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THE IMPORTANCE OF EFFECTIVE SUBCONTRACTOR DUE DILIGENCE

By Joy Charles, M.S. Leadership & Business Ethics

Every Chief Executive Officer should periodically assess the veracity of information shared with clients about the effectiveness of subcontractor due diligence reviews by asking: "How is my organization ensuring that appropriate due diligence reviews are conducted?" When that client is a government agency, the question becomes more about ensuring that subcontractors meet the standards of responsibility as defined in procurement rules such as the Federal Acquisition Regulations Subpart 9.1. Of course, irrespective of whether the client is in the public or private sector, the bigger question should be: What is the organization doing to create and sustain a culture of compliance with all laws and regulations? A positive answer to this question is important to ensuring that organizations have the means to detect, prevent, and otherwise deter the possibility of fraud, waste, and abuse from infiltrating the organization. Effective due diligence aligned with corporate values should be the standard for how companies conduct business in the marketplace. But what exactly, you may ask, is due diligence, and why is it important?

Due Diligence

Due diligence in a business context speaks to an obligation to examine/investigate and otherwise assess the assets, business relationships, liabilities, net worth, reputation, business ethics and culture, leadership, industry standing, etc., of an entity in order to reach conclusions that may affect future decisions. Government agencies conduct due diligence assessments of prospective contractors as part of what is known as a "responsibility determination." In the world of government procurements, "due diligence" speaks to procedures, standards, practices, and/or policies considered in making a responsible determination about whether to award a contract/purchase



order to a particular competing business entity. Whether it is a small purchase or a mega contract, contracting agencies are required--by federal and state laws and/or regulations--to make determinations about contractors' responsibility. Conducting effective due diligence of one's own operations, as well as on any subcontractor to be proposed for a prospective subcontract award, could mean the difference between getting a new contract award or being deemed not responsible.

A responsibility determination is a review of a prospective awardee to shine a spotlight on the business' operations in the areas described below as the "Elements of Responsibility." In this type of review, the results are usually either positive, meaning the entity has been deemed responsible; or potentially negative, meaning there may be reason(s) to reach a determination of "not responsible." When a determination of not responsible is reached, the agency is compelled to deny the award, notwithstanding the price or overall proposal. Of course, in such cases, entities are given opportunities for due process, which could make a difference. Notwithstanding, while a deficiency in one area may not be enough to reach a determination of "not responsible," the decision is entirely up to the agency.

The dollars involved and the agency's risk assessment procedures determine the depth of the information dive and data collection activities. For example, a small purchase (less than \$15K in some cases) may require a different approach compared to one valued at 10 times greater. Regardless of the dollars involved, contractors bear the burden of convincing procurement officers/decision makers that they are responsible. In the final analysis, it is the picture painted by an aggregate assessment of the Elements of Responsibility that



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influence decisions reached regarding an entity's responsibility and thus, its capacity to receive new contract/purchase order awards.

Elements of Responsibility

- Integrity and Business Ethics
- Experience
- Technical Skills
- Facility
- Financial Capacity
- Operational Controls
- Safety Practices
- Quality Assurance
- Satisfactory Performance Record - Includes MWDBE compliance where applicable
- Equipment

Each element is important, and may also include an assessment of how a contractor's responsibility is affected by business relationships maintained as part of executing its work on prospective, current, or previous contracts. For example, if in order to perform the work proposed on a prospective contract, a prime contractor is relying on particular subcontractors (making them significant subcontractors), those subcontractors' capacities to be deemed responsible are considered in reaching a determination about the prime contractor.

In another example, the responsibility element of Satisfactory Performance includes an assessment of whether contractors met defined Minority/Women Disadvantaged Business Enterprise (M/WDBE) goals on previous contract awards. In such cases an assessment of, for example, DBE compliance, considers whether certified DBE subcontractors performing towards specified DBE goals performed commercially useful functions, a tenet of compliance outlined in the governing federal regulations. Overall M/WDBE compliance is critical to responsibility

determinations and should be the focus of all contractors for which government contracting is an important business sector. When a prospective awardee is deemed to be "responsible," it means that having reviewed the prospective awardee in the Elements of Responsibility, the procurement officer/decision maker is satisfied that the business is qualified, and eligible to receive an award under applicable laws and regulations governing the acquisition decision.

