The Subcontracting Game:
From Flirting with Disaster to Happy Marriages on Public Projects

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Setting Up For A Successful Project: Subcontractor Bidding Issues

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I. INTRODUCTION.

Unlike private construction projects, public works projects generally must be competitively bid, allowing all qualified contractors the opportunity to submit a bid and secure the contract. The competitive bidding process traditionally involves public advertisement for the submission of sealed bids, the public opening of bids, and the award of contracts to the lowest responsible bidder that is responsive to the solicitation for bids.\(^1\) In their bids, bidders may be required to list subcontractors to which they commit work on the project if the bidder is awarded the contract. For example, many jurisdictions have outreach and listing requirements for socially disadvantaged business enterprises, such as local businesses, woman- or minority-owned businesses, or disabled veteran business enterprises, or for small businesses. When federal funding is involved, outreach to minority- or woman-owned disadvantaged business enterprises, which by definition must be small businesses, may be required, even absent a state or local law requiring such outreach. Other jurisdictions, such as California, require bidders to list subcontractors that the contractor will use for work above a threshold dollar value. Where subcontractor listing is required, bidders often are required to use listed subcontractors unless limited, specified grounds for substitution exist.

Bidders that are required to list and use subcontractors have additional pre-bid responsibilities at a time when they are rushed to complete a bid and minimize the price. At a minimum, bidders should verify that selected subcontractors are properly licensed and have the skill and experience to perform the work. In addition, contracts that have a goal for a specified percentage participation by disadvantaged businesses may require bidder

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\(^1\) Alternatives to competitive bidding exist, such as design-build, which do not require award to the lowest bidder. This article does not address such alternatives.
outreach to establish “good faith efforts” to involve such businesses if the goal is not met. These efforts must be documented, and extensive documentation may be required with, or shortly after, the bid is submitted. Moreover, the listed disadvantaged subcontractor often is required to perform a “commercially useful function” (“CUF”) to ensure that it is not merely an extra participant in the transaction, listed only for the appearance of actual participation. Bidders must do due diligence to confirm that the listed subcontractor can perform a CUF following award.

Even where outreach is not required, bidders must carefully review subcontractor bids where the bidder is bound to list and use subcontractors. Absent a teaming agreement to work exclusively with one bidder, subcontractor bids often are submitted only hours before the prime bid is due. Bidders then are rushed to review and compare all sub-bids in various trades and determine the most appropriate bid. Potential subcontractors will not necessarily bid the same scopes of work within one trade and may offer various options that change their pricing. Some subcontractors will exclude work from a scope that the bidder would expect to be included. In addition, the sub-bids may require the prime contractor to agree to terms in the sub-bid, often in fine print, which may differ from terms in the prime contract when awarded. For example, sub-bids may require payment by the prime contractor before the contractor is paid by the public owner. Critically, a sub-bid may provide that its pricing expires before the time that the public owner expects to award the contract. If a bidder does not identify such discrepancies during bidding, it may be bound to use a subcontractor at terms that are different from what the bidder expected.

This paper addresses common subcontractor outreach and listing requirements, as well as subcontractor bidding issues that arise during the pre-bid process that may have material implications on performance if not addressed prior to bidding.
II. SUBCONTRACTOR LISTING REQUIREMENTS.

A. Listing and Use of Disadvantaged Business Subcontractors.

1. Socially disadvantaged businesses

Whether under requirements on contracts that are federally funded or pursuant to state law, many states establish percentage participation goals for disadvantaged businesses to remedy past discrimination or to lower barriers to under-represented groups participating in construction. As noted in Washington regulations:

‘Socially disadvantaged individuals’ means those individuals who have been subjected to racial or ethnic prejudice or cultural bias, gender, disability, long-term residence in an isolated environment, or other similar causes negatively impacting entry into or advancement in the business world within American society because of their identities as members of groups and without regard to their individual qualities. Social disadvantage must stem from circumstances beyond their control.²

Programs supporting socially disadvantaged businesses frequently require contractors either to be a disadvantaged business or to commit to use disadvantaged businesses for a specified percentage of work. Bidders may have the option to establish “good faith efforts” to meet the goal percentage. Bidders who fail to meet the goal or establish good faith efforts generally are not eligible for the contract award. In addition, or in the alternative, some public entities provide pricing preferences to bidders who are, or commit to use, disadvantaged businesses in performing the contract.

Disadvantaged businesses frequently include businesses owned by minorities, women, or veterans (sometimes disabled veterans). Some public entities have preferences for businesses in economically undeveloped or underdeveloped areas. Local public entities, in particular, may award preferences to contractors that are or commit to use businesses located in the awarding entity’s jurisdiction. Although types of preferences and

² Wash. Admin. Code 326-02-030
details of their implementing statutes and regulations vary, certain principles are common. It is important for bidders, subcontractors, and awarding entities to be familiar with such requirements when bidding a public works project.

a. Federal DBE requirements.

Many state contracts involve funding provided by the federal government, in whole or in part, which may require the contractor to attempt to spend some portion of the contract funds on disadvantaged business enterprises (“DBE”). Even where federal funding is not involved, state programs may be modeled in whole or in part on the federal requirements. Familiarity with federal requirements is critical when approaching a contract with requirements for outreach to, and use of, socially disadvantaged businesses.

The federal Department of Transportation (“DOT”) provides substantial funds to states for constructing highway projects and has particularly well-developed DBE outreach requirements, as set forth in Title 49, part 26 of the Code of Federal Regulations. Under those regulations, DBEs are small businesses in which the majority owner is a socially or economically disadvantaged individual (or individuals), including racial minorities and women, with a personal net worth of $1.32 million or less. The socially disadvantaged owner must “control” the business, which includes controlling the board of directors or other governing body, holding the highest officer position, having experience in the specific field in which the business operates (not just general office experience), having the ability to hire and fire, and otherwise controlling daily operations. Under those requirements, DOT has a national goal of expending at least 10% of its funding on DBEs.

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3 49 C.F.R. § 26.5; see also id., § 26.67 (determining socially and economically disadvantaged individuals). Personal net worth excludes the person’s ownership interest in the DBE business and the person’s equity in their primary residence. Id., § 26.67(a)(2)(iii).

4 Id., § 26.71. The question of control is complicated, and beyond the scope of this paper. Perceived lack of control by the disadvantaged owner(s) often is grounds to challenge the business’ certification or claim to be disadvantaged.

5 Id., § 26.41.
States establish their own overall DBE outreach goals, which may exceed 10%. While DOT states a preference for meeting the participation goal using race- and gender-neutral means, a state may require use of non-neutral outreach techniques if it does not anticipate meeting its annual DBE participation goal using neutral means. Failing to implement permissible non-neutral outreach, when neutral outreach is not expected to meet the goal, arguably may result in withdrawal of federal funding.

