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DBE FRAUD AND THE COST OF NON-COMPLIANCE

The DBE Program has successfully provided disadvantaged businesses the opportunity to become involved in work that had been previously dominated by larger companies.¹ Unfortunately, the DBE Program has also been the subject of excessive fraud. The Inspector General for the DOT has stated that of its active procurement and grant fraud investigations, DBE cases represent 29 percent of the total investigations.²

I. DISADVANTAGED BUSINESS ENTERPRISE ("DBE") PROGRAM BACKGROUND

The Department of Transportation ("DOT") provides substantial funding to state and local governments and public transit and airport agencies each year for various highway, transit, and airport projects ("DOT grant recipients").³ The DOT therefore, has a shared responsibility to prevent discrimination in the competitive bidding processes held by the DOT grant recipients for DOT funded contracts. The DOT DBE Program created in 1980, and later codified by Congress in 1983 ("DBE statutory provision"), seeks to "level the playing field" for small businesses owned and controlled by socially and economically disadvantaged individuals competing for DOT fully or partially funded contracts.⁴ DBEs include companies owned by minorities ("MBE") and women ("WBE").⁵ The objectives of the current statute are intended to "ensure nondiscrimination in the award and administration of DOT assisted contracts," "help remove barriers to the participation of DBEs in DOT assisted contracts," and "promote the use of DBEs in all types of federally assisted contracts."⁶ The statute also explicitly aims to "provide appropriate flexibility to recipients of Federal financial assistance in establishing and providing opportunities for DBEs."⁷

1. This article focuses on the DOT DBE Program; however, there are other similar federal and state programs with the same stated purpose of providing a level playing field for disadvantaged businesses.
2. Office of Inspector Gen., Weaknesses In The Department's Disadvantaged Business Enterprise Program Limit Achievement Of Its Objectives (2013). <https://www.oig DOT gov/assetmgr/documentfile/1012>
3. The DOT's Fiscal Year 2016 budget is \$94.7 billion. Funding is distributed to state and local government and agencies such as the Federal Highway Administration ("FHWA"), the Federal Aviation Administration ("FAA") and the Federal Transit Administration ("FTA") to support federal and state infrastructure projects. Dept. of Transportation, Fiscal Year 2016 Budget Highlights (2016) <https://www.transportation.gov/mission/budget/fiscal-year-2016-budget-highlights>.
4. Following a series of Constitutional challenges and decisions regarding affirmative action based programs, specific provisions of the 1983 federal statute have been amended over the years. The final rule is Participation by Disadvantaged Business Enterprises in Department of Transportation Financial Assistance Programs, 49 C.F.R. § 26.
5. In order to qualify as a certified DBE, a company must be owned and operated by socially and economically disadvantaged individuals; be an independent business whose viability does not depend on its ties with another company; employ its own workforce; provide its own equipment for the job; and be able to meet financial regulations. 49 C.F.R. § 26.61-26.73. To be considered economically disadvantaged, individual owners of MBEs and WBEs cannot have a personal net worth that exceeds \$1.32 million. 49 C.F.R. § 23.35 and § 26.67. The firm's gross receipts must also meet Small Business Administration standards and the firm's average annual gross receipts in the previous three fiscal years must not exceed \$23.98 million. 49 C.F.R. § 26.65. Appeals are heard by the Office of Civil Rights.
6. 49 C.F.R. § 26.1.
7. Id.

The DBE Program requires that all DOT grant recipients establish goals for the overall participation of DBEs in the contracts they award (“DBE goal”).⁸ Throughout the year, recipients are then required to establish contract specific DBE participation contracting and subcontracting goals.⁹ DOT itself has established a national goal of 10% DBE participation – meaning that of the financial assistance granted to state and local governments and public transit and airport agencies, 10% is awarded to and subsequently completed by DBEs through the contract bidding process.¹⁰ DBE funding recipients are required to be certified as DBEs by participating in the Unified Certification Program.¹¹ For their part, DBEs must perform a “commercially useful function” – meaning the DBE must be responsible for the work of the contract, perform, manage, and supervise the work involved, and provide the supervision, labor, and equipment necessary to perform the work for to ensure the funds paid contribute toward the overall DBE goal.¹²

