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FOREFRONT

CAN OPPORTUNITY BE REGULATED?

Catching Scammers and Finding Solutions for Disadvantaged Businesses

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"Your foot hurt?" U.S. Rep. Tammy Duckworth asks with a straight face. "Your left foot?"

"Ah, yes ma'am," replies Braulio Castillo, the witness. He has been sworn in for a hearing of the U.S. House Oversight and Government Reform Committee. The committee is investigating the latest case of alleged abuse of a government set-aside program designed to help disadvantaged groups — from minorities to small-business owners to disabled veterans — land lucrative government contracts that typically go to big businesses owned by white men.

Castillo's firm, an IT company called Strong Castle, has done well by these programs, winning $50 million in IRS contracts, in large part owing to his certified status as a disabled veteran. Castillo's injury? A twisted ankle he received 27 years ago while attending a military prep school, a 12-month stint that represents Castillo's entire service record in the U.S. military.

Duckworth nods in mock concern. Then she attacks. "My feet hurt too. In fact, the balls of my feet burn continuously, and I feel like there is a nail being hammered into my right heel right now, so I can understand pain and suffering and how service connection can actually cause long-term, unremitting, unyielding, unstoppable pain." Left unspoken is the fact that Duckworth no longer has any feet. She lost both her legs in November 2004, when an Iraqi insurgent fired a rocket-propelled grenade at the helicopter she was piloting.

She leans forward and continues. "So I'm sorry that twisting your ankle in high school has now come back to hurt you in such a painful way, if also opportune for you to gain this status for your business as you were trying to compete for contracts."

Duckworth piles on. "Shame on you, Mr. Castillo. Shame on you. You may not have broken any laws… but you have broken the trust of this great nation."

The exchange went viral. It was picked up by the cable networks and political blogs across the spectrum, and understandably so. The case was clear-cut: A greedy businessman unscrupulously exploits a government program created to help people with real needs.

And yet, the real scandal is that Castillo's behavior is commonplace. At every level of government, programs designed to level the playing field for disadvantaged entrepreneurs — minorities, women and the disabled — have consistently fallen short of expectations and proven highly vulnerable to exploitation and fraud.

Nowhere is this clearer than in big cities, where investigations and indictments linked to contracting programs are depressingly routine.

In May, Philadelphia's inspector general identified 11 city contractors using a sham minority firm to pass work through to white-owned subcontractors. In New York, investigations into fraudulent hiring of minority- and women-owned subcontractors are so common that they have become something of a specialty for local prosecutors. The most recent instance was a $10 million settlement reached with Siemens Electrical.

The fraud in Chicago's programs has been so "broad and pervasive" in recent years that a grand jury was called in and the Inspector General was compelled to disqualify 65 firms from future business with the city, and strip another 20 of their bogus status as disadvantaged firms.

The story is much the same in Seattle, Dallas, Washington, D.C. and Bridgeport, all of which have endured high-profile minority contracting scandals in the last few years.

All of this may just scratch the surface of the fraud. A Next City analysis of Philadelphia's roster of certified minority- and female-owned firms finds that many appear to lack even the most basic evidence that they are in legitimate enterprises. Many lack phone numbers and web presences. Many more list residential addresses as their place of business. Others share addresses with white-owned firms, raising the specter that the firms are nothing more than pass-throughs.

Yet there is no disputing the need for greater equity in the awarding of publicly funded contracting dollars. Consider the case of Philadelphia: The most recent Census figures, from 2007, show that in the broad metro area, only about 17 percent of businesses were minority-owned, even though minorities accounted for nearly a third of the regional population.

The picture is even bleaker when considering employment levels. In 2007, there were just 74,000 workers in the entire Philly metro area working

Philadelphia Inspector General Amy Kurland works with a special unit to quash bogus contracting arrangements and deal with the perpetrators.

for minority-owned firms, compared to 2.5 million working for white and publicly owned companies.

The inequities become clearer still when the sales volume of regional firms is taken into account. Out of $723 billion in total sales, minority-owned businesses claimed just $14 billion, a paltry 1.9 percent, according to the Census data.

