Plenary Session 3: Effects of the Federal Disadvantaged Business Enterprise Program on Local Transportation Projects

*The Commercially Useful Function Test and Penalties for Non-Compliance with Project DBE Goals*

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A contractor who focuses primarily on municipal and state construction may find itself subject to different rules for engaging disadvantaged businesses as federal dollars are infused into local road construction projects. While most states and some municipalities have their own small business contracting programs, when the Federal Highway Administration (FHWA) even partially funds a project, contractors must comply with the Federal Department of Transportation’s Disadvantaged Business Enterprise (DBE) rules.

With the change from state to federal regimes come new aspects of compliance, two of which are restrictions on which disadvantaged subcontractors can be counted toward the project DBE goal and the consequences of not achieving the goal. To that end, this article explores application of the “commercially useful function” test in 49 C.F.R. § 26.55(c) to disadvantaged subcontractors in privity with the contractor, including in the framework of federal and state court decisions evaluating commercially useful function in both criminal and civil contexts. This article also analyzes the potential consequences of failing to achieve the established goal, including what it means under 49 C.F.R. § 26.53(f) to engage in “good faith efforts” to demonstrate compliance with 49 C.F.R. Part 26, the penalties for DBE non-compliance in selected states, and recommendations for contractors on post-award DBE utilization.

I. To What Projects Does the Federal DBE Program Apply?

The Federal DBE Program regulations, codified in 49 C.F.R. Part 26, apply to projects that receive funding from the Federal Department of Transportation (DOT). These projects include federal-aid highway, transit, and airport projects. However, projects to be performed entirely outside of the United States (including its territories, possessions, Puerto Rico, Guam, and the Northern Marianas Islands) are not required to have DBE programs.
Owners are prohibited from receiving financial assistance from DOT until they have an approved DBE program in place. Therefore, states and localities who desire to receive (and continue to receive) FHWA funding for road construction typically adopt their own DOT-approved DBE program, with associated annual goals, prior to letting federally-funded contracts out for bid. The specific goals applicable to a given project will be set forth in the solicitation and become binding contractual obligations on the contractor upon award.

II. The Commercially Useful Function Test:

In an effort to prevent contractors from circumventing the intent of the DBE regulations by using sham DBEs, DOT imposes rules as to which subcontractors count toward a project DBE goal. In particular, the project gets credit for DBE participation only when a subcontractor performs a “commercially useful function” (CUF). “The basic premise behind CUF is that DBEs perform their contract with their own resources, independently of the prime contractor.”

Although no standard definition or formula for CUF exists, the regulations, DOT, and courts have provided guidance on the factors to consider when assessing whether an entity is performing a CUF.

A. Code of Federal Regulations Guidance on CUF:

49 C.F.R. § 26.55(c) sets forth the CUF requirement. It provides that a DBE performs a CUF when it:

- “[I]s responsible for execution of the work of the contract and is carrying out its responsibilities by actually performing, managing, and supervising the work involved”; and
• Is “responsible, with respect to materials and supplies used on the contract, for negotiating price, determining quality and quantity, ordering the material, and installing (where applicable) and paying for the material itself.”

Further, performance of CUF is evaluated with regard to “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.”

The regulations make clear, however, that the CUF standard is not achieved when a DBE’s “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.” Similarly, a presumption exists that a DBE is not performing a CUF when it “does not perform or exercise responsibility for at least 30 percent of the total cost of its contract with its own work force” or where it otherwise “subcontracts a greater portion of the work of a contract than would be expected” based on the type of work and industry in which it is performed. Special rules exist for trucking companies and material manufacturers and dealers.

**B. What FHWA Says About CUF:**

In its guidance to local public agencies who administer federal aid transportation projects, FHWA prescribes how to evaluate whether a DBE is performing a CUF. The primary inquiries for assessing CUF are whether the DBE manages the work, self-performs at least thirty percent (30%) of the work, supervises its own employees, and supplies equipment and materials necessary to perform the work.