Such non-neutral outreach requirements have been subject to constitutional challenge and must be carefully established and implemented. In fact, California banned outreach based on race and gender in public contracting, except where necessary to establish or maintain federal funding. However, at least the Seventh, Eighth, Ninth, and Tenth Circuits have “found the federal DBE program constitutional on its face.” In particular, DOT regulations prohibit use of quotas and generally prohibit set-aside contracts in attempting to meet the goal. To guard against constitutional challenge, DOT

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6 Id., §§ 26.41(a), 26.45.
7 Id., § 26.47.
8 “[A]ll racial classifications, imposed by whatever federal, state, or local governmental actor, must be analyzed by a reviewing court under strict scrutiny. In other words, such classifications are constitutional only if they are narrowly tailored measures that further compelling governmental interests.” Adarand Constructors, Inc. v. Pena, 515 U.S. 200, 227 (1995). “By requiring strict scrutiny of racial classifications, we require courts to make sure that a governmental classification based on race, which “so seldom provide[s] a relevant basis for disparate treatment,” [citation] is legitimate, before permitting unequal treatment based on race to proceed.” Id. at 228.
9 Cal. Const., Art. I, § 31. The Sacramento Municipal Utility District implemented an outreach program based on a study which established historical under-utilization of minority-owned businesses, claiming that its program was required to retain federal funding. C&C Construction, Inc. v. Sacramento Municipal Utility Dist., 122 Cal. App. 4th 284 (2004). In considering whether the program was lawful, the court found that SMUD needed to “have substantial evidence that it will lose federal funding if it does not use race-based measures.” Id. at 298. SMUD was also required to “narrowly tailor those measures to minimize race-based discrimination.” Id. Because SMUD did not present evidence that it would lose its federal funding if it did not continue its minority outreach program, the court invalidated the program.
10 Midwest Fence Corp. v. United States Dep’t of Transportation, 840 F.3d 932, 942 (7th Cir. 2016), cert. denied sub nom. Midwest Fence Corp. v. Dep’t of Transp., 137 S. Ct. 2292 (2017).
11 49 C.F.R. § 26.43.
regulations require states to comply with detailed steps in establishing their goals, including supporting goals in excess of participation expected from neutral outreach by research and studies reflecting actual identified discrimination against a group in the jurisdiction, which must include consultation with affected groups and publication of the proposed goal.12

In any procurement involving a federal DBE outreach goal, the public entity must award the contract to a bidder either meeting the goal or establishing good faith efforts (“GFE”) to meet the goal.13 In other words, the low bidder is not entitled to the contract award unless it meets the goal (by being a DBE or by subcontracting the goal percentage work to the DBE) or establishes GFE to meet the goal. All bidders must provide certain information about DBEs either with their bids or within five days after bid opening, as specified by the public entity.14 The required information includes 1) the names and addresses of the DBEs, 2) a description of the work they will perform, 3) the dollar amount of their participation, 4) documentation of the commitment to use the DBE, and 5) confirmation from the DBE that it is participating in the contract.15 At the same time, the bidder may submit documentation of its GFE if it has not met the goal, or if it wants to guard against the awarding entity disallowing anticipated DBE participation.16 That GFE documentation must include copies of each DBE and non-DBE quote for a scope of work where the bidder selects a non-DBE over a potential DBE subcontractor.17

The criteria for evaluating GFE require the bidder to establish that it “took all necessary and reasonable steps to achieve a DBE goal . . . which, by their scope, intensity, and appropriateness to the objective, could reasonably be expected to obtain sufficient DBE

14 Id.
15 Id.
16 Id.
17 Id.
participation . .”\(^\text{18}\) The public entity must “consider the quality, quantity, and intensity of the different kinds of efforts that the bidder has made,” and the efforts must be those that the public entity reasonably would expect a bidder to take when “actively and aggressively” trying to obtain enough DBE participation to meet the goal.\(^\text{19}\) Actions supporting GFE may include 1) conducting research to identify DBEs, 2) selecting appropriate portions of work for DBEs, including possibly breaking the work into smaller portions and not withholding work simply because the bidder prefers to perform the work itself, 3) soliciting DBE interest as early as practical, 4) providing interested DBEs with information and assistance, if necessary, 5) considering and/or negotiating with interested DBEs, and 6) not rejecting DBEs without “sound reasons.”\(^\text{20}\) Critically, “the fact that there may be some additional costs involved in finding and using DBEs is not in itself sufficient reason for a bidder’s failure to meet the contract DBE goal, as long as such costs are reasonable.”\(^\text{21}\) In determining whether GFE were established, the awarding public entity may consider the participation achieved by other bidders.\(^\text{22}\)

Once DBEs are identified for use on the contract, the contractor must not terminate the DBE without the public entity’s consent.\(^\text{23}\) “Termination” includes reducing a listed DBE’s work by performing work originally identified to a DBE with the contractor’s own forces or the forces of another subcontractor, even if the replacement is a DBE.\(^\text{24}\) Further, if the contractor improperly substitutes another entity for work for which a DBE was listed,

\(^{18}\) 49 C.F.R. Part 26, App. A.
\(^{19}\) Id.
\(^{20}\) Id.
\(^{21}\) Id. In other words, rejecting a DBE based solely on price, if its price is reasonable when compared to other bids, may result in the bidder being found not to have made a GFE.
\(^{22}\) Id.
\(^{23}\) 49 C.F.R. § 26.53(f).
\(^{24}\) Id.
the contractor is not entitled to payment for the work or material improperly supplied. A DBE may be terminated or substituted only for “good cause,” which includes 1) failing or refusing to execute a written contract, 2) failing or refusing to perform its work, 3) failing to meet reasonable bond requirements, 4) bankruptcy or insolvency, 5) being suspended or debarred, 6) being found not responsible, 7) voluntary withdrawal, 8) ineligibility to receive DBE credit for the work, 9) death or disability of the DBE owner, or 10) “[o]ther documented good cause.” Termination of a DBE requires notice to the DBE and an opportunity to object. Finally, even if termination of a listed DBE is approved, the contractor must make good faith efforts to find another DBE subcontractor to substitute.

These detailed federal requirements reflect substantial work required of bidders to identify, select, list, and use DBEs. Bidders that fail to invest sufficiently in required outreach may lose a contract to which they otherwise would be entitled for failing to meet a goal or establish GFE. Similarly, contractors that do not select DBEs carefully may be faced with time-consuming substitution hearings in the middle of the project. Contractors who disregard DBE use and substitution requirements do so at their own peril, facing denial of payment for the work, penalties, and potential contract termination, even if the awarding public entity is aware of the substitution and grounds for substitution would exist. Thus, all parties must be aware of DBE requirements, where applicable, and carefully comply.

b. State disadvantaged business programs.

Many states also have outreach requirements to disadvantaged businesses, some of which are similar to the DOT requirements. As with many other states, Illinois has adopted various procurement preferences “[t]o promote business and employment opportunities in

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25 Id.
26 Id.
27 Id.
28 Id., § 26.53(g).
Illinois.” On Illinois construction contracts, the state has an “aspirational goal” of awarding “not less than 20% of the total dollar amount of State construction contracts . . . to minority-owned and women-owned businesses.” Oregon may require participation from a “required participant,” including various disadvantaged business entities, and may award a public contract to a bidder that has “made good faith efforts to encourage required participants to participate in the public contract.” North Carolina has a 10% goal for participation by minority businesses on State building projects, permits use of GFE, and prohibits substitution of a listed business without good cause. In evaluating GFE, North Carolina established point values for each aspect of GFE, and bidders are required to meet a minimum score to be found to have established GFE. As another example, Rhode Island has a policy of supporting the participation of businesses owned by individuals with disabilities in state contracting. Some states include or permit set-aside programs to award a percentage of contracts to qualified disadvantaged business entities.