The DBE Program has the potential to benefit minority and women owned business immensely. For example, the new Tappan Zee Bridge project in New York, constructed by the New York State Thruway Authority, has a design-build budget of roughly \$3.142 billion.¹³ A 10% DBE goal was set for the project which means that if the goal is met, approximately \$314 million in contracts and subcontracts for this project will be awarded to DBEs. Tappan Zee Constructors, LLC, a consortium of firms, was awarded the main design-build contract and is responsible for making “good faith efforts” to achieve 10% DBE participation including the use of subcontractors.¹⁴

The DBE Program seeks to ensure that DBEs can compete fairly for DOT funded contracts, and it also contains enforcement tools to prevent exploitation and abuse. This article highlights various schemes known to have been employed during phases of DBE contract bidding and contract execution, including sham purchases by prime contractors of supplies and equipment from DBEs, using prime employees to complete DBE assigned work, and creating DBEs through straw owners to win contracts and meet DBE goals. These schemes have resulted in prison sentences, large fines, debarment from bidding

to or contracting with government agencies, and severe reputational damage. The absence of a compliance program that detects, deters, and remediates these schemes creates a large risk for construction companies using DBEs. As such, the authors provide some suggested best practices that compliance teams can incorporate to avoid DBE fraud.

II. DBE FRAUD ENFORCEMENT

A. *United States v. Elizabeth Perino*¹⁵

1. Background

Elizabeth Perino (“Perino”), owner of Perdel Contracting, a WBE-certified Company, was found guilty this year of charges related to a pass through scheme. Perino allowed a general contractor to claim her company as a subcontractor on various projects so the contractor could meet its 5% WBE requirement. Perino submitted fraudulent documents to the Chicago Transit Authority that concealed the fact that her company would **not** actually perform work on the projects. For example, Perino entered into a sham contract to purchase equipment from the general contractor and re-title the equipment in her name, and then sell the equipment back to the general contractor for a nominal amount after the work was complete. She also conspired with the general contractor to allow its employees to operate the equipment, but appear as if they were on her payroll.

A federal investigation was launched after one of Perino’s former project managers filed a lawsuit alleging the misconduct. On June 17th 2016, the District Court of the Northern District of Illinois found Perino guilty on three counts of wire fraud and one count of mail fraud. She is currently awaiting a sentencing hearing, but faces a maximum punishment of 80 years in prison.¹⁶

2. Best Practices

Compliance teams should periodically review WBE purchase invoices to make sure that prices are in

8. 49 C.F.R. § 26.45

9. DEPT. OF TRANSPORTATION, DBE PROGRAM OVERVIEW, <https://www.transportation.gov/civil-rights/disadvantaged-business-enterprise/dbe-program-overview> (last visited July 26, 2016).

10. 49 C.F.R. § 26.41.

11. 49 C.F.R. § 26.85

12. 49 C.F.R. § 26.55.

13. Press Release, New NY Bridge Project, New NY Bridge Project Demonstrates Commitment to Disadvantaged Business Enterprises New York and Hudson Valley Companies Play Major Role (Mar. 5, 2014).

14. *Id.*

15. *United States v. Elizabeth Perino*, 11-CR-492 (N.D. IL. 2016).

16. Press Release, U.S. Dept. of Justice, Jury Convicts Lockport Contractor of Defrauding City of Chicago’s

line with industry standards and fair market value. Compliance teams should also verify that the signage on equipment matches the supplier and speak to project managers to confirm the origin and description of the equipment.