The managerial component of CUF requires the DBE to be in charge of scheduling its own operations, ordering necessary equipment and materials, preparing and submitting its own
certified payrolls, and hiring and firing its employees. The disadvantaged owner of the DBE must be meaningfully involved in personally supervising the DBE’s daily operations or closely monitoring a qualified superintendent who reports directly to the DBE owner. A DBE owner who simply performs administrative tasks for the company does not sufficiently “manage” the DBE with regard to establishing CUF. In evaluating whether a DBE sufficiently manages its own work, FHWA considers factors such as whether the subcontracted scope of work is within the DBE’s area of expertise, capabilities, and capacity.\(^{14}\)

A DBE subcontractor must maintain its own workforce and is prohibited from using temporary labor or borrowing employees from or sharing employees with non-DBEs, in particular the prime contractor. As part of these requirements, the DBE is responsible for preparing and funding its own payrolls.\(^{15}\) The DBE also is responsible for supplying its own equipment, except that specialized equipment (along with skilled operators) may be leased for short periods of time in limited circumstances.\(^{16}\) In any case, operation of equipment—whether leased or not—must be under the DBE’s full control. When analyzing CUF, FHWA does not substantively distinguish between DBEs who informally borrow, rather than lease, a prime contractor’s equipment.\(^{17}\)

A DBE performs a CUF with regard to procuring materials only when it: negotiates the price; prepares its own estimate; determines the type of material needed; places the order; and pays for the materials itself, as documented by the invoice.\(^{18}\)

To evaluate CUF, FHWA recommends that agencies:

- Review the DBE’s contract to glean the proposed scope of work to be performed;
- Visit the jobsite to confirm that the DBE is performing the contracted scope of work, self-performing at least 30% of the work, the DBE owner is present on the
jobsite, and that, for example, the DBE’s logo appears on its vehicles and equipment;

- Interview DBE employees to determine who they report to and who signs their paychecks. If key staff report to someone other than the DBE—particularly the prime contractor—CUF may not be established.

- Review project records such as payrolls, invoices, and delivery tickets to verify that the DBE—rather than a non-disadvantaged contractor—is paying the DBE’s employees, submitting orders, and paying for materials.\(^{19}\)

C. Federal Court Guidance on CUF:

Most federal cases that analyze CUF do so in the context of blatant attempts by contractors to defraud the government, which result in criminal charges along with, more often than not, convictions and debarment. These cases illustrate the extreme lengths to which unscrupulous contractors are willing to go to achieve DBE status on DOT contracts. Most of the federal body of case law does not address the types of “close call” situations that might actually offer constructive guidance to contractors trying to legitimately participate in the DBE program. However, the fraudulent actions discussed in these cases highlight just how crucial DBE credit can be to a contractor’s bottom line.

For example, in a series of decisions arising out of the Middle District of Pennsylvania (the “Schuylkill Products” cases), various co-conspirators were found guilty of using a sham DBE to defraud the Pennsylvania Department of Transportation (PennDOT) on hundreds of federally-funded contracts worth over $100 million. *United States v. Nagle*,\(^ {20}\) *United States v. Fink*,\(^ {21}\) and *United States v. Campbell*,\(^ {22}\) arose from a scheme between a DBE and two non-DBEs in which the non-DBEs “found, negotiated, coordinated, performed, managed, and supervised”
the contracts, while the DBE essentially did nothing other than function as a conduit through which profits flowed to the non-DBEs. The fact that the DBE was nothing more than a front was clear from the egregiousness of the co-conspirators’ attempts to make it appear that the DBE was performing a CUF. Among other things, the non-DBEs:

- Sent correspondence on stationery bearing the DBE’s name;
- Used e-mail addresses in the DBE’s name;
- Used the DBE’s log-in information to access PennDOT’s electronic contract management system;
- Affixed magnetic signs bearing the DBE’s logo to cover non-DBE logos on project vehicles;
- Supplied non-DBE employees with business cards bearing the DBE’s name;
- Supplied non-DBE employees with additional cell phones in the DBE’s name;
- Used a stamp of the DBE president’s signature to endorse checks; and
- Used the DBE’s payroll account to pay project employees, and then reimbursed the DBE for the payrolls.

Another decision, United States v. Taylor, involves an unrelated conspiracy to defraud PennDOT (as well as the Pennsylvania Turnpike Commission) on projects receiving federal funds. In Taylor, the DBE was used as a front for a non-DBE, who was responsible for:

- Finding jobs, preparing bids, and negotiating the actual contracts;
- Coordinating, performing, managing, and supervising the work; and
- Drafting erection drawings, negotiating crane rentals, arranging for transportation of materials to the job site, and recruiting union workers to perform the work.
Like in the *Schuylkill Products* cases, the non-DBE in *Taylor* went to great lengths to conceal the fact that the DBE was not performing a CUF, including:

- Falsely representing to various involved agencies that the DBE was performing the work;
- Using the DBE’s letterhead for project correspondence;
- Submitting fraudulent time sheets showing that the DBE’s employees were performing work, when in fact they were not;
- Impersonating DBE employees at construction progress meetings with the owner;
- Using the DBE’s e-mail account to communicate with the owner, general contractor, and suppliers;
- Using the DBE’s business cards, t-shirts, and hard hats;
- Using magnetic signs bearing the DBE’s logo to conceal the non-DBE’s logo on construction vehicles; and
- Using a stamp of the DBE president’s signature to endorse checks, sign union documents, and certify payrolls.27

*United States v. Maxwell*28 addresses yet another conspiracy, this time aimed at defrauding the Miami International Airport on several contracts funded by the Federal Aviation Administration, which, like FHWA, falls within the ambit of DOT. In *Maxwell*, a non-DBE:

- Transferred its foremen and other employees to the DBE’s payroll and then reimbursed the DBE for all labor costs of the transferred employees;
- Paid for and supplied the job site trailer;
- Supervised all project labor;
- Negotiated for, ordered (in the DBE’s name), and paid for all materials; and
• Prepared daily progress reports and other project documentation on the DBE’s behalf.29

Meanwhile, the DBE’s own personnel failed to attend construction meetings and did little to supervise the workers other than to “ma[k]e sure they didn’t have any [non-DBE] stickers on their hard-hats.”30 Despite Maxwell’s claim that this type of “mentoring” of a small business by a larger business is “very common” in the construction industry,”31 the Eleventh Circuit confirmed his conviction in the Southern District of Florida.32

In a qui tam action under the False Claims Act, the court in United States ex rel. Hedley v. ABHE & Svoboda, Inc.33 discussed CUF in its opinion. It found that a non-DBE’s assistance to a DBE in the form of helping the DBE “find union workers for the job” and advancing funds to the DBE did not preclude a finding that the DBE performed a CUF.34 The court stressed that, despite potentially problematic actions by the non-DBE, the DBE still:

• Paid all of its employees (even the workers found by the non-DBE) and was responsible for their benefits and workers compensation;
• Ordered and acquired all required scaffolding, rigging, and containment equipment; and
• Maintained control over barges, scaffolding, and containment tarps used on the project.35

With regard to the non-DBE’s advancement of funds to the DBE, the court considered that federal regulations do not expressly prohibit advancement of funds by a non-DBE to a DBE. Based on the “amount of work subcontracted, industry practices,” and other relevant factors, the court stated in dicta that it believed the DBE performed a CUF.36
D. State Court Guidance on CUF:

In addition to the federal decisions analyzing deceptive practices aimed at concealing bogus DBE schemes, a number of state courts have weighed-in on CUF in a non-criminal context. While federal criminal cases addressing CUF deal with such extremely fraudulent behaviors that they are of little value to contractors endeavoring to comply with DBE requirements, state court decisions offer more useful guidance to contractors trying to act within the parameters of 49 C.F.R. § 26.55.

In Adonizio Brothers v. Commonwealth of Pa. Dept. of Transportation,37 a prime contractor on a PennDOT contract appealed an adverse decision by the PennDOT review board. At issue was whether Adonizio complied with the contract’s ten percent (10%) DBE participation goal, specifically with regard to a DBE hauler employed on the project. The contract defined CUF similarly to 49 C.F.R. § 26.55(c), by requiring the DBE to be “responsible for the execution of a distinct element of the work of a contract and [to carry] out its responsibilities by actually performing, managing and supervising the work involved.”38

The court affirmed the Board of Review’s findings that:

- The DBE “owned and operated only one truck” and in fact leased trucks from Adonizio;
- Adonizio—not the DBE—was responsible for dispatching the leased trucks; and
- Adonizio paid the DBE an hourly rate for hauling services performed by other subcontractors.39

The review board concluded that the DBE “did not perform any function in the procurement of trucks used on the project” and that the “entire scope of truck hauling on [project] was controlled and coordinated” by Adonizio.40 The court agreed, finding it was “clear that [the
DBE] was an inactive straw party which functioned only to appear on documents as a lessor for the trucks used on the project.” In response to Adonizio’s argument that it “acted in good faith in aiding a minority business in getting started,” the court stated that “[t]he exercise of good faith or the lack of bad faith is irrelevant” to whether Adonizio achieved the established goal.41

In *Gary Merlino Construction Co. v. City of Seattle,*42 the Washington Supreme Court reviewed a city decision to debar Merlino for not meeting its DBE goal on a city contract. The project was not federally funded, so 49 C.F.R. Part 26 did not apply. Regardless, the city relied upon a definition of CUF similar to the definition in 49 C.F.R. § 26.55(c), which provided:

An MBE or WBE is considered to perform a commercially useful function when it is responsible for execution of a distinct element of the work of a contract and carrying out its responsibilities by actually performing, managing, and supervising the work involved.43

In reaching its conclusion that the DBE did not perform a CUF, the Seattle Board of Public Works considered that the DBE’s subcontract required it to supply concrete and perform associated paving work. However, due to insufficient access to credit, the DBE was unable to place orders for the concrete it needed to perform its work.44 Rather than trying to find a solution that would allow the DBE to meaningfully perform its subcontracted scope of work, Merlino just paid for the required concrete itself, thereby depriving the DBE of the opportunity to gain valuable experience or improve its credit rating, both of which were central objectives of the DBE program.45 On appeal, the court found that the city’s determination that the DBE did not perform a CUF was not arbitrary or capricious.46

Courts in other states have reached similar conclusions regarding CUF. For example, *C.C. Myers, Inc. v. Department of Transportation,*47 involved a bid protest on an California Department of Transportation (Caltrans) project wherein a disappointed bidder challenged Caltrans’ finding
that the bidder’s proposed DBE would not perform a CUF. In concluding that the DBE’s work did not count toward the project goal, Caltrans relied on the following definition of CUF:

(i) A person or an entity is deemed to perform a ‘commercially useful function’ if a person or entity does all of the following: (I) Is responsible for the execution of a distinct element of the work of the contract. (II) Carries out the obligation by actually performing, managing, or supervising the work involved. (III) Performs work that is normal for its business services and functions. (IV) Is not further subcontracting a portion of the work that is greater than that expected to be subcontracted by normal industry practices.

(ii) A contractor, subcontractor, or supplier will not be considered to perform a ‘commercially useful function’ if the contractor’s, subcontractor’s, or supplier’s 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 a disabled veteran business enterprise participation.48,49

Applying this definition of CUF, Caltrans cited the following factors in support of its determination that the DBE “was not responsible for a distinct element of the work on the Project” and therefore did not perform a commercially useful function:

- The DBE did not “own [or] have a long-term lease for trucks that [could] haul the aggregate base.”
- The DBE “had no opportunity to manage or supervise any element of the Project for the same reason—it neither owned nor leased trucks that could haul the aggregate base.
- The DBE “was not performing work normal for its business services and functions, as it was not a transporter of aggregate base.”
- “[A]gain for the reason that [the DBE] neither owned nor leased trucks capable of hauling the aggregate base, [it] appeared to be subcontracting the transport aspect of the job.”50
The court found the evidence was sufficient to support Caltrans’ determination that the DBE was merely “an extra participant” in the performance of the project.51

III. What Happens to a Contractor Who Does Not Achieve its Contract DBE Goal?

The potential penalties for a contractor who falls short of a stated project DBE goal vary depending on whether the contract has been awarded. Pre-award, a contractor who has not demonstrated compliance with 49 C.F.R. Part 26 risks having its bid eliminated. Post-award, contractors face even more severe and enduring consequences.

After the contract has been awarded, a contractor’s failure to carry out the requirements of Part 26 can be a material breach of the DOT contract, placing the contractor at risk for termination of the contract “or such other remedy as the [contracting agency] deems appropriate.” These remedies may include, but are not limited to:

(1) Withholding monthly progress payments;

(2) Assessing sanctions;

(3) Liquidated damages; and/or

(4) Disqualifying the contractor from future bidding as non-responsible.52

However, the mere failure to attain the stated project goal does not, itself, constitute a violation of Part 26. Instead, a contractor who falls short of the goal can nonetheless comply with 49 C.F.R. Part 26 by making documented good faith efforts to achieve the goal.53 One question, then, is what sort of efforts rise to the level of post-award “good faith efforts” within the meaning of 49 C.F.R. § 26.53?
A. Defining Good Faith Efforts under 49 C.F.R. § 26.53:

Like CUF, good faith efforts cannot be reduced to a precise definition or quantifiable formula. The types of efforts that constitute good faith efforts vary depending on the facts of each procurement. 49 C.F.R. § 26.53(g) states that:

When a DBE subcontractor is terminated as provided in . . . this section, or fails to complete its work on the contract for any reason, you must require the prime contractor to make good faith efforts to find another DBE subcontractor to substitute for the original DBE. These good faith efforts shall be directed at finding another DBE to perform at least the same amount of work under the contract as the DBE that was terminated, to the extent needed to meet the contract goal you established for the procurement. The good faith efforts shall be documented by the contractor.