Although California prohibits preferences based on race or gender in public contracting (except where required to preserve federal funding), it does include obligations to secure participation from Disabled Veteran Business Enterprises (“DVBE”) in certain state or state-funded contracts, and requires contractors to use listed DVBEs. California originally permitted bidders to meet DVBE requirements through GFE similar to the

33 Id.; 1 N.C. Admin. Code 30I.0102.
35 See, e.g., N.J. Stat. Ann. § 40A:11-42 (authorizing the governing body of a county or municipality to adopt set aside programs, including for minority or woman business enterprises).

[00615894; 2]
federal requirements, but now has eliminated the GFE option for state contracting.\textsuperscript{37} One reason for eliminating GFE was the perception that bidders were making only \textit{pro forma} efforts without real efforts to involve DVBEs on contracts. On state contracts, bidders now must meet the stated DVBE goal, generally 3\%, to be eligible for award. In addition, California has a DVBE preference program, under which state entities may give price preferences to bidders that achieve specified levels of DVBE participation.\textsuperscript{38} Other states also have adopted veteran-owned business outreach or participation provisions.\textsuperscript{39}

Numerous other state statutes and local ordinances mandate some sort of outreach to or utilization of socially disadvantaged businesses. For example, in some states, a resident bidder may receive a preference over a non-resident bidder from a state that gives a preference to its own bidders, in the amount of the other state’s preference.\textsuperscript{40} This is not an uncommon provision to combat preferences adopted by other jurisdictions. Contractors must be aware of the requirements in any jurisdiction in which they bid. In particular, bidders must be familiar with the requirements (or ability) to establish GFE to avoid loss of a contract on which the bidder otherwise would be the low bidder.

Similarly, contractors must be aware of the obligation to use listed businesses.\textsuperscript{41} Improper substitution may carry substantial penalties. For example, Washington provides

\textsuperscript{37} Under California Education Code section 17076.11, certain school district projects impose a DVBE participation goal on the school district. Because the Education Code requirement is different from the state DVBE requirement, school districts may continue to award contracts where the bidder does not meet a goal but establishes GFE to meet the goal.

\textsuperscript{38} 2 Cal. Code Regs. §§ 1896.99.100, 1896.99.120.

\textsuperscript{39} See, e.g., 30 Ill. Comp. Stat. Ann. 500/45-57 (providing for a goal of at least 3\% of the total dollar amount of State contracts to be awarded to veteran and disabled veteran owned small businesses); N.J. Stat. Ann. § 40A:11-42 (authorizing governing body of a county or city to adopt a veteran business enterprise set-aside program); 37 R.I. Gen. Laws Ann. § 37-14.3-4 (3\% goal for veteran-owned small business enterprises to participate in state procurements).

\textsuperscript{40} See, e.g., 30 Ill. Comp. Stat. Ann. 500/45-10; Md. Code Regs. 21.05.01.04.

\textsuperscript{41} See, e.g., Md. Code Ann., State Fin. & Proc. § 14-302 (prohibiting a contractor from terminating the subcontract of a listed minority business enterprise subcontractor “without showing good cause and obtaining the prior written consent of the minority business enterprise liaison and approval of the head of the unit”).
for withholding payment until a violation is remedied, debarment for up to three years, suspension or termination of a contract, suspension or decertification of the disadvantaged business, and/or civil penalties up to $5,000 per violation or 10% of the amount of the contract.\textsuperscript{42} As with federal DBE requirements, failing to carefully select disadvantaged subcontractors under state requirements may result in substantial delays or disruption of the contract from a difficult subcontractor or penalties from an unauthorized substitution.

2. **Small businesses.**

In addition to outreach to, or preferences for, socially disadvantaged businesses (which also may have to be small, by definition), states may grant preferences for use of small business subcontractors regardless of whether the business is owned and controlled by a socially disadvantaged individual.\textsuperscript{43} California Government Code section 14836 states the reasons for California’s small business preference, which includes common justifications for such programs:

(a) The Legislature hereby declares that it serves a public purpose, and it is of benefit to the state, to promote and facilitate the fullest possible participation by all citizens in the affairs of the State of California in every possible way. It is also essential that opportunity is provided for full participation in our free enterprise system by small business enterprises.

(b) Further, it is the declared policy of the Legislature that the state should aid, counsel, assist, and protect, to the maximum extent possible, the interests of small business concerns, including microbusinesses, in order to preserve free competitive enterprise and to ensure that a fair proportion of the total purchases and contracts or subcontracts for property and services for the state be placed with these enterprises.\textsuperscript{44}

\begin{footnotesize}
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\item \textsuperscript{42} Wash. Admin. Code 326-02-050.
\item \textsuperscript{43} See Cal. Gov’t Code § 14838(b).
\item \textsuperscript{44} Cal. Gov’t Code § 14836; see also 15 U.S.C. § 631 (similar declaration by the federal government of the policy of aiding small business).
\end{itemize}
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The definition of a small business varies across states. In California, a small business is independently owned and operated, not dominant in its field, with its principal office in California, whose officers live in California, that (including affiliates) has up to 100 employees, and that has average annual gross receipts capped at $15 million over the previous three years.\(^45\) A “microbusiness” is similarly defined, but originally had a capped average annual gross receipts of $2.5 million over three years; that cap has increased to $3.5 million.\(^46\) Beginning in 2019, California implements a higher cap—an average of $36 million in gross receipts over the prior three years—for purposes of public works contracts.\(^47\) Iowa small businesses are smaller. They also must be located in the state, and must be for profit and operated under a single management, but the business must have under 20 employees and average annual gross income over the past three years of under $4 million.\(^48\) In Illinois, a small business must be independently owned and operated, not dominant in its field, with a capped number of employees (depending on the field) and, for construction, with a cap on “annual sales and receipts” of $14 million.\(^49\)

California offers a 5% preference to a small business bidder, or to a non-small business that subcontracts at least 25% of the work to a small business.\(^50\) The preference is capped at $50,000 for contracts awarded to the low bidder.\(^51\) For a contract awarded to the low bidder, the preference is calculated by taking 5% of the lowest responsive bid submitted by a responsible bidder that is not a small business and subtracting the amount, up to $50,000, from the bid of any bidder entitled to the preference.\(^52\)

\(^{45}\) Cal. Gov’t Code § 14837. The cap originally was $10 million.
\(^{46}\) Id. The threshold increases to $5 million in 2019. Id.
\(^{47}\) Id.
\(^{48}\) Iowa Code Ann. § 15.102.
\(^{52}\) 2 Cal. Code Regs. § 1896.8.
Maryland, in comparison, offers a preference of up to 8%, determined by industry, including up to 5% for small businesses plus either 2% for veteran-owned small businesses or 3% for disabled veteran owned small businesses.\(^{53}\) The preference amount is calculated and applied similar to how California applies its preference, without the dollar cap.\(^{54}\)

As another example, every agency, department, commission, or other governing body in Iowa with purchasing authority must set an annual small business procurement goal for purchases of goods and services, including construction, supplied by Iowa small businesses, which goal must exceed the goal from the previous fiscal year.\(^{55}\) Community colleges, area education agencies, and school districts must have a small business procurement goal of at least 10% of the value of anticipated procurements, including construction.\(^{56}\)

Another way small business goals may be implemented is to set aside certain smaller procurements for award to a small business (or other disadvantaged business entity).\(^{57}\) California has such a provision.\(^{58}\) In using that authority, the state agency must obtain two or more written bid submissions from small businesses, microbusinesses, or DVBEs, for projects valued up to a specified dollar threshold which increases over time.\(^{59}\) New Jersey also authorizes the governing body of a county or city to “establish a qualified small business enterprise set-aside program.”\(^{60}\) In Illinois, each chief procurement officer may


\(^{54}\) Id.