B. *United States v. Kleinberg Electric Inc.*¹⁷

1. Background

Kleinberg Electric Inc. (“Kleinberg”) was hired as a subcontractor by the prime contractor of the federally funded project for the design and construction of the Fulton Street Transit Center Dey Street Concourse (the “Dey Street Project”). The Metropolitan Transit Authority (“MTA”) set the DBE participation goal for this project at 10%. Kleinberg informed the prime contractor that they planned to subcontract a portion of its contract to a DBE to help the prime contractor reach the 10% goal. In reality, Kleinberg planned to perform all the work themselves and pay the DBE a “commission.” Relying on representations by Kleinberg, the prime contractor submitted at least 34 requisitions to the MTA between September 2005 and April 2007. The prime contractor also made representations to the MTA, based on information from Kleinberg, that the DBE was performing legitimate work on the project, even though it was *not*.¹⁸

On June 12th 2013, Kleinberg settled with the U.S. Attorney for the Southern District of New York. Under the settlement, Kleinberg Electric admitted, acknowledged, and accepted responsibility for causing false certifications to be submitted to the MTA. Kleinberg agreed to pay \$936,000 in damages.

2. Best Practices

Subcontractor payment reviews can uncover illicit payments made by prime contractors to subcontractors, second tier subcontractors or DBEs. The review should look to identify red flags such as round dollar payments, unusually large or small payments based on the work performed, or payments that do *not* reflect retainage. Payments should also be compared to invoices submitted

by the subcontractors or DBE to determine if the underlying invoices support the payment. Invoices with high level descriptions or generic titles can be red flags. Duplicate, missing, or incomplete sets of supporting invoices can also be a red flag.

C. *United States v. Carol Sanzo*¹⁹

1. Background

Carol Sanzo (“Sanzo”) is the former owner of Sanzo Ltd., a broker and supplier of construction equipment. Sanzo Ltd. was certified as a DBE. Sanzo was accused of “routinely misus[ing] the DBE status of Sanzo, Ltd. to enrich herself and others through material misrepresentations designed to circumvent the DBE Program requirements.”²⁰ As part of a guilty plea, Sanzo admitted that in return for kickbacks, her company acted as a sham pass through used by other contractors to meet their required DBE goals. For example, Sanzo admitted that she allowed her company to be used as “pass through” on the Willis Avenue Bridge Project in New York. Between 2008 and 2011, her company purchased fuel from a non-DBE supplier and passed it along to the prime contractor. Sanzo submitted falsified documents to the Port Authority of New York and New Jersey and the DOT that falsely represented that the fuel was purchased directly from Sanzo Ltd.

On July 6th 2016, Sanzo pled guilty before the U.S. District Court for the District of New Jersey to one count of conspiracy to commit wire fraud. Her sentencing hearing is scheduled for October 18th, 2016. She faces a maximum penalty of 20 years in prison and a \$250,000 fine.²¹

2. Best Practices

One of the keys to an effective compliance program is having a strong whistleblower policy. A well communicated and confidential whistleblower policy will allow for employees to confidentially submit potential acts of fraud or misconduct. It will also protect the whistleblower from retaliation from the company or its employees.

17. *United States v. Kleinberg Electric Inc.*, 13 Civ. 3979, (S.D.N.Y. June 12, 2013).

18. Press Release, U.S. Dept. of Justice, Manhattan U.S. Attorney Files and Settles Civil Fraud Lawsuit against Subcontractor for Violating the Federal Disadvantaged Business Enterprise Regulations, (June 12, 2013).

19. *United States v. Carol Sanzo*, 2012R00826/ADL, (D. NJ July 6, 2016).

20. *Id.*

21. Press Release, U.S. Dept. of Justice, New Jersey Woman Admits Conspiracy To Circumvent Minority Owned Business Requirements For Federal Projects, (July 6, 2016).