As its title suggests, Appendix A to Part 26 – Guidance Concerning Good Faith Efforts, provides direction to agencies for evaluating whether a contractor has engaged in good faith efforts to meet the project DBE goal. Appendix A unquestionably applies to pre-award good faith efforts by prospective bidders whose bids do not demonstrate that they meet the DBE goal, pursuant to 49 C.F.R. § 26.53(a)—it expressly mentions “bidders.” Less clear is whether these same actions also allow a contractor who loses DBE participation post-award to demonstrate it has made good faith efforts under 49 C.F.R. § 26.53(g). Only one provision of Appendix A references the post-award phase:

A prime contractor’s inability to find a replacement DBE at the original price is not alone sufficient to support a finding that good faith efforts have been made to replace the original DBE. The fact that the contractor has the ability and/or desire to perform the contract work with its own forces does not relieve the contractor of the obligation to make good faith efforts to find a replacement DBE, and it is not a sound basis for rejecting a prospective replacement DBE’s reasonable quote.

Other than this sole provision, Appendix A exclusively deals with good faith efforts by bidders.

Still, many of the same considerations that apply in a pre-bid context also are relevant post-
award. Therefore, in the absence of other guidance regarding post-award good faith efforts, Appendix A is the best evidence of DOT’s expectations for what steps a contractor should take during contract performance as it endeavors to comply with the stated DBE goal. A clear understanding of DOT’s views in this regard is imperative, as a contractor who has not met the goal and who fails to satisfy the owner it is engaging in good faith efforts risks being assessed penalties for non-compliance pursuant to 49 C.F.R. § 26.13.

In its guidance for evaluating a contractor’s good faith efforts under Appendix A, FHWA instructs agencies to consider not only the number of DBE firms a contractor solicits for work, but also whether the type of work to be provided by each DBE is part of the subject contract scope. For example, if landscaping is not part of the work available to be performed, then the contractor’s outreach efforts to landscaping DBEs should not be counted as good faith efforts. This consideration is particularly important post-award when the unspoken for scope of work could be very narrow. FHWA further instructs evaluators to consider the following factors as evidence a contractor has engaged in good faith efforts:

- Contractor advertisements for DBEs;
- Written solicitations sent by the contractor to all firms qualified to perform the subject scope of work;
- Offers of assistance by the contractor to potential DBEs; and
- Documentation of the contractor’s follow-up efforts to DBEs who do not respond to solicitations for bids.

On the other hand, FHWA cautions that a contractor’s reasons for rejecting a DBE bid could suggest inadequate good faith efforts. For example, did the contractor accept a non-DBE bid that
was only marginally lower than a DBE bid? Did the contractor reject a reasonable DBE bid and opt instead to self-perform the work?\textsuperscript{58}

**B. Penalties Under Selected State Programs:**

Like the type of efforts that constitute “good faith efforts,” the penalties specified in 49 C.F.R. § 26.13(b) for non-compliance with Part 26 vary depending on the circumstances of each case. Each state DOT has discretion to impose any “such other remedy as [it] deems appropriate.”\textsuperscript{59} The following are examples of potential consequences in selected states for failing to comply with 49 C.F.R. Part 26:

1. **California:**

Caltrans “does not pay for work unless it is performed or supplied by the DBE listed on the DBE Commitment form” submitted by the contractor at the outset of the contract, unless Caltrans has authorized the contractor’s request to terminate or substitute a listed DBE.\textsuperscript{60} “If the prime contractor replaces a listed DBE without written approval from the resident engineer, payment for the items of work committed to the DBE must be temporarily withheld from the next progress payment.”\textsuperscript{61}

If the contractor’s termination or substitution of a DBE also violates the California Subletting and Subcontracting Fair Practices Act,\textsuperscript{62} the contractor will be assessed a penalty in the form of an administrative deduction equal to up to 10% of the subcontract amount, taken out of the next estimate.\textsuperscript{63}

Contractors working for Caltrans are required to use good faith efforts to comply with stated DBE goals. “If the contractor’s DBE attainment falls short of the contract commitment,” funds equal to the amount necessary to meet the original DBE goal can be withheld from the contractor, unless the reason for the shortfall was beyond the contractor’s control.\textsuperscript{64}
2. **Colorado:**

The Colorado Department of Transportation (CDOT) “requires a contractor to make good faith efforts to replace a DBE that is terminated or has otherwise failed to complete its work on a contract with another certified DBE, to the extent needed to meet the contract goal.”