Nationally, the picture is almost as bad. The 12.6 percent unemployment rate for African Americans is nearly twice as high as the white unemployment rate. And according to the last business owner Census, in 2007, minority-owned firms accounted for only $1 trillion out of $30 trillion in total gross receipts, or about 3.33 percent.

It is just that kind of staggering inequality that led many U.S. cities to begin adopting minority contracting programs in the 1970s and 1980s that were intended to ensure that, at least when it comes to taxpayer dollars, disadvantaged business owners get something closer to a fair share.

In theory, this sounds like a good way to level the playing field for disadvantaged businesses. Government contracting can be very lucrative. The federal government paid out $517 billion to private companies for goods and services in 2012, about 14 percent of the total federal budget. State and municipal contract spending accounts for tens of billions more, though no reliable national tally is available.

The hope of affirmative action advocates is that, by getting a larger cut of government work, disadvantaged business owners could develop the capacity and cash reserves, as well as the experience and contacts, needed to compete more effectively in the private sector. These stronger firms would, in turn, lead to better job prospects and more opportunities for workers in disadvantaged communities.

Angela Dowd-Burton, executive director of Philadelphia's Office of Economic Opportunity, puts it succinctly. "These programs are designed to give minority- and women-owned businesses a chance to catch up."

Those chances, she said, won't come along often without government intervention. "If there is no compelling reason for big, established firms to partner with smaller disadvantaged companies, they won't do it," she said. "It's not in their best competitive interests to do it."

Outright discrimination is no doubt a problem, but perhaps a bigger competitive hurdle for minority-owned businesses are the networking advantages that longer-established white-owned companies enjoy. Not discrimination per se, but favored treatment by those in power — both in the public and private sectors — of friends and past associates. Recent research by Nancy DiTomaso, a Rutgers University management professor and author of The American Non-Dilemma: Racial Inequality Without Racism, shows that this effect is widespread in the job market.

"The whole point of my book and the work I've been doing is to focus in on how people help other people who are like themselves," DiTomaso said, "and in doing that they don't have to discriminate in order to continue the inequality."

In the past, before good government protections were enacted and minority inclusion programs rolled out, government contracting was rife with favoritism, DiTomaso said. "And there are lots of reasons to believe that people are still trying to get around those regulations and procedures, believing that the people they know are more competent or trustworthy, or they just want to do them a favor."

Indeed, culture is slow to change and programs have fallen far short of their ambitions in cities across the country. Many fail to meet their minority participation targets on a routine basis. Even when the benchmarks are met on paper, the overarching policy objective of stronger minority- and female-run firms often do not materialize.

Experts and practitioners blame poorly run city agencies, an old boy's club culture that reflexively freezes out female and minority run firms, and, importantly, extensive fraud and abuse.

In some cases, white men run the companies, but give titular ownership to their wives in order to qualify for the contracting programs. In others, shell subcontractors "owned" by minorities are used as pass-throughs, enabling big contractors to claim they have hired a disadvantaged business as a partner, when the real work and most of the money instead flow to yet another white-owned firm. In some cities, word goes out to contractors that the minority firm to hire is the one on good terms with a powerful councilmember or political boss.

That was the story in Philadelphia when a big firm, in this case Reading, Pa.-based UGI HVAC, won a big contract to perform the weatherization of low-income homes. Unable to find a minority-owned firm to work with — or perhaps unwilling to look for one — the company instead went to a white-owned subcontractor (William Betz Jr., Inc), who funneled the work through a sham minority company (JHS & Sons Supply) brought on board for a 3 percent take of the $1.85 million contract.

This time, however, the scammers were caught. In January 2012, Philadelphia Inspector General Amy Kurland banned Betz from doing business with the city for three years. UGI had to pay a $100,000 fine. It was not Kurland's only strike against bogus minority contracting arrangements — in the past two years, she has exposed fraud in city prison health care and caught food services giant Aramark lying about the amount of work it was contracting out to a minority subcontractor to meet regulations.

"We realized pretty fast that there were an awful lot of companies out there that either used sham minority enterprises or simply overstated the minority participation on their jobs," Kurland said.