\(^{55}\) Iowa Code Ann. § 73.16. The procurement goal excludes utility services. Id.

\(^{56}\) Id. The procurement goal also excludes utility services. Id.

\(^{57}\) See, e.g., Iowa Code Ann. § 314.14 (authorizing set aside contracts for bidding by prequalified small businesses of up to 10% per year of the total dollar amount of highway construction contracts let by the department); La. Stat. Ann. § 38:2233.1 (allowing school boards to set aside up to 10% of the value of procurements, including construction, for awarding to small businesses).

\(^{58}\) Cal. Gov’t Code § 14838.7.

\(^{59}\) Id. For 2018 and 2019, that dollar threshold is $314,000.

designate a “fair proportion” of contracts for Illinois small business set-asides, including contracts for construction.\textsuperscript{61} For construction, the “fair proportion” for Illinois agencies must be between 25\% and 40\%.\textsuperscript{62}

Just as with socially disadvantaged businesses, bidders generally must use small businesses to perform work for which they were listed, unless grounds for substitution exist. For example, in California, if a non-small business is awarded a contract based on applying the small business preference, then the contractor must use the small businesses listed in its bid, or request substitution for one of limited grounds.\textsuperscript{63} If a contractor requests substitution, then it must replace the original small business with another small business, or explain its attempts to do so and justify why it was unable to do so.\textsuperscript{64} Similarly, for Texas Department of Transportation contracts, the contractor may not substitute or terminate a listed small business subcontractor except for good cause and with the prior written consent of the department, following notice to the listed subcontractor.\textsuperscript{65} Again, the contractor must attempt to replace the listed subcontractor with another small business.\textsuperscript{66}

Use of small business subcontractors may give a bidder a significant advantage in securing the award of a valuable public contract. However, contractors must be aware of the requirements to use such listed subcontractors, and the penalties for failing to do so. Further, bidders must verify that the selected business remains small, as established and well-known small businesses may gain sufficient work to exceed the small business size limitations. In particular, claiming small business preference using businesses that no longer qualify may give rise to a protest, and may result in loss of a contract.

\textsuperscript{62} Id.
\textsuperscript{63} 2 Cal. Code Regs. § 1896.10.
\textsuperscript{64} Id.
\textsuperscript{66} Id.
3. **Requirement to perform a “commercially useful function.”**

Given past abuses of preference programs, public entities commonly require that the disadvantaged business perform a “commercially useful function” for the contractor to receive a preference or credit. In general, a business performs a CUF if it 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 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.

(V) Is not further subcontracting a portion of the work that is greater than that expected to be subcontracted by normal industry practices.  

A subcontractor or supplier generally will not be considered to perform a CUF if its role is “limited to that of an extra participant in a transaction” through which funds are passed for the appearance of actual disadvantaged business participation.  

Washington considers,  

67 Cal. Mil. & Vet. Code § 999(b)(5)(B)(i) (DVBEs); Cal. Gov’t Code § 14837(d)(A) (small businesses); see also 49 C.F.R. § 26.55(c) (also directing that an evaluating agency consider “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”); 2 Cal. Code Regs. §§ 1896.4 (h), 1896.62(l); 15 Cal. Code Regs. § 3476(b); D.C. Code Ann. § 2-218.02; Miss. Code. Ann. § 57-69-3 (CUF “means being responsible for execution of a contract or a distinct element of the work under a contract by actually performing, managing, and supervising the work”); Ohio Admin. Code 123:2-16-15; Wash. Admin. Code 326-02-045 (considering whether the business will execute “a distinct element of work” and whether the principals or employees “actually perform, manage, and supervise the work”).

68 See 49 C.F.R. § 26.55(c) (also directing that an evaluating agency “must examine similar transactions, particularly those in which DBEs do not participate”); Cal. Mil. & Vet. Code § 999(b)(5)(B)(ii); Cal. Gov’t Code § 14837(d)(B).
among other factors, “[w]hether the business could be considered a conduit, front, or pass-through.” A federal DOT regulation contains a guideline not reflected in California. That regulation provides for a rebuttable presumption that a DBE that “does not perform or exercise responsibility for at least 30 percent of the total cost of its contract with its own work force” is not performing a CUF.

More specific DOT guidance relates to the use of either trucking companies or material suppliers. A trucking company must 1) manage and supervise all trucking for which it is responsible, and 2) own and operate at least one truck on the contract. The regulation further limits the amount of trucking that can be counted towards the goal when trucking is further subcontracted or trucks are leased. With respect to materials, the credit available depends on whether the disadvantaged business is a manufacturer, “regular dealer,” or broker. On many contracts, contractors seek DBE credit for 60% of the cost of the materials purchased from a materials supplier acting as a “regular dealer.” To be a regular dealer, the DBE generally must own or operate a store or warehouse stocking materials “of the general character described by the specifications” and sell the materials to the public in the usual course of business. If the materials are bulk items such as petroleum products or aggregate, then the DBE need not keep the materials in stock if the DBE “both owns and operates distribution equipment for the products.” If the DBE material supplier is not a manufacturer and does not meet the definition of a regular dealer, then it may be a broker, entitled only to credit for its commission.

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70 49 C.F.R. § 26.55(c)(3)-(4); see also Proposed Suspension of Mainelli (Hugo R.), Brown (Mariano J., Brenda Francis), Aetna Bridge Holding Co., B&F Excavating, Inc., DOTCAB No. 12, 1985 WL 17691 at *41-*44 (July 22, 1985) (upholding a finding that a joint venture that had entered into a “labor agreement” to obtain its workforce from another entity was performing a “commercially useful function”).
73 Id. If the equipment is leased, it must be on a long-term lease. Id.
74 Id., § 26.55(e)(3).
States may have other restrictions on specific types of disadvantaged businesses. For materials brokers, Washington permits the greater of the fee charged or 20% of the dollar value of expenditures.\(^{75}\) Unlike the DOT, Washington permits regular dealers of materials to claim 100% of the dollar value of the materials.\(^{76}\) With respect to bonds or insurance required for the contract, Washington gives credit for the fee charged for providing the bonds or insurance.\(^{77}\) For travel agencies or businesses performing similar functions, Washington gives credit for 20% of the expenditures.\(^{78}\)

CUF is evaluated at least twice over the course of the contract. First, the public entity must evaluate whether listed disadvantaged business subcontractors will perform, or are capable of performing, a CUF in fulfilling the portion of work for which they have been identified. This analysis is performed prior to contract award, often using information supplied by the bidder, and sometimes the listed subcontractor, at or just after the time of bidding. If the evaluating public entity finds that a listed subcontractor cannot perform a CUF, then it will disqualify the subcontractor for disadvantaged business credit. The bidder may or may not be required to use the listed subcontractor on the contract, depending on whether the jurisdiction protects the right of a listed subcontractor to the work for which it was listed. Critically, disqualifying a listed disadvantaged subcontractor may disqualify the bidder from award of the contract. For example, if the bidder did not document good faith efforts to meet a goal, believing the goal to have been met, then its bid may be rejected. Or, where meeting the goal is a condition of award, rejection of a disadvantaged subcontractor may make the bid non-responsive and unavailable for award.\(^{79}\)

\(^{75}\) Wash. Admin. Code 326-30-051.