“Modifications to the [contractor’s] commitments must be approved by the CDOT Regional Civil Rights Office.” “CDOT may withhold payment or seek other contractual remedies” if the Contractor fails to comply with DBE requirements. CDOT also “may withhold approval of the sublet or stop performance of the work if the Contractor has reduced, terminated, or otherwise modified the type or amount of work to be performed by a DBE without seeking prior approval.”

Upon project completion, Colorado applies a total earnings amount to determine whether a contractor met its contract goal. CDOT may reduce final payment to the Contractor if the Contractor has failed to fulfill the commitments or made good faith efforts to meet the contract goal. CDOT will not release retainage until it determines “whether the Contractor will be subject to a payment reduction” for failing to achieve the contract goal.

3. **Florida:**

The Florida Standard Specifications for Road and Bridge Construction obligate the contractor to “carry out applicable requirements of 49 C.F.R. Part 26 in the award and administration of DOT-assisted Contracts.” A contractor who fails to do so is in material breach of its contract with the Florida Department of Transportation (FDOT), which can trigger the following penalties:

- Contract termination;
- Withholding of monthly progress payments;
• Assessment of sanctions;
• Assessment of liquidated damages; and/or
• Disqualification of the Contractor from future bidding as a non-responsible bidder.\textsuperscript{72}

The FDOT Equal Opportunity Construction Compliance manual specifies two sanctions for noncompliance with DBE requirements:

• Withholding of monthly progress estimates: FDOT can withhold the entire then-pending monthly progress estimate, as well as subsequent estimates, until the contractor complies with DBE requirements, at which time the estimates are released; and
• Issuance of a Performance Deficiency Warning and Notice Letters: Once a letter is issued, it becomes part of the contractor’s FDOT Performance Rating, which can adversely affect the contractor’s Past Performance Rating on future procurements. Unlike the withholding of monthly progress estimates—the effect of which ends when the contractor comes into compliance and the estimates are released for payment, once a Performance Deficiency letter is issued, the damage to the contractor is done.\textsuperscript{73}

In addition to these penalties, FDOT has resorted to public shaming to encourage compliance with DBE requirements. The Contractor and Consultant Grading System assigns a letter grade (A+ through F) to contractors based on anticipated DBE participation. The list of grades is publicly available.\textsuperscript{74}
4. **New York:**

Upon a contractor’s noncompliance with DBE utilization goals on a New York State Department of Transportation (NYSDOT) contract, NYSDOT can assess the following penalties:

- Suspend contract payments;\(^{75}\)
- Make the contractor attend a hearing before the Contract Review Unit;
- Cancel, terminate, or suspend the contract, in whole or in part;\(^{76}\)
- Impose “any other lawful procedure upon due notice in writing to the Contractor”; and
- Refer the contractor to USDOT for possible suspension or debarment and such other sanctions as authorized under 49 C.F.R. Part 26.\(^{77}\)

Additionally, if a contractor fails to comply with **MWBE** requirements, NYSDOT can impose liquidated damages equal to the “difference between the amount committed to MWBEs by the Contractor at award; and the amount actually paid to MWBEs for work performed or materials supplied under the Contract, not including any amount for work deleted by the Department.” If liquidated damages are imposed, they must be paid within sixty (60) days of assessment, unless the contractor challenges the assessment prior to then. NYSDOT also can file a complaint with the NYS Department of Economic Development, Division of Minority and Women's Business Development, for MWBE violations.\(^{78}\)

5. **Texas:**

The Texas DOT (TxDOT) will initiate administrative actions against a prime contractor who does not comply with DBE requirements, including the following:

- Withholding all or a percentage of monthly partial payments;
- Liquidated damages;
• Initiation of appropriate suspension or debarment or decertification proceedings;
• Termination of the contract;
• Referral of any unlawful actions to the appropriate enforcement agencies; and
• Other actions as appropriate.79

“A Contractor’s failure to comply with DBE requirements “will constitute a material
breach of [its] Contract” with TxDOT. “In such a case, the Department reserves the right to
terminate the Contract; to deduct the amount of DBE goal not accomplished by DBEs from the
money due or to become due the Contractor; or to secure a refund, not as a penalty but as
liquidated damages, to the Department or such other remedy or remedies as the Department
deems appropriate.”80

6. Virginia:

A contractor performing work for the Virginia Department of Transportation (VDOT)
who fails to meet required DBE participation goals at project completion “may be enjoined from
bidding as a prime Contractor, or participating as a subcontractor on VDOT projects for a period
of 90 days.”81 The ban can be extended to the contractor’s “prime contractual affiliates,” for
example, in the case of a joint venture.82