Her office now has an investigative unit tasked with monitoring contract fraud. The unit has had some firms debarred — banned from city contract work —

> "If there is no compelling reason for big, established firms to partner with smaller disadvantaged companies, they won't do it. It's not in their best competitive interests to do it."

for a few years. Others have paid settlement fines and agreed to improve minority contracting performance in the future. Aramark and its minority subcontractor, for instance, paid a $400,000 fine and were forced to implement new compliance programs.

While the crackdown has only served to stabilize political support for affirmative action-based contracting in Philadelphia and most large Northeastern and Midwestern cities, Western and Southern cities have responded differently to endemic corruption, gradually mothballing affirmative action contracting programs. Even states as liberal as Massachusetts have shifted gears, moving to voluntary supplier diversity programs.

Yet Philadelphia's experience with these programs, from wretched failure in years past to guarded optimism today, offers some lessons for all these places struggling to develop systems that level the playing field without inviting abuse and fraud.

"We realized pretty fast that there were an awful lot of companies out there that either used sham minority enterprises or simply overstated the minority participation on their jobs."

For all the negative headlines, it is possible to view the nationwide spate of minority contracting scandals as a good thing: A sign that, at long last, cities are cleaning up dirty systems. "I think there was much more fraud 20 years ago then there is today," said Tim Lohrentz, director of the Inclusive Business Initiative at the Insight Center for Community Economic Development in Oakland. "We're seeing a lot more scrutiny now. Cities are tightening up their checks and balances, and you're seeing the results with these high-profile cases."

"MONEY CAN CONFUSE PEOPLE"

Ask Emmanuel Kelly if minority contracting programs can give disadvantaged firms a toehold in a competitive marketplace, and the answer is an emphatic "yes." Thirty-seven years ago, he co-founded Kelly/Maiello Architects, a Philadelphia firm whose work is now ubiquitous in the city, particularly in the public sector. Like a lot of minority-owned firms, Kelly/Maiello often serves as a subcontractor, handling, for instance, portions of the Philadelphia International Airport.

But unlike most minority-owned firms that regularly work on public sector projects, Kelly/Maiello has built the capacity and expertise to take on the lead role of prime contractor, heading up high-profile Philly jobs such as the President's House on Independence Mall and the interior renovation of the wildly popular Reading Terminal Market.

Kelly credits his firm's growth in significant part to minority contracting programs. "They have really helped us," he said. "It helped us in the early years to get started, they helped us establish our reputation for doing good work." Kelly, who has a master's degree in city planning and urban design from Harvard University, started his firm after 10 years working at construction companies and architecture shops in Boston and Philadelphia. He'd been around the block. Even so, at first Kelly found opportunities for work were few and far between.

"Typically people don't like to give work to people that they don't know, that they haven't worked with before," he said. "In the private sector, it's about relationships."

As an African-American proprietor of a start-up architecture firm in Philadelphia in the 1970s, Kelly lacked the relationships of his more established rivals. So the public sector work — and the minority contracting programs that began to accompany it in the 1980s — was essential. "That opened the doors for us," he said. "People got to know us, and then they were willing to engage us on future projects."