D. *United States v. Yonkers Contracting, Inc.*²²

1. Background

Yonkers Contracting, Inc. (“Yonkers Contracting”) was part of a joint venture with another firm that obtained a contract from the New York State Department of Transportation (“NYS DOT”) to reconstruct part of the Cross Westchester Expressway.²³ The NYS DOT originally set a DBE goal of 10%, but lowered the goal to 8.03% after a proposal from the joint venture. Thereafter, the joint venture submitted the names of 15 DBEs slated to complete the work that in aggregate would satisfy the 8.03% DBE goal. Yonkers Contracting specifically claimed that a DBE called Global Marine Supply Co. was going to serve as a steel supplier. The DBE’s subcontract represented 31% of the 8.03% total DBE requirement for the project. Yonkers Contracting instead hired a non-DBE supplier to actually supply the steel for the project. Instead, Yonkers Contracting paid the DBE subcontractor a kickback to use its name as the supplier. Global Marine received invoices from the non-DBE supplier, copied them over adding a 1% mark-up, and then submitted the invoices to the joint venture. The Joint Venture regularly made submissions to the NYS DOT representing that steel purchases were made through the DBE.

On November 5th 2015, Yonkers Contracting settled a lawsuit with the U.S. Attorney for the Southern District of New York. Under the agreement, Yonkers Contracting admitted to violating DBE regulations and agreed to pay a fine of \$2.6 Million. They also entered a non-prosecution agreement with the United States Attorney’s Office. Yonkers Contracting agreed that, “it has instituted and will continue to maintain internal corporate remediation measures regarding Disadvantaged, Minority Owned, and Women Owned Business Enterprises (“D/M/WBEs”) for a period of two years, including: (1) creation and maintenance of a D/M/WBE Policy Manual and updated Code of Business Ethics for distribution to all employees; (2) implementation of an internal D/M/WBE training program for its employees; (3) creation and maintenance of a position focused on D/M/WBE issues; and (4)

development and implementation of a checklist for D/M/WBE compliance to be used on all projects.”²⁴

2. Best Practices

Conducting periodic supply chain testing will help identify potential areas of concern. This involves understanding what entities are involved and verifying that the supplies are being delivered and invoiced in a transparent manner. Supplies with inconsistent signage or altered signage would be a red flag.

E. *United States v. Larry Davis*²⁵

1. Background

Larry Davis (“Davis”), CEO of DCM Erectors Inc. (“DCM”), was awarded an approximately \$256 million trade contract for work to be performed on One World Trade Center in 2007, and another approximately \$330 million trade contract for work to be performed on the World Trade Center Port Authority Trans-Hudson (“PATH”) Transportation Hub in 2009. The contracts had a 17% DBE goal (12% MBE and 5% WBE). Davis “hired” Solera Construction Inc., a minority owned business that was established by Davis and DCM for the main purpose of satisfying the MBE requirements. Davis and DCM initiated a joint venture with Solera whereby DCM owned 60% of the joint venture and Solera owned 40%. DCM then represented to the Port Authority that Solera/DCM performed work on the One World Trade Center, when the work was actually performed by DCM itself. Davis also hired a WBE, GLS Enterprises Inc., to complete payroll management work. GLS Enterprises was owned by a former employee of DCM. GLS Enterprises’ only client was DCM. DCM was therefore, *not* independent as required and did *not* provide a commercially useful function. Davis put his company at risk by developing this DBE fraud scheme.

Davis was recently convicted of one count of wire fraud and one count of conspiracy to commit wire fraud in the U.S. District Court for the Southern District of New York for engaging in the DBE fraud scheme. Davis is scheduled to be sentenced later this year and could face up to 20 years in

22. *United States v. Yonkers Contracting*, 7:15 cv 08630, (S.D.N.Y. Nov. 5, 2015).

23. Press Release, U.S. Dept. of Justice, Manhattan U.S. Attorney Files and Settles Civil Fraud Lawsuit against Subcontractor for Violating the Federal Disadvantaged Business Enterprise Regulations, (June 12, 2013).

24. *United States v. Yonkers Contracting*, 7:15 cv 08630, (S.D.N.Y. Nov. 5, 2015).