\(^{76}\) Id.

\(^{77}\) Id.

\(^{78}\) Id.

\(^{79}\) Even if meeting the goal is not required, some public entities will find a bid non-responsive if a disadvantaged subcontractor is rejected. However, the issue should be evaluated as a question of responsibility—whether the bidder knew that the subcontractor would not qualify and listed it anyway, showing lack of trustworthiness or care—instead of responsiveness.
In an unreported case analyzing a claimed CUF of a material supplier, a California court addressed whether the California Department of Transportation ("CalTrans") properly found that a bidder’s listed DVBE did not perform a CUF.\textsuperscript{80} The low bidder listed a DVBE to furnish aggregate base in the amount of $185,010, of which $52,597 was allocated for trucking.\textsuperscript{81} CalTrans determined that the DVBE would not provide a CUF as an aggregate base supplier because it did not own or lease the trucks that would deliver the aggregate base, so could not transport, supervise or manage that portion of the project.\textsuperscript{82} As a result, CalTrans found the DVBE was an extra participant in the purchase and delivery of material and denied the DVBE credit.\textsuperscript{83} On appeal after denial of a writ of mandate, the court found that CalTrans’ decision was supported by substantial evidence.

CalTrans apparently found that the DVBE did not perform a distinct element of the work with respect to aggregate base because it did not perform trucking of the aggregate. CalTrans concluded that the DVBE could not actually perform, manage, or supervise the trucking because it neither owned nor leased trucks to haul the aggregate base. CalTrans also concluded that transporting aggregate base was not normal for the DVBE’s business. CalTrans found that the DVBE was subcontracting trucking. However, the court did not address, and it is unclear whether CalTrans considered, whether normal industry practices would involve subcontracting delivery of the aggregate base. Finally, CalTrans concluded that, because the DVBE obtained the aggregate from another supplier, who arranged for the trucking, the DVBE’s role was simply as an “extra participant in the transaction.”\textsuperscript{84}

\textsuperscript{81} Id. at *2.
\textsuperscript{82} Id. If the DVBE had been subject to DOT regulations, it would not have been entitled to credit because it did not own and operate aggregate distribution equipment. 49 C.F.R. §26.55(e)(2)(ii).
\textsuperscript{83} C.C. Myers, 2011 WL 3506179 at *2.
\textsuperscript{84} Id. at *4.
The CalTrans analysis demonstrates how application of the CUF criteria may be unpredictable. Further, the awarding public entity may be familiar with a listed subcontractor through other bidders and contracts and may have informally concluded that the business cannot perform a CUF. Where meeting a goal is required, or where the bidder has not submitted GFE documentation, a determination like that by CalTrans in the case discussed above may result in the loss of the contract.

The second time that CUF is evaluated is during the subcontractor’s performance. Even if a subcontractor can perform a CUF, it may not actually do so. For example, the subcontractor may not perform, manage, or supervise the work involved, even if it is capable of doing so. The subcontractor may subcontract work to a non-disadvantaged business, partially or entirely eliminating credit. A trucking subcontractor may have over-committed to contracts based on the number of trucks it owns and operates, and may subcontract too much trucking to non-disadvantaged owner-operators. A disadvantaged business claiming to be a regular dealer may not actually offer the materials for sale to the public, undermining its regular dealer status.

One critical issue that may arise, particularly with materials suppliers of bulk items, is a demand by a lower-tier supplier to be paid by a joint check written to the supplier and disadvantaged dealer of the materials. Federal regulations do not prohibit such joint checks. As the DOT explains in its Official Questions and Answers regarding DBE regulations:

[DOT] understands that prime contractors, subcontractors and suppliers may wish to use joint check arrangements for a variety of legitimate reasons, such as assuring that timely payment will be made for the supplier’s items or dealing with situations in which it is difficult for a subcontractor to obtain bonding at a competitive rate. Consequently, recipients and UCPs should not assume that the use of joint checks is illegitimate.85

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That same guidance recognizes that use of a joint check may raise questions about whether the DBE purchased materials with its own funds. The DOT considers accounts receivable from the prime contractor to be the DBE’s own funds. Accordingly, a joint check may be payment with the DBE’s funds if the DBE was in control of the check and determined when to endorse the check and provide it to the supplier, absent evidence to the contrary. However, states may prohibit use of joint checks or require the contractor to receive state authorization before paying by joint check. Contractors must be aware of joint check limitations before paying by joint check to avoid undermining claimed DBE participation.

In short, the contractor must take reasonable steps to monitor how the work is being performed to protect against later claims that the subcontractor failed to perform a CUF. Of course, a tension exists in supervising a subcontractor. If a contractor is overly involved in the disadvantaged subcontractor’s business, then—in addition to raising its own costs—it risks a conclusion that the subcontractor did not supervise its own work. However, a contractor that trusts entirely in its disadvantaged subcontractor’s knowledge of the CUF requirements and commitment to abide by those obligations may find itself with a shortfall between claimed disadvantaged business credit and actual credit achieved. Because state programs must include monitoring and enforcement to ensure that DBEs perform the work committed to them, including legal and contractual remedies for failure to comply with federal regulations, a shortfall in participation may result in substantial penalties to the contractor. In particular, failure to comply with requirements of the DOT regulations is deemed a material breach of the contract, and (depending on remedies the state adopts) may result in contract termination, withholding progress payments, sanctions, liquidated damages, or finding the contractor not responsible for future bidding.

86 Id. at 43–44.
87 Id. at 44.
89 Id., § 26.13.
It likely is not sufficient for a bidder to select a certified DBE or other disadvantaged business as a subcontractor. The bidder should verify that the subcontractor actually has performed the type of work for which it is listed, or is capable of performing the work. The bidder should verify that the subcontractor understands requirements to perform a CUF, and that it has the resources to perform a CUF on the contract. Further, even if the awarding public entity finds that the subcontractor can perform a CUF, the contractor must reasonably monitor that performance to avoid loss of credit in how the work is performed. These obligations add cost and risk to the contractor that must be considered in bidding on any public contract.