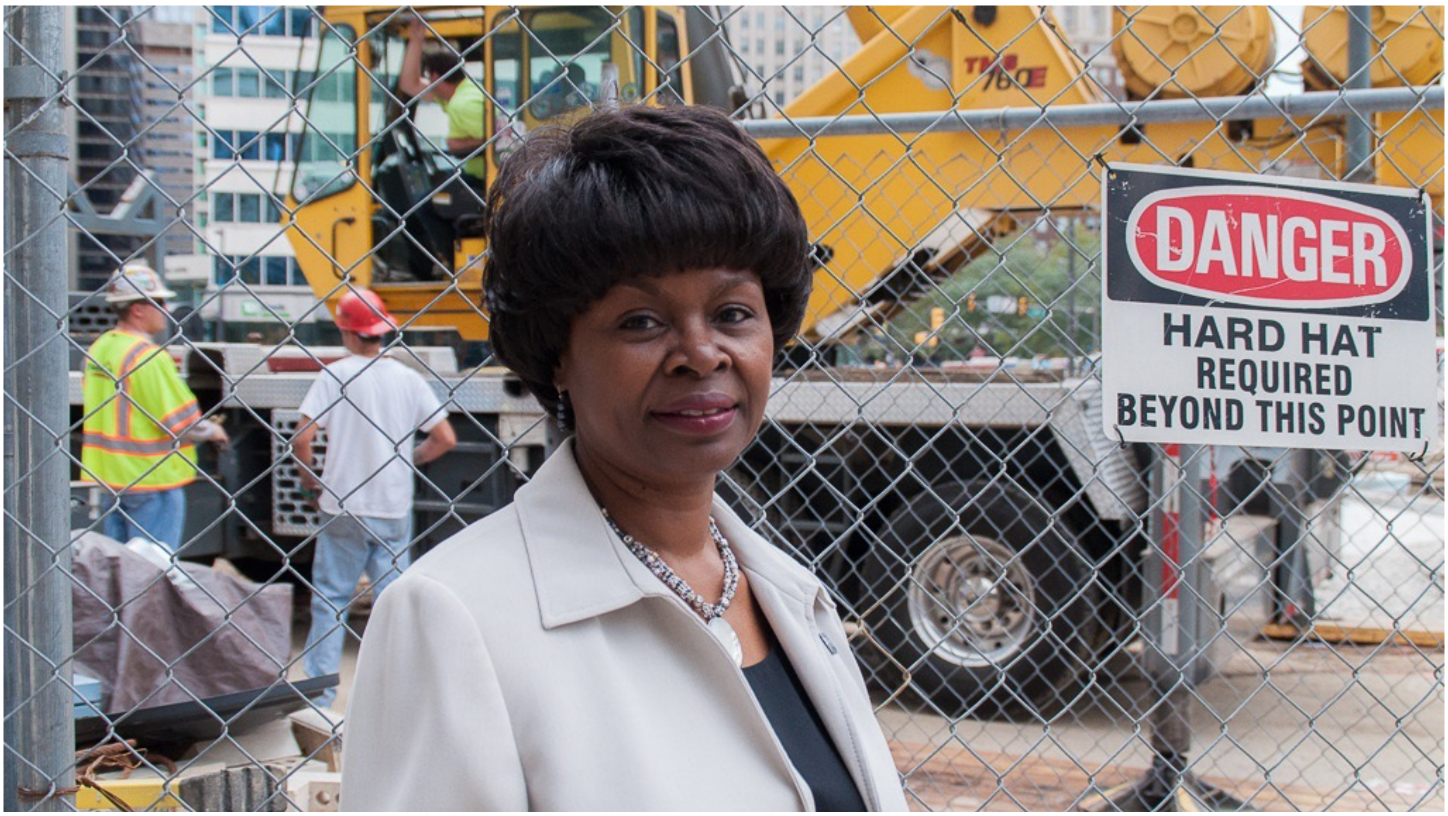
This is exactly how the programs are designed to work: Give a disadvantaged entrepreneur the chance to crack into a business dominated by white men, build capacity and a reputation, and graduate from subcontracting into prime contractor work and private sector jobs won purely on merit.

But Kelly/Maiello's experience is relatively rare.

Take Johanna Johnson-Harris, the African-American proprietor of ARB Construction Inc. Born and raised in North Philadelphia, she graduated from college and for 15 years worked in the administrative and collections offices of big local hospitals. A born entrepreneur, Johnson-Harris said she was "bored and complacent" in her cubicle job, and abruptly quit to try a totally different line of work: Operating heavy construction machinery. She got active in the local union and, soon after, combined her office experience with her construction know-how to start a firm of her own.

Ambitious, hard working and well versed in both contracts and construction, Johnson-Harris is precisely the sort of entrepreneur minority contracting programs are designed to aid. Instead, she said, larger white-owned firms have taken advantage of her. "I've many times been approached to be a pass-through," she said. "Earlier I went into some deals blindly not knowing I would be used as a pass-through."