25. *United States v. Larry Davis*, 14-mj-01687, (S.D.N.Y. July 31, 2014).

prison for each count.²⁶ Solera Construction, Inc. owner, Johnny Garcia, pled guilty for his role in the fraudulent scheme. He agreed to forfeit \$669,000 of the approximately \$2 million he was paid by DCM. GLS Enterprises owner, Gale D'Aloia, also pled guilty for her role in the scheme. She agreed to forfeit all of the approximately \$575,000 DCM paid GLS Enterprises.²⁷

2. Best Practices

Employee checks on job sites are often a good way to verify that work is being completed by the workers for whom the subcontract was awarded. Creating a record of the workers identified on-site will allow companies to identify non-approved or ghost workers. This information can be further analyzed by matching the employee checks with historical records such as certified payrolls and timesheets. A worker identified during the employee checks, but *not* identified in the payroll records or for the correct company would represent a red flag.

F. *United States v. Moretrench American Corporation*²⁸

1. Background

Moretrench American Corporation (“Moretrench”) was hired as a subcontractor for the World Trade Center Transportation Hub Project being constructed by the PANYNJ. Moretrench was required to make a good faith effort to reach a DBE goal of 17% participation. Moretrench hired Environmental Energy Associates (“EEA”) as a DBE subcontractor to operate the dewatering system for the project. The two companies had a fraudulent agreement in place where EEA would actually use Moretrench employees but submit payroll invoices for EEA employees. EEA received a markup on the payroll records as compensation. Moretrench then filed reports to the PANYNJ that falsely represented that they paid EEA for work on the project, when in fact, Moretrench completed the work themselves.

Moretrench settled with the U.S. Attorney for the Southern District of New York announced and agreed to pay \$3 million in fines and \$50,000 for investigative costs.²⁹

2. Best Practices

Keeping a database of all workers used on a project can identify workers being billed on incorrect payrolls. The database can be used to check if workers are appearing on payrolls for both the prime and DBE. The database can also identify other anomalies, such as different employees being listed at the same home address, Social Security Number, or employees being paid with unusual or non-existent fringe benefits.

G. *United States v. Nagle*³⁰

1. Background

Joseph W. Nagle (“Nagle”) and Ernest G. Fink (“Fink”) were co-owners of Schuylkill Products, Inc. (“SPI”), a company that manufactured concrete beams. Nagel and Fink set up a sham company, Marikina Construction Corp. (“Marikina”), with a sham owner, and had it certified as a DBE. Nagel and Fink then “subcontracted” work to Markina to meet DBE goals, but their employees actually performed all of the work. The sham owner of Markina was paid a small fixed fee by Nagel and Fink. This scheme ran from 1993 through 2008 and required numerous fraudulent actions to continue the sham. For instance, employees of SPI pretended to be Markina employees by using Marikina business cards, email addresses, and stationery. Markina magnetic placards and decals were also used to cover-up SDI logos on its equipment.³¹

Fink was sentenced to 51 months in prison and Nagel to 84 months. Fink and Nagel were ordered to pay fines of \$1,037,828.61 and \$850,931.20, respectively.³² The fines are equal to the amount of profit Fink and Nagel diverted from legitimate DBEs as a result of their scheme. Two other SPI executives were given two year prison terms

26. Press Release, U.S. Dept. of Justice, CEO Of Steel Contractor On World Trade Center Site Convicted At Trial Of Fraud In Connection With Program Designed To Encourage Participation Of Minority And Women-Owned Businesses, (August 10, 2016).

27. Press Release, U.S. Dept. of Justice, CEO Of Steel Contractor On World Trade Center Site Charged In Manhattan Federal Court with Fraud In Connection With Program Designed To Encourage Participation Of Minority And Women-Owned Businesses, (July 31, 2014).

28. *United States v. Moretrench American Corporation*, 14 Civ. 3250, (S.D.N.Y. May 12, 2014).

29. Press Release, U.S. Dept. of Justice, Manhattan U.S. Attorney Files And Settles Civil Fraud Lawsuit Against Subcontractor For Fraudulent Conduct That Violated Rules Designed To Encourage Participation Of Minority And Women-Owned Businesses, (May 13, 2014).