B. General Subcontractor Listing and Substitution.

In California, the Subletting and Subcontracting Fair Practices Act (“Act”) requires bidders to list each subcontractor that will perform contract work valued in excess of one-half of one percent of the prime contractor’s total bid. For each subcontractor, the bidder must list the subcontractor’s name, business location, and certain licensing information, and must uniquely identify the “portion” of the contract work to be performed by the subcontractor. If the bidder does not list a subcontractor for a portion of the work valued above the listing threshold, or if the bidder lists two subcontractors for the same portion of work, then the bidder must perform that scope of work itself. Not listing a subcontractor for a portion of work constitutes a representation that the prime contractor is qualified to

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91 Id.
92 Id., § 4106. Bidders can list more than one subcontractor for the same type of work if they clearly identify that the listed subcontractor will not perform all of the work, such as by stating “partial” (which may be subject to challenge) or more specifically identifying the scope. Subcontractors may further subcontract work, but the first tier subcontractor must be listed for the scope of work that it is subcontracting. The New Mexico Supreme Court considered whether a contractor could substitute itself for a listed subcontractor under a statute similar to California’s and concluded that such a substitution was unauthorized as inconsistent with the purpose of the New Mexico statute. *Romero Excavation & Trucking, Inc. v. Bradley Const., Inc.*, 121 N.M. 471, 475 (1996).

[00615894; 2]
perform that scope of work.\textsuperscript{93} Other states have similar subcontractor listing requirements, and some provide that failure to comply with the subcontractor listing requirements render the bid non-responsive and unavailable for award.\textsuperscript{94}

After bid acceptance, the Act requires the contractor to use its listed subcontractors unless grounds for substitution exist.\textsuperscript{95} The contractor must use the listed subcontractor not because a contract is formed by listing the subcontractor, but because the statute requires the listed subcontractor to be used. “The Act thus binds a contractor to its listed subcontractors, even though the parties have not yet entered into a contractual relationship.”\textsuperscript{96}

In states that do not require subcontractors to be listed, the mere listing of the subcontractor generally will not bind the bidder to use the listed subcontractor if it is awarded the contract.\textsuperscript{97} As one court explained:

The use of Fisher’s [the subcontractor’s] bid proposal by Galway in its general contractor’s bid and the subsequent acceptance by the Authority of Galway’s bid did not amount to Galway’s or the Authority’s acceptance of Fisher’s bid. A contract is only formed when an offer is accepted, and this record is void of any evidence that Galway or the Authority conveyed to Fisher an acceptance of its offer.\textsuperscript{98}

\textsuperscript{97} See, e.g., \textit{Finney Co. v. Monarch Const. Co.}, 670 S.W.2d 857, 859 (Ky. 1984), stating:

The basic question confronting this court is whether the incorporation of the name and amount of bid of a subcontractor by a general or prime contractor in its bid to the owner constitutes an acceptance which would create a contractual relationship between the general contractor and the subcontractor should the general contractor become the successful bidder. Our answer is that in the absence of a contrary statute, it does not.

Another court clearly explained that the nature of the bidding process was one reason not to bind bidders to use their listed subcontractors, stating:

Typically, subcontractors submit their bids only a few hours before the general bid must be submitted to the awarding authority. The general’s representatives take the bids over the telephone and hurriedly compile their own bid. This period of time is hectic and complex. The bids received consist of the contract price and a listing of work included. Specifics are left for future negotiation and clarification.

The last-minute procedure is designed to prevent bid-shopping. This court has recognized the undesirable nature of bid-shopping, [citation], and the last-minute bidding process seems well entrenched in the construction industry. [citation]

The bidding process puts the subcontractor and the general in very different positions as to the content of the subcontract. The subcontractors have the luxury of preparing their bids on their own timetable, subject only to the deadline for submitting their bids to the general contractors. The same bid goes to all the general contractors and covers the same work. The generals, on the other hand, are dealing with all the various construction aspects of the project and with numerous potential subcontractors. They compile their bids, as the various subcontractor bids are received, within a few hours of the deadline for submission of the prime bid. Specifics are necessarily given less than thorough consideration and are left for future negotiations. Finally, the lowest dollar amount bidder is not always the one chosen to do the work or the one listed as the potential subcontractor. Reliability, quality of work, and capability to handle the job are all considerations weighed by the general in choosing subcontractors. MBE regulations requiring an effort to use a percentage of minority contractors are another potential consideration.

Binding general contractors to subcontractors because a particular bid was listed in the general bid or was utilized in making the bid would remove a considerable degree of needed flexibility.99

Notwithstanding the circumstances described by the Minnesota court, California elected to combat bid shopping and bid peddling by requiring use of listed subcontractors unless grounds for substitution exist. In Washington, substitution is prohibited if it is “in furtherance of bid shopping or bid peddling,” and the originally-listed subcontractor may recover monetary damages from the prime contractor, but not the public entity. “Bid shopping” is the use of one subcontractor’s bid to coerce lower bids from other subcontractors after a contract has been awarded to the prime bidder. “Bid peddling” involves efforts by a subcontractor to undercut the price of a successful subcontractor after the prime contract has been awarded. These practices often result in poor quality of material and workmanship to the detriment of the public and may lead to insolvencies, loss of wages to employees, and other “evils.” The California Act, and similar acts, are designed to protect the public entity, the subcontractors, and the public.

Under the California Act, grounds for substitution include, among others, a subcontractor’s 1) refusal to execute a contract for the scope of work for which it was listed, 2) insolvency, 3) refusal to perform its subcontract, 4) failure to provide a required bond, 5) inadvertent listing in the bid, 6) failure to be licensed, 7) unsatisfactory work or delay to the project work (as found by the public entity), 8) ineligibility under the Labor Code, and 9) lack of responsibility (as found by the public entity). Other states list similar grounds, and may include others, such as when the bidder can establish that the subcontractor’s bid is incomplete or when selection of bid alternates supports substitution. In California,
substitution for inadvertently listing the wrong subcontractor requires the bidder to notify the public entity in writing within two working days after the bid opening, and to file affidavits establishing that the subcontractor was listed as the result of an inadvertent clerical error.\(^\text{107}\) This circumstance may arise where the bidder decides to use a different subcontractor just before bidding, but fails to document the change in its subcontractor listing. In any proposed substitution under the California Act, the listed subcontractor has the opportunity to object, and the public entity must hold a hearing on the substitution if the listed subcontractor objects.\(^\text{108}\)

States that include subcontractor listing laws have an added layer of protection for subcontractors, which increases the consequences to the bidder of a hasty listing. Even where grounds for substitution exist, the delay required for a substitution hearing regarding a non-performing subcontractor may impact the project significantly. For example, in one California project in which the author was involved, the contractor requested substitution based on non-performance of a subcontractor who eventually walked off the job and declared bankruptcy. The prime contractor notified the public entity, who acknowledged the issue, directed the contractor to do what was necessary to keep the project on schedule, and recommended a replacement subcontractor. However, the contractor was penalized for an unlawful substitution when it brought in the recommended new subcontractor to cover work that the listed subcontractor failed to perform, including after it walked off the job, because the new subcontractor began work prior to the prime contractor completing the substitution process. The contractor was penalized notwithstanding California caselaw that recognizes that a contractor need not be penalized where it substantially complies with substitution requirements and where the purposes of the Act are not violated.\(^\text{109}\)


\(^{108}\) Id.; id., § 4107.