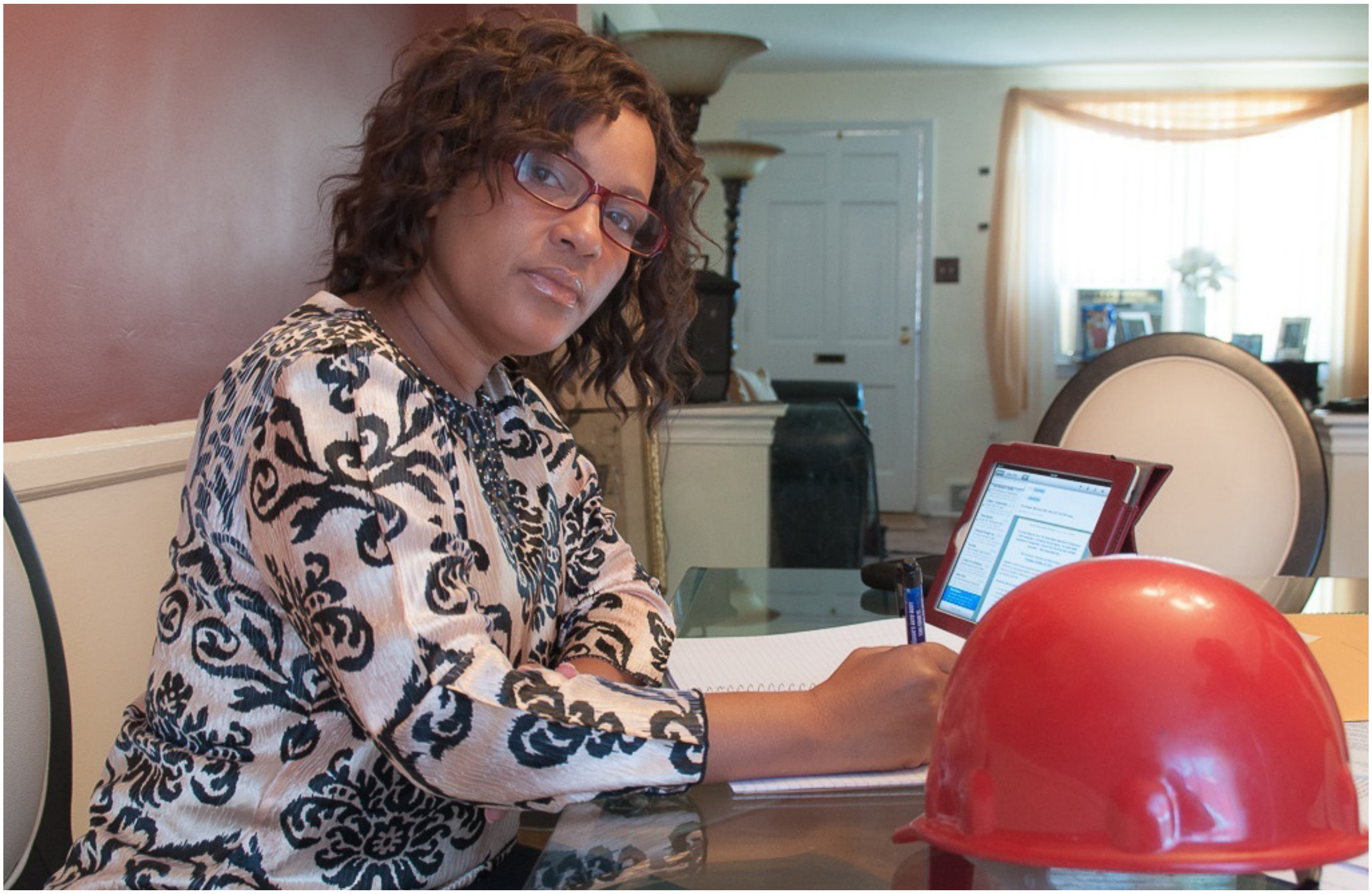
This is commonplace, argues Gloria Shealey, president of the National Association for Minority Contractors. Shealey considers the firms used as pass-throughs to be victims of insufficiently policed systems. "From my perspective, they're being taken advantage of," she said. "The major money being made on these fraud cases gets made by the prime contractor. The minority contractor gets a few crumbs for a being a front, and that does not benefit anyone whatsoever."



Angela Dowd-Burton, executive director of Philadelphia's Office of Economic Opportunity, supports affirmative action policies for increasing the diversity of business owners in the U.S.