Prior to being enjoined, the contractor can submit to the State Construction Engineer
information regarding the contractor’s efforts to comply with the DBE goals.83 However, in this
submission to the State Construction Engineer, the contractor must document that “all feasible
means have been used to obtain the required participation.”84 The requirement to use “all feasible
means” appears to be a higher standard than mere “good faith efforts” required by 49 C.F.R. §
26.53.
VDOT can withhold payment of monthly progress estimates based on the contractor’s failure to submit required DBE-related documentation.\textsuperscript{85}

A contractor’s failure to carry out the requirements of 49 C.F.R. Part 26 “is a material breach of [the] contract,” which can result in contract termination “or other such remedy, as VDOT deems appropriate.” All administrative remedies provided in Section 107.15 are “automatic unless the Contractor exercises the right of appeal within the [specified] timeframe(s).”\textsuperscript{86}

“VDOT has the authority and discretion to determine the extent to which the DBE contract requirements have not been met, and will assess against the contractor any remedies available at law or provided in the contract in the event of such a contract breach.”\textsuperscript{87}

Although most state departments of transportation impose penalties for noncompliance with 49 C.F.R. Part 26, none appear to penalize a contractor for merely failing to meet the contract DBE goal. As long as contractors can demonstrate sufficient documented good faith efforts to achieve DBE compliance, they can in most cases avoid adverse consequences.

\textbf{IV. Conclusion}

Unsurprisingly, contractors who intentionally try to defraud federal and state DBE requirements face severe consequences. Often overlooked, however, are the potential penalties well-intended contractors face for inadvertent DBE noncompliance. Significant risk for this type of noncompliance arises where a DBE subcontractor is terminated post-award for non-performance.

Accordingly, contractors performing transportation work subject to 49 C.F.R. Part 26 should consider the following to maintain DBE compliance in the post-award phase:
• At the outset, the contractor should understand the extent of its obligations to replace DBEs following contract award. If a DBE is terminated or drops out after award, is the contractor required to use good faith efforts, or something more (e.g., VDOT’s “all feasible means” standard)?

• If the contractor has a non-performing DBE subcontractor, it should start early to identify potential replacements;

• The contractor should determine whether it is required to obtain the owner’s permission prior to terminating a non-performing DBE subcontractor;

• The contractor should consult with the owner’s DBE Program Office for assistance in locating potential replacement DBEs;

• Industry trade associations also can assist the contractor to identify potential replacement DBE subcontractors;

• The contractor should ensure that the potential replacement DBE subcontractors it solicits perform the same type of work as the scope of the subcontract being terminated: solicitations to DBEs who perform different types of work do not count toward the contractor’s good faith efforts;

• The contractor should record all contacts (including required follow-ups) it makes with potential replacement DBEs; and

• For any potential replacement DBE with whom a subcontract is not executed, the contractor should document all reasons why it decided not to subcontract with that potential replacement DBE subcontractor.
Contractors who follow these steps increase the likelihood they will be found to have engaged in good faith efforts under 49 C.F.R. § 26.53, and thus be able to demonstrate their compliance with 49 C.F.R. Part 26.

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1 I would like to express my gratitude for the research assistance summer associate Daniel L. Stephens provided for this paper.


3 *Id.* at §§ 26.3(a), 26.21(a).

4 *Id.* at § 26.3(c).

5 *Id.* at § 26.21(c).

6 FHWA Civil Rights Memo, Subject: “Lease or Use of Prime Contractor’s Equipment by DBE Firms” (June 28, 2005).

7 Because each state’s DOT is tasked with administering the DBE program, most opinions evaluating CUF come from the state courts. Federal court guidance comes mostly from criminal cases wherein a contractor or subcontractor has been charged with egregious failures to perform a CUF in the form of sham DBE schemes set up to defraud the government. *See infra* the *Schuylkill Products* cases (*U.S. v. Nagle, U.S. v. Fink, and U.S. v. Campbell*).


9 *Id.* at § 26.55(c)(2).

10 *Id.* at § 26.55(c)(3).

11 *Id.* at § 26.55(d) addresses the commercially useful function standard in the trucking industry.

12 *Id.* at § 26.55(e) provides guidelines for determining commercially useful function for manufacturers and dealers.


14 FHWA Tips on Evaluating a Commercially Useful Function, p. 3.

15 *Id.* at p. 4.

16 Leasing of specialized equipment is permitted under circumstances generally recognized in the industry and only pursuant to a formal lease agreement. Absent special advance permission from the owner/agency, the DBE may not lease equipment—even specialized equipment—from the prime contractor. *Id.* at p. 5.