\(^{109}\) Titan Elec. Corp. v. Los Angeles Unified Sch. Dist., 160 Cal. App. 4th 188, 205 (2008) (concluding that “nothing in the statutory language purports to invalidate an awarding authority’s consent to substitution simply because a prime contractor has . . . allow[ed] a subcontract to be
III. TEAMING AGREEMENTS.

One way to combat last-minute submission of subcontractor bids is for the bidder to enter into a “teaming agreement” with a subcontractor. A teaming agreement is an agreement between one or more contractors to act together for purposes of pursuing and performing a contract. Typically, teaming agreements are entered into between a prime contractor and one or more subcontractors to increase cooperation prior to bidding and, thus, competitiveness of the bid. Such agreements are more common where the work requires specialized expertise or equipment held by limited subcontractors, or where the size of the job requires that large portions of work be subcontracted, sometimes to a contractor that may more commonly bid as a prime contractor. In such circumstances, bidders gain assistance in compiling a bid and assurance that they have sufficient resources to construct a project if awarded the contract. Teaming agreements that commit the parties to work only with each other may give a bidder a competitive advantage if it enters an agreement with a particularly desirable subcontractor. In jurisdictions that do not require bidders to list and use subcontractors, teaming agreements give subcontractors assurance that they will be used on a project without facing bid shopping or bid peddling after prime contract award. Such an assurance encourages a subcontractor to dedicate its resources to successfully and carefully compiling a bid on a public contract.

While similar to a joint venture or partnership, a teaming agreement does not necessarily involve the creation of a legal entity made up of the teaming members. Rather, a teaming agreement essentially is a contract between the teaming members to join forces, improve their collective ability to efficiently bid and perform construction services and, as a result, become more competitive and more successful at obtaining desirable government

performed by a replacement subcontractor without the prior consent of the awarding authority”). The court held that a post-substitution hearing will substantially comply with the statute “so long as the procedure used actually complies with the substance of the reasonable objectives of the statute: namely, the prevention of bid peddling and bid shopping after the award of a public works contract, and the providing of an opportunity to the awarding authority to investigate the proposed replacement subcontractor before consenting to substitution.” Id. at 193.
contracts. A teaming agreement frequently contemplates and/or commits that the parties will subcontract for a specified scope of work upon award of a specific contract. However, parties may enter into broader teaming agreements covering multiple projects, usually of a specified type and/or in a specific geographic area.

Like any contract, a teaming agreement must reflect agreement on the material terms to be enforceable. For example, where a teaming agreement lacked the material term of price, and the logistics of how any work would be done was to be left to subsequent negotiations, it was found to be unenforceable.\footnote{Syringa Networks, LLC v. Idaho Dep’t of Admin., 305 P.3d 499, 508 (Idaho 2013).} The agreement was unenforceable even though the purported subcontractor had provided a fixed price bid to the prime contractor that the prime contractor relied on in submitting its bid.\footnote{Id.} In another case, a teaming agreement that obligated the parties to negotiate in good faith regarding a subcontract if the bidder was awarded the prime contract did not obligate the parties to actually enter into the subcontract; it was an agreement to agree and could not compel execution of a subcontract.\footnote{Advance Telecom Process LLC v. DSFederal, Inc., 119 A.3d 175, 185-86 (Md. App. 2015).} Thus, while teaming agreements may be valuable tools to securing early and detailed involvement by potential subcontractors, they must carefully address the obligation to subcontract following award, or the purported subcontractor may offer its expertise without realizing the expected benefit.

IV. PRACTICAL CONSIDERATIONS.

A. The Subcontractor Bid That Does Not Match Expectations.

As noted above, subcontractor bids often are submitted only hours before the prime contract bid is due. In that time, the bidder must compile all sub-bids, compare them, and determine the sub-bids to select. Bid comparison is more difficult when subcontractors performing the same type of work do not bid on the same scope of work, such as where certain parts of the work are excluded or where options are provided for adding or
eliminating part of the quote. For example, some subcontractors will offer an option to purchase materials from a DBE with a specified added cost or will offer optional work, such as traffic control. In addition to comparing sub-bids, where subcontractor listing is required and bidders must use listed subcontractors, the bidder must do basic due diligence, such as confirming that the subcontractor is licensed, insured, and/or otherwise registered and qualified to bid. If the contract involves outreach requirements, then the bidder must verify that the subcontractor properly is claiming to be a disadvantaged (or other qualified) business and may need to determine whether the subcontractor can perform a CUF.

Bidders predictably make errors during bidding, sometimes listing subcontractors that they would not have selected with more time to consider the sub-bid. In one California case, a bid was rejected as non-responsive because the bidder listed an unlicensed subcontractor. Although an appellate court later reversed the rejection, finding that subcontractor licensing is a question of responsibility, not responsiveness, the contractor expended significant time and money challenging the rejection. Similarly, a bidder may list a DBE that appears, on its face, to comply with requirements for DBE credit. However, the subcontractor may not meet required standards, such as a supplier that appears to be a regular dealer but operates out of its house without delivery equipment and is deemed only a broker, or a trucking company that does not own sufficient trucks to meet the timing and demand of the contract. Or, the bidder may list an apparent small business subcontractor only to learn that the business exceeded revenue standards to qualify as small. Some due diligence can be conducted before bidding by discussions with potential subcontractors, but other subcontractors may submit unexpected and/or last-minute bids with little time for review. Being aware of areas of risk will help focus review of sub-bids in the short time available and minimize risk of listing a subcontractor that cannot perform as represented.

In addition to ensuring that the subcontractor is qualified, the bidder must verify that the sub-bid contains the expected terms. Many subcontractors will include terms in their sub-bids that they will require in any subcontract. Some of those terms are not necessarily consistent with the prime contract. For example, a subcontractor may require payment within 30 days after submitting an invoice, when the public entity may not pay for 45 days after receiving a progress payment application. Or, a subcontractor may require full payment within a specified time after completing its work, while the public entity may hold a percentage of billings as retention until completion of the entire job. As another example, the subcontractor may provide for arbitration, when the prime contract does not. Where the contractor is bound to use its listed subcontractor, such deviations in terms may lead to difficult negotiations following award or to the prime contractor bearing risk that it did not expect to bear. As a result, in bids where the bidder will be bound to use its listed subcontractors, the bidder must carefully review the sub-bid, particularly the fine print, and attempt to resolve any deviations between the sub-bid and prime contract prior to listing the subcontractor in the bid.