Minority-owned contractors, Shealey said, have "got to take a stand, got to be willing to say no and call it what it is." The problem, she continued, is that "money can confuse people."

Even when minority firms enter into a deal



Johanna Johnson-Harris, owner of ARB Construction Inc., has found that there are many ways for white male-owned firms to avoid hiring minority and women contractors.

with every intention of doing the work, Johnson-Harris said, the deal could go sideways. She said big construction companies might hire minority firms to meet diversity goals, and then find excuses to switch out the disadvantaged company for a tried-and-true white-owned subcontractor when it is time for the work to actually get done.

"There's a difference between being awarded a contract and completing a contract," Johnson-Harris said. "The numbers in the report say a minority firm got a contract. But at the end of the day, did they actually finish it? Did they actually get paid? The numbers that really matter are what happened at the end." The city doesn't track those numbers.

Even when a minority firm does complete the work, getting paid in a timely fashion is often a challenge. That's true for many contractors, big and small, minority and white-owned alike. But unlike their deep-pocketed and long-established competitors, many disadvantaged firms operate on razor-thin margins. When payment is delayed, the lack of a check can sink a firm, or destroy its credit, which makes it all but impossible to get another job in the future.

Some white-male owned construction firms are genuinely committed to helping disadvantaged firms grow, Johnson-Harris said, but not many. Most excel at finding excuses to either not hire disadvantaged firms in the first place (while claiming to have made their "best effort") or to bounce them from a project after checking off the diversity box. "There are a lot of wolves in sheep's clothing," she said. "You have vultures out there. Piranhas."

Philadelphia City Councilmember Wilson Goode, Jr. has heard these sorts of complaints for years. In his view, the stickiness of minority contracting fraud is a symptom of entitlement.

"Some people believe they are entitled to work they have always been given," said Goode, the son of

Philadelphia's first black mayor. "And they are entitled to do business with the people they've always done business with. And that's simply not the case with public dollars."

For white-owned firms, the temptation to cheat or to lie can be strong. Although there are large numbers of registered minority and women-owned businesses (MWBEs) in the city's directory, only a small percentage of those firms are actually capable of performing significant subcontracting work, said Christopher I. McCabe, a former procurement lawyer for the city and now a public contracts attorney with Jacoby Donner. That can make it challenging for white-owned prime contractors to meet their minority participation goals, he said, and that's where too many contractors get into trouble.

"There is a perception that if they don't meet those goals, they'll lose the contract," McCabe said.

That perception isn't necessarily accurate. Contractors who can document that they diligently tried but failed to find qualified minority suppliers or subcontractors can get a waiver. But it has often been easier to cheat. Kurland said if her office can prove criminal intent, she will forward the case to the Feds or the district attorney for prosecution. But she's more concerned with getting companies to follow the rules. "Our goal is not to put companies out of business," she said. "It's to bring them into compliance."

To some, the penalties are far too mild. "You have the same firms go out and do the same things they've always done right after being smacked on the hand," Johnson-Harris said. "Until people serve time or get arrested, it will never change."

Kurland, though, does not buy the premise that minority-contracting programs are doomed to forever be magnets for fraud. "These programs can be effectively policed," she said. "I think it just takes a long time to change the culture. Once people see they can't get away with it, they're going to stop."

Her investigations in Philadelphia are certainly receiving plenty of local press. And, anecdotally, it seems to have had an impact on contractor behavior.

"The city is shining a spotlight on the program and abuses of the program, no question," McCabe said. "My advice to my clients more than ever is to be careful, to dot your I's, cross your T's and make sure you are performing above board and not skirting any rules." Philadelphia's Office of Economic Opportunity reports that more city contractors are calling the office looking for assistance in finding a qualified minority-owned partner, when perhaps in the past they would have chosen the easier route of a sham company.

"There are a lot of companies that want to do the right thing, and some that don't," Dowd-Burton said. "Some of the companies that want to do right don't know the rules. And the others — well, those companies chose to play on the fringe. Now those companies can look at the newspaper and see what happens when you don't do the right thing."