30. *United States v. Joseph W. Nagle*, 09-cr-00384-001, (M.D.PA July 26, 2013).

31. Press Release, U.S. Dept. of Justice, Former President and Owner of Schuylkill Products Sentenced in Largest Disadvantaged Business Enterprise Fraud in Nation's History, (June 30, 2014). *United States v. Joseph W. Nagle*, 09-cr-00384-001, (D. M.D.PA Nov. 30, 2015).

32. *United States v. Joseph W. Nagle*, 09-cr-00384-001, (D. M.D.PA Nov. 30, 2015).

and ordered to pay restitution. The former owner of Marikina, was sentenced to 33 months' imprisonment and also ordered to pay restitution.

2. Best Practices

Instilling a culture of compliance, which starts at the top from ownership and senior management throughout the company, that illegal and unethical behavior will **not** be tolerated is a key deterrent for employees and business partners looking to commit fraud against the government.

H. *United States ex rel. Parker v. TesTech et al*³³

1. Background

TesTech, a civil engineering firm, obtained certification as a DBE representing that its owner, Sherif Aziz, qualified under the program. TesTech obtained multiple contracts while representing itself as a DBE. TesTech, however, was actually owned by a group of companies known collectively as CESO, not Sherif Aziz. A former employee of TesTech brought the fraud to light through the filing of a whistleblower claim.

In June 2013, TesTech, Sherif Aziz, CESO, and its owners settled charges with the DOJ. In aggregate, the parties agreed to pay \$2,883,947. The whistleblower received \$562,370 of the settlement.³⁴

2. Best Practices

Performing due diligence and other compliance reviews on DBEs before they are awarded contracts is key to preventing and detecting DBE fraud.

III. BEST PRACTICES FOR ON-BOARDING DBES

As detailed above, there have been multiple abuses of the DBE Program that have resulted in individual and company prosecutions. These prosecutions are common for the Inspector General's office at the DOT and other federal, state and local agencies. The best way to avoid DBE abuse is to develop, implement and maintain a compliance program that is tailored to identify these risks and remediate potential red flags. The compliance program should also make sure to address risk from the time that the DBE relationship is created.

Understanding and documenting how the DBE and prime contractor relationship was created is an important step in approving the use of new DBEs. The following are questions that can help you address risk before the DBE is awarded a contract:

- A. Was there a transparent procurement of the DBE?
- B. Does the DBE have the expertise and personnel to perform the required work?
- C. Was the bidding for the DBE open to other DBEs?
- D. Does the DBE have other customers?

Another important step is performing due diligence on both the DBE and its executives to identify adverse information, including a search for previous convictions, violations, and debarment from working for any government agencies. Additional questions that can be addressed through due diligence include the following:

- A. Does the prime contractor and DBE have any previous business dealing together?
- B. Are there persons that are connected to both the prime contractor and DBE?
- C. Does the DBE have the proper DBE certifications to work on the contract?

Finally, it is important to have proper procedures for escalating potential compliance issues identified with a DBE. There needs to be proper channels of communication with senior management and government agencies to report these issues if and when they arise.

IV. CONCLUSION

The cost of DBE non-compliance is high and could severely damage company and professional reputations. A robust compliance program can help you address DBE issues, as well as other various acts of fraud, waste and abuse, before they escalate into an incident that is beyond repair.

ABOUT NAVIGANT

Navigant is a specialized consulting firm providing DBE compliance, integrity monitoring, investigative, operational, risk management and advisory services to government agencies, public authorities, corporations, legal counsel and other organizations. Our integrity monitoring and construction compliance personnel include former federal and state law enforcement agents and prosecutors; Certified Public Accountants; Certified Fraud Examiners; Professional Engineers; and specialists in computer forensics and data analytics.

33. *United States v. TesTech, Inc.*, No. 2:10-cv-01028, (S.D.O.H. June 11, 2013).

34. Press Release, U.S. Dept. of Justice, *TesTech and CesO Agree to Pay \$2.88 Billion to Resolve False Claims Act Allegations*, (June 6, 2013).