The bidder also must carefully examine the sub-bid to ensure that it includes all work expected, particularly where the bidder must list the subcontractor and use the subcontractor for the scope of work listed. In some cases, California bidders have listed a subcontractor to perform a scope of work that is not included in the sub-bid, or even expressly excluded from the sub-bid. If the bidder is awarded the contract, then it must use the listed subcontractor for the scope of work for which it was listed in the bid, even if the subcontractor’s bid did not cover that scope of work. A cooperative subcontractor will work with the prime contractor to cover the gap in the work, but negotiations over responsibility for the additional cost may be difficult. In the alternative, if the bidder notices the error immediately, it may be able to obtain substitution on the ground of an inadvertently listed subcontractor. However, even in those cases, the general contractor likely will be required to pay the added cost of the excluded work.
Another sub-bid concern is pricing expiration dates. Some subcontractors will provide that their pricing expires after a short period, such as 30 or 60 days, and the prime contract may not be awarded within that timeframe. Even where the prime contract is awarded before the sub-bid expires, if the contractor delays in presenting a subcontract, then the pricing on which the contractor relied may expire. A good argument exists, in such circumstances in California, that substitution is warranted if the subcontractor refuses to honor its original pricing. The contractor could argue that the subcontractor was failing or refusing to execute a written contract at the price specified in the subcontractor’s bid.\textsuperscript{114} However, the contractor will have to participate in the substitution process, which may delay its work, with no guarantee that substitution will be granted. In one such case in which the author was involved, a subcontractor insisted throughout the substitution process that the contractor must pay a much higher rate than the subcontractor’s bid price, and only agreed to honor its original price when it appeared to be losing at the substitution hearing. The contractor was required to use the listed subcontractor, following a significant delay and added costs of the hearing, with a less-than-ideal working relationship on the project.

For reasons such as these, many prime contractors prefer to work with known subcontractors with a history of performance. Working with known subcontractors is no guarantee against an inadvertent failure to timely renew a license or a public entity that has concluded that a subcontractor does not perform a CUF notwithstanding past performance. However, particularly when a teaming arrangement or longstanding business relationship is involved, working with known subcontractors may be the best way to minimize risks associated with listing and being obligated to use specified subcontractors.

\textbf{B. DBE Challenges.}

Use of DBEs creates additional subcontracting concerns. As discussed above, when DBE or other disadvantaged business outreach is required, the bidder must spend additional

time and resources identifying and reaching out to potential DBE subcontractors. The bidder may be required to document such outreach efforts with its bid or shortly thereafter, particularly if the bidder can satisfy the requirement by establishing GFE.

The awarding public entity will review the documentation to determine whether the bidder has met a stated goal and, if applicable, whether the bidder has established GFE to meet the goal. In some cases, the public entity may request further information from the listed DBE itself to evaluate whether the DBE is capable of performing the work and/or a CUF. The public entity may find that a listed DBE cannot receive credit and/or perform a CUF because the DBE is not certified under the proper North American Industry Classification System (“NAICS”) code for the work for which it is listed. This may disqualify a DBE even if it has the necessary experience and resources to perform the work. CalTrans also requires DBEs to be listed under “work category codes,” which differ from NAICS codes required by federal regulation for certification. In some awards, DBEs have been disqualified by CalTrans because they did not self-identify as qualified under the work category code that CalTrans deemed applicable to the work. Public entities may have greater familiarity with local DBEs than the bidder and may be aware of (actual or perceived) grounds to disqualify an apparently-qualified DBE.

Even if the public entity accepts the DBE participation, other bidders likely will review the documentation closely as a key basis for protest. Bidders may challenge the calculation of DBE percentage participation, such as claiming that a DBE inappropriately was listed as a “regular dealer” of materials when it will be only a broker. Bidders may claim that a listed DBE will not perform a CUF, often based on their past experience with the DBE or past determinations of the awarding public entity or another public entity. Bidders also may claim that the DBE impermissibly will further subcontract work, which

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115 CalTrans periodically requests such information, particularly when verifying that a trucking company has sufficient trucks to meet workload requirements, or when verifying that a bulk materials supplier can meet the definition of a regular dealer.
may reduce the participation that can be claimed for the listed DBE.\textsuperscript{116} Of course, errors in the listing, such as not including the subcontractor’s license number or dollar amount of work or omitting other required information, may be grounds to protest. Similarly, a miscalculation of the percentage participation may be the basis for a protest for failing to meet the goal.

Even if some participation is eliminated or reduced through protest or awarding entity review, the bidder still may be entitled to award if GFE are permitted. For this reason, bidders always should submit GFE documentation, where available, to guard against unexpected loss or reduction of DBE participation. However, challenges to GFE are another common protest ground. Such challenges frequently compare the bidder’s efforts and/or achieved participation with the efforts and participation claimed by other bidders. For example, a protestant may claim that a bidder could have achieved the goal if it had solicited more DBEs, solicited for more categories of work, advertised earlier, or followed up further with those DBEs that it identified. While public entities generally do not change a determination that efforts documented reflected GFE, such challenges cannot be disregarded, particularly if they raise facts unknown to, or not appreciated by, the public entity when evaluating GFE.

After contract award, contractors must continue to be cognizant of DBE participation, particularly ensuring that listed DBEs perform a CUF, as discussed above. Critically, DBE participation may fall below the amount anticipated in the bid for reasons beyond the reasonable control of the contractor. During performance, a listed DBE may lose its certification. Federal regulations provide that the dollar value of work performed after a DBE has ceased to be certified does not count toward a goal.\textsuperscript{117} If a DBE is not

\textsuperscript{116} See 49 C.F.R. § 26.55 (requiring that, when a DBE subcontracts part of its work to another firm, “the value of the subcontracted work may be counted toward DBE goals only if the DBE’s subcontractor is itself a DBE”).

\textsuperscript{117} 49 C.F.R. § 26.55(g).
performing and is substituted, then the contractor must seek to replace the listed DBE with another DBE. If it is unable to do so, then participation may fall below the amount claimed in the bid. As another example, for bids based on estimated quantities, the actual quantities may vary, particularly if a change order is issued. Again, variance in quantities may affect DBE participation percentages. Finally, the DBE’s own actions, as discussed above, may preclude finding that the DBE performed a CUF.

In any of these circumstances, the contractor’s actual DBE participation may fall below the amount stated in its bid. As noted above, failure to comply with requirements of the DOT regulations is deemed a material breach of the contract; depending on remedies the state adopts, such failure may result in contract termination, withholding progress payments, sanctions, liquidated damages, or finding the contractor not responsible for future bidding.\footnote{Id., § 26.13.} At least one public entity—CalTrans—has taken the position that failure to meet the DBE participation percentage stated in the bid is a material breach of contract. Moreover, CalTrans has claimed that missing the DBE participation percentage entitles CalTrans to withhold from the prime contractor 100% of the amount of the shortfall, regardless of the contractor’s culpability (or lack thereof) in the shortfall or the lack of a contract term or state statute or regulation providing for such a withhold. While that position should be overturned by courts, if not changed by CalTrans, contractors should be aware that failure to meet a represented DBE participation may subject them to serious penalties.

V. CONCLUSION.

Bidders on public contracts must be aware of the requirements for outreach to disadvantaged businesses, or preferences available from using disadvantaged businesses, to avoid losing a contract on a public works project to which they otherwise may have been entitled. Contractors also must be aware of requirements to use listed disadvantaged
businesses, and for those businesses to perform a real portion of the contract work, to avoid sometimes extreme penalties for unauthorized substitution or misrepresentation during the bidding process. Similarly, bidders must know whether a jurisdiction requires subcontractors to be listed, and if the contractor is required to use its listed subcontractors if awarded the contract. In such jurisdictions, an added level of care is necessary in reviewing and selecting subcontractor bids and listing selected subcontractors. By careful review of local requirements and of subcontractor bids, general contractors can be best prepared for successful contract and subcontract performance.