The Integrity and Business Ethics responsibility elements assess whether satisfactory records exist to confirm the ethics and integrity of the contractor under consideration for award. The presence of pending criminal charges or criminal convictions, or civil actions against the business, its affiliates, or any person related to the firm, are considered when assessing ethics and integrity of a business. Ethical behavior, whether by a corporate entity or an individual, embodies certain basic principles such as honesty, fairness, equitable behavior in all business practices, respect for the property and resources of others, and a commitment to be law-abiding citizens and to cooperate with all government investigations.

Why it's Important

Investing in effective due diligence reviews of each subcontractor before executing subcontracting agreements will provide the intelligence needed to spot risks associated with the elements of responsibility. Expecting subcontractors with inadequate resources, inadequate experience for the project at hand, or with criminal convictions in their history, to support projects without effective due diligence and a plan to remediate ethical or integrity breaches demonstrates poor judgment and weak project management controls; but there are more dangers involved. Sometimes the issues affecting subcontractors may be so severe

and central to their ability to continue existing work, that it may impede the prime's ability to move the project forward without compromising its own integrity. In such cases some project owners may even question the prime's business ethics, integrity, as well as its present responsibility. Weaknesses in subcontractor selection and oversight are areas that leave contractors--even those with the best of intentions--vulnerable to allegations of fraud, waste, and abuse. The irony in many cases is that effective due diligence on the front end of the subcontractor retention process could have provided enough early warning signs to avoid perilous consequences.

Engaging in fraud, waste, or abuse (whether it is in having subcontractors that do not provide commercially useful functions, or by some other means) has serious consequences. The company, its leadership, and employees that participate in any alleged schemes to defraud government contracts (whether it's by not performing a commercially useful function in such programs or some other means) could end up, as all should, in

serious trouble with the law. Federal charges may result from DBE fraud violations, while state charges may result from M/WBE fraud violations.

Even if the best legal team is retained and it manages to reach a civil settlement, agree to pay hefty fines, and engage an Integrity Monitor, the resultant cost could threaten the very existence of the company; leaving an indelible mark against its reputation, and possibly becoming an impediment to being deemed responsible for a future government contract award. In addition, this information may follow all involved parties for years, as its disclosure may be required in government qualification/responsibility documents with every bid or proposal going forward. Still, if all manage to be exonerated, they may want to ponder the question posed by a former U.S. Labor Secretary after being acquitted of fraud charges involving the construction industry; "...which office do I go to get my reputation back...?"

So, what should you do? Here are some suggestions to stay on the right side of the law:

1. Having an ethics program is good, but not good enough. Having an ethics program, about which all employees are continuously trained, with defined program procedures incorporated into the business practices and culture of the organization, should be the standard. You should strive for a best in class policy with documented proof of related training and testing to ensure compliance. If one is not in place, get started immediately on correcting that deficiency. If you already have an ethics program in place, assess compliance with its requirements. The compliance target should be 100 percent, and include top management.

- 2.** Effective due diligence reviews are critical to confirming the bona fides of all subcontractors, including those performing towards M/WDBE goals. Review of the DBE directory without assessing the responsibility of a subcontractor is not adequate due diligence.
- 3.** A robust due diligence process for all potential subcontractors will speak volumes about a company's commitment to being a responsible firm.
- 4.** Just as each company should do its due diligence homework before engaging subcontractors, so too, the government will perform due diligence reviews on each prospective awardee. A firm's reputation and future hangs on its due diligence practices.
- 5.** Every proposer or bidder should assess its public image to identify any negative information that may pose potential risks to its reputation.
- 6.** Be sure that selected subcontractors have the capacity and can actually provide the products or services required, particularly when M/WDBE goals are part of the equation.
- 7.** Remember, it is illegal to submit falsified reports and other business records to government agencies.
- 8.** M/WDBE participation should be continually tested throughout the life of the contract to ensure the program is compliant, but more importantly, that M/WDBE firms are getting a fair opportunity to participate in the marketplace.

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