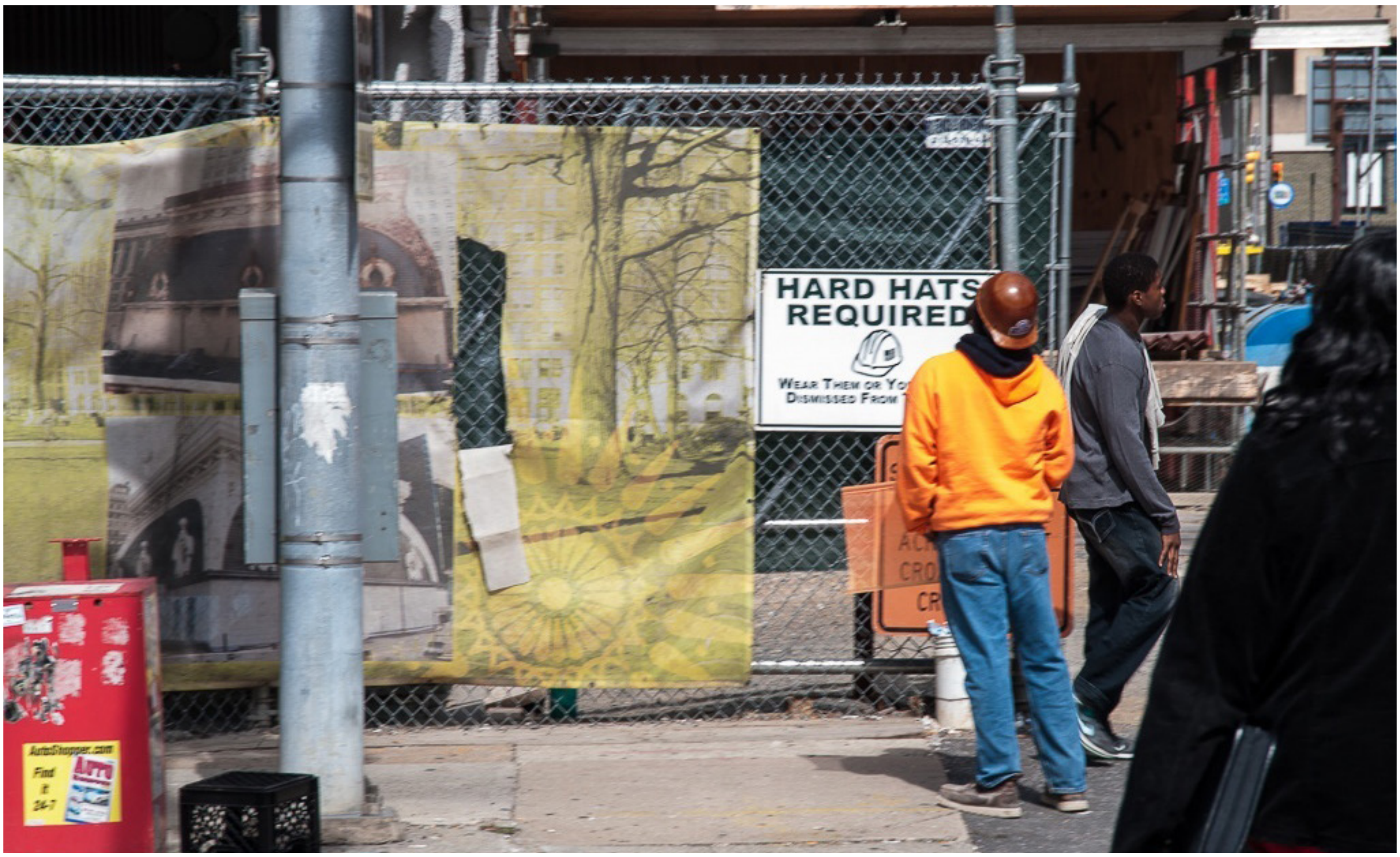
Since 2009, disadvantaged firms have upped their share of city contracting dollars from 20 percent to 28 percent.

Minority participation rates in Philadelphia contracting are improving as well. Since 2009, disadvantaged firms have upped their share of city contracting dollars from 20 percent to 28 percent. There are now 2,000 certified disadvantaged firms in OEO's pool of potential contractors, a 52 percent increase since Dowd-Burton was installed.

