to use them because they could give the illusion of the DBE not being the one that is paying."

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About 20% of her portfolio includes projects such as these, but they take about 30% or more of her time, she said. Turning the projects down is not an option because they have ongoing relationships with many of the contractors. The situation has improved some, she noted, because once she knows it a disadvantaged entity she goes directly to the GC if there's a problem.

Developing a Plan

Begin by finding out who owns the job and then determine if it has a CUF regulation, Fullerton said. "If there is one, then

only discuss price, quantity or quality with the DBE involved. The prime contractor must only communicate with the DBE in reverse.” Regardless, if you meet DOT requirements, you’re pretty safe, Fullerton said. It is critical to involve DBE suppliers in all communications with the GC from the project’s start. 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, Fullerton said. “The DBE supplier can’t perform a CUF.” The only way for the traditional supplier to avoid the risk of fines is by selling the product directly to the non-DBE customer or refraining from selling the product at all. Or, the GC can get new bids from new DBE suppliers, who will then get pricing information from the traditional supplier.

“This is an area filled with landmines,” said attorney Randy Lindley, a partner with Bell Nunnally. Spotting a pass through requires the same level of due diligence as when trying to spot fraud of any kind, Lindley said. He suggests beginning with the basics by asking for the enterprise’s certification documentation. “If you have a concern, ask for authentication of the documents or copies of the application. If it has a waiver status, what is it?” He also promotes following the “Four Es” in credit investigations: expertise, equipment, employees and exclusivity. “Does the DBE have the background, expertise and credentials to perform the work? Does it have the necessary equipment? Does it have its own employees? Does it work exclusively with the same GC?” Answers to these questions could help determine whether the enterprise is legit, he said.

Ring recommends digging deeper to determine whether the DBE performed a useful function. “Claiming ignorance doesn’t work,” said Ring, who is moderating a Credit Congress educational session panel on the topic. “A CUF analysis is a transactional analysis,” Fullerton said. “What role did the DBE play in this project? Were they actively participating?”

Don’t assume what you’re told about DBE requirements is accurate, offered Fullerton. For example, some GCs might tell you joint checks or a GC guarantee is not allowed, he said. “Ask for them to show you where that’s stated. Typically, it’s because the GC doesn’t want the additional risk.”

Credit departments need to develop a policy and checklist because it could take a lot of time to investigate these companies, Lindley said. “It’s a constant weighing of cost-benefit analysis. The possibility that fraud is at play is very real because of the dollars at play in these projects,” he noted. “You don’t want to become the customer that had a blind eye toward something that was obvious.” ■

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NACM is offering an educational session, Managing Minority Contractor Sales, at the 120th Annual Credit Congress & Expo presented by stakeholders to help credit professionals understand the problems and risks as well as possible solutions of working with DBEs.

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