17 FHWA Civil Rights Memo, June 28, 2005, Subject: “Lease or Use of Prime Contractor’s Equipment by DBE Firms.”

18 49 C.F.R. § 26.55(c)(1).


20 803 F.3d 167 (3d Cir. 2015)


Act against the non-DBEs, DBE, and their principles.

23 Id. at *2.

24 Nagle, 803 F.3d at 172.


26 Id. at 746.

27 Id. at 746-47.

28 579 F.3d 1282 (11th Cir. 2009)

29 Id. at 1292, 1300.

30 Id. at 1291.

31 Id. at 1293.

32 Id. at 1307.


34 Id. at *6.

35 Id.


38 529 A.2d at 60, 108 Pa. Cmwlth. at 27.


43 741 P.2d at 37, 108 Wash. 2d at 602.

44 741 P.2d at 36-37, 108 Wash. 2d at 601.

45 Id.

46 741 P.2d at 37, 108 Wash. 2d at 601.


48 Id. at *4 (citing Cal. Mil. & Vet. Code § 999(b)(5)(B) and Cal. Code Regs., tit. 2, § 1896.61, subd.(l)).

49 Note that after C.C. Myers was decided, Cal. Mil. & Vet. Code § 999(b)(5)(B)(i) was amended to add a requirement that the disadvantaged person or entity “is responsible, with respect to products, inventories, materials, and supplies required for the contract, for negotiating price, determining quality and quantity, ordering, installing, if applicable, and making payment,” with regard to establishing CUF status. See also Cal. Code Regs. tit. 2, § 1896.71.

50 2011 WL 3506179 at *4.

51 Id. at *6; see also Niles Freeman Equipment v. Joseph, 161 Cal. App. 4th 765, 773 (finding entity having no distinct employees, work force, materials, or facilities performed no CUF within the meaning in Cal. Mil. & Vet. Code § 999(b)(5)(B)); Envirotech, Inc. v. Thomas, 259 S.W.3d 577, 583 (Mo. App. 2008) (in business tort case, referencing finding by Missouri Department of Transportation that subject DBE performed no CUF where it “never performed any work on the project” and another contractor performed the work DBE was contracted to perform).

52 49 C.F.R. § 26.13(b).

53 See id. at § 26.53.
(the following is a list of types of actions which you should consider as part of the bidder’s good faith efforts to obtain DBE participation” (emphasis added)).

Id. at A.IV.E.2.


Id. FHWA also recommends looking for “[A] large number of DBE bids and a good variety of work to be performed by them.” However, this factor is relevant only during the pre-bid phase. Id.

Id.

49 C.F.R. § 26.13(b)


Caltrans DBE Program Plan, Part II FHWA DBE Program Plan Section I.F, pp. 35-36, Administrative Remedies for noncompliance §26.53(f)(3).


Caltrans Construction Manual § 3-507C (5c), After the Violation Hearing (July 2017).

Id. at § 8-305A, Final Report, Use of Disadvantaged Business Enterprises or Disabled Veteran Business Enterprises (July 2017).


DBE Standard Special Provision, DBE Requirements (Local Agency), § 1: Overview (January 20, 2017).

Id. at § 8: Ongoing Oversight of DBE Participation.

Id. at § 3: Definitions, (C)(1).

Id. at § 1.

Id. at § 10: Payment Reduction.


Id.


NYSDOT Standard Contract Agreement, Article 8, No Payment on Contractor’s Non-Compliance.

Id. at Article 11, Right to Suspend Work and Cancel Contract.


NYSDOT Standard Specifications § 105-21 Civil Rights Monitoring, D.3 Contractor Compliance (May 1, 2018).

TxDOT Prime Contractor’s DBE Guide, Chapter 19 – Enforcement, Section 1 (July 2017).

TxDOT Special Provision 000-394, Disadvantaged Business Enterprise in Federal-Aid Contracts, § 2.3.12: Failure to Comply.

82 Id.
83 Id. at (C)(1).
84 VDOT Road and Bridge Specifications, Special Provision for § 107.15(G), *Documentation and Administrative Reconsideration of Good Faith Efforts, Project Completion* (2016) (emphasis added).
85 Id. at § 107.15(J), *Verification of DBE Participation and Imposed Damages.*
86 Id. at § 107.15(P), *Summary of Remedies for Non-Compliance with DBE Program Requirements,* (1) Disadvantaged Business Enterprise (DBE) Program Requirements.
87 Id. at (2) DBE Program-Related Certifications Made by Bidders\Contractors.