As heartening as these numbers sound, the continuing prevalence of sham contractors casts doubt on just how much progress has been made. MWBEs are hardly job-creating engines bringing new opportunities to disadvantaged communities. And that's a problem, because part of the policy justification for these programs is the presumption that the contracting requirements will have a multiplier effect, indirectly creating jobs in minority communities. As Dowd-Burton put it, "The expectation is that minority and women-owned businesses will hire more minorities and women."

Anecdotally, there is some reason to think that might be the case, at least for the relatively small numbers of minority-owned contracting companies that have significant workforces. Johnson-Harris said she is far more likely to hire a relatively inexperienced minority laborer than a larger white-owned construction firm. "And what I find is those people work harder and are more dedicated because they don't get many chances to succeed," she said.

But anecdote is not data. And Philadelphia, like most cities, has not researched its assumption that more contracting work for disadvantaged firms does in fact lead to more jobs for disadvantaged communities. "People may believe it to be true," said Goode, "but you can't determine it one way or the other unless you're actually tracking it. Where's the data?"



Minority-owned businesses are underrepresented in fields like construction.

AFFIRMATIVE ACTION REVISITED

California, Washington and Michigan have all banned consideration of race and gender in the awarding of state and municipal contracts, and a growing number of cities in other states are abandoning their old programs as well. The replacement models are trending toward two options: One that sets aside contracting dollars for small businesses (a group that includes the vast majority of MWBEs), and another that maintains explicit diversity contracting targets but makes contractor participation voluntary.

The results have been mixed, said Lohrentz, who has a Ford Foundation grant to examine best practices in state and municipal disadvantaged business contracting. Some cities, such as San Diego, have excelled. In 1993, a report commissioned by the city itself found that contracting opportunities for women and minorities were so limited that it described San Diego's system as "passively racist."

For years afterward there was much talk of increasing contracting equity, but no progress. In 2010, the city switched its focus to small business certification, creating contracting preferences for companies with less than $5 million in annual revenue that were based in San Diego County. There was no special provision for minority- or women-owned businesses — which would be illegal in California — but there was the hope that women and minorities would fare better under the new system, given that most women and minority-owned contracting businesses are small.

It worked. San Diego increased contracting dollars awarded to minority-owned businesses from a shockingly low $1.5 million in 2009 to $63.5 million in 2012.

The advantages of a small-business-oriented contracting program are twofold. First, there appears to be less cause for fraud, because the program is open to all small-business owners, making sham operators and pass-throughs less necessary. Second, it avoids some of the political static that accompanies race-based programs.

But a small business program on its own is no guarantee of solid minority participation rates. "It's worked in San Diego because they've done everything they can within the small business program to include minorities," Lohrentz said.

Advocates of race and gender-based programs are deeply wary of the slow shift to small business preferences. "If you really are authentic about seeing the ethnic and gender populations grow in their capability and capacity, you have to target that," Shealey said. "Focus on that. And you have to be able to track that specifically."

In Los Angeles, for instance, the end of affirmative action has gutted minority and female contract participation rates. Firms owned by white men snagged 92 percent of the city's total contract spending last year, even though white men represent just 14 percent of its total population. For a city as diverse as Los Angeles, those figures are an embarrassment. Unlike San Diego, L.A. has no program setting aside contracting dollars for small businesses. Instead, it has a handful of inclusion programs that operate with small budgets and no teeth, in light of California's affirmative action ban.

Ultimately, Lohrentz said, there is no one model or best practice that will work everywhere.

"There are places where the barriers and structural discrimination are so strong that the best solution is affirmative action," he said. "There are other places where you don't see the same level of discrimination, so a volunteer program or diversity program may be the best solution there."

He wants to see cities, counties and states rigorously examine their own practices, consider the strength of the local minority contracting market and make a decision based "on an actual analysis of the problem at hand."

ABOUT THE AUTHOR

Patrick Kerkstra has covered Philadelphia and the region for 12 years, including a decade at the *Philadelphia Inquirer*, where his beats ranged from City Hall to real estate development and the Iraq war. Now a freelancer, Patrick is a writer at large for *Philadelphia* magazine, a special projects reporter for PlanPhilly and a guest columnist at the *Inquirer,* where he writes about urban affairs.

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