

THE GRAND JURY OF THE SUPREME COURT
OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

REPORT OF THE GRAND JURY
OF THE SUPREME COURT STATE OF
NEW YORK
FIRST JUDICIAL DISTRICT
ISSUED PURSUANT TO
CRIMINAL PROCEDURE LAW
SECTION 190.85 SUBDIVISION (1)(c)

CYRUS R. VANCE, JR.
DISTRICT ATTORNEY
NEW YORK COUNTY

After considering evidence before it and legal instructions from the District Attorney of New York, the Grand Jury hereby submits a report, pursuant to Criminal Procedural Law §190.85(1)(c), “[p]roposing recommendations for legislative, executive or administrative action in the public interest based upon stated findings.”

INTRODUCTION

Small businesses are an important part of the American economy. Minority-owned and women-owned small businesses make up a sizeable and vital part of the small business population. New York State and New York City have developed programs to provide opportunities for minority-owned and women-owned business enterprises (“MWBE”) to obtain government procurement contracts, especially in the construction industry.¹ The programs direct government contracting agencies to establish a percentage of the work on each agency’s projects that must be performed by MWBEs. The programs also include business-management training, mentoring programs, and workshops on surety bonds and bidding. The State’s goal is to have MWBEs perform 20% of the work on all applicable contracts. The City’s goal with respect to construction contracts is to have MWBEs perform 37% of the work.

This Grand Jury investigated the activities of several prime contractors and subcontractors in the construction industry doing business in New York County that

¹ These programs are modeled on the federal government’s Disadvantaged Business Enterprise (“DBE”) program established to address the underrepresentation of minority-owned and women-owned companies. The programs apply to New York State and New York City contracts that receive federal funding.

committed fraud in relation to the MWBE goal requirements specified in their contracts.² In the course of its work, the Grand Jury received testimony from witnesses familiar with several contracting agencies, and also from witnesses who were familiar with the workings of the city and state agencies responsible for certifying that enterprises were, in fact, MWBEs. It also received evidence from owners and employees of MWBEs, and of non-MWBE prime contractors, subcontractors, and suppliers. The Grand Jury also reviewed property seized pursuant to court-ordered search warrants.

The evidence before the Grand Jury revealed criminal conduct by several individuals and corporations in the construction industry, spanning at least a decade. To date, the Grand Jury returned an indictment charging a scheme to defraud, pursuant to Penal Law §190.65(1)(b), and ten counts of Offering a False Instrument for Filing in the First Degree, pursuant to Penal Law §175.35, against a contractor and its owner. The Grand Jury's investigation is ongoing.

In broadest outline, the criminal conduct involving MWBEs was as follows: The prime contractors' contracts with government agencies required that certain parts of the contract were required to be performed by certified MWBEs, or that specified

² This Grand Jury was impaneled by the Honorable Roger S. Hayes, upon application of New York County District Attorney Cyrus R. Vance, Jr. on April 9, 2014, and extended on April 24, 2014, to a term ending on October 23, 2014.

materials were to be supplied by certified MWBEs. The MWBEs did not perform the services or supply the materials. Instead:

- Contractors purported to use MWBEs to perform the work or provide the materials required under the contract, but in fact used businesses that were neither women-owned, nor minority-owned. The contractors represented that MWBEs were providing the services or materials, but in fact the MWBEs that they listed did not have the capacity to do so.
- Invoices and other billing documents were created to make it appear as though the work and payments flowed to MWBEs, when in fact the money was merely passed through those businesses to the non-MWBEs that performed the work.
- The non-MWBE contractors submitted paperwork to State and City contracting agencies misrepresenting the participation of the purported MWBEs.
- Even in the small sample of cases presented in these Grand Jury proceedings, the aggregate amount of diverted money – *i.e.*, the money that was supposed to go to MWBEs, but instead went to non-MWBEs -- exceeded \$10 million.

The conduct of fraudulent contractors threatens the very goals of the MWBE programs: To develop MWBEs in industries and businesses in which women and

minorities are currently under-represented. The wrongful conduct retards the efforts of fledgling MWBEs to compete on a level playing field and to gain a foothold in the government procurement marketplace because the number of contracts available for MWBEs is reduced and the prospect of obtaining experience is diminished.

The Grand Jury therefore recommends the following administrative, executive, and legislative steps to deter MWBE fraud and improve enforcement and prosecution efforts to bring those who abuse MWBE programs to justice:

1. Require a representative with knowledge from the prime contractor and from each MWBE on a contract to certify on penalty of perjury to the contracting agencies that the MWBE performed the services or provided the materials as contractually required, and the MWBE was not a mere “pass-through” entity.
2. Increase the resources devoted by the certifying and contracting agencies to oversee the MWBE programs.
3. Add gradations to the scheme-to-defraud statute, Penal Law §190.65, under which many MWBE fraud cases are prosecuted so that the criminal charge reflects the magnitude of the offense.
4. Enhance existing criminal fines to help take the profit incentive out of MWBE fraud.

THE NEW YORK STATE AND CITY MWBE PROGRAMS

The MWBE State program, which applies to 95 state agencies or authorities, is managed by the Division of Minority and Women’s Business Development of Empire State Development Corporation (“ESDC”).³ The City program, which covers 34 City agencies, is jointly administered by the Mayor’s Office of Contract Services and the Division of Economic and Financial Opportunity of Small Business Services (collectively, “SBS”).⁴

To be eligible for State or City MWBE certification, an enterprise must be controlled, operated, and at least 51% owned, by United States citizens or permanent resident aliens who are women or members of a designated minority group. To establish its eligibility, an enterprise must submit to the contracting agency documentation concerning the enterprise’s ownership, management, finances, operations, and experience. An MWBE is required to be re-certified every five years by the City and every three years by the State. Between certification and recertification, the MWBE is also required to report any changes in its profile, either through a short annual affidavit or by online self-reporting.

The MWBE may participate in an agency-contracted project as a prime contractor, a subcontractor, a sub-consultant, or a supplier of materials. The program applies to a wide variety of contracts, ranging from the construction of buildings and

³ See Executive Law Article 15-A.

⁴ See New York City Administrative Law §6-129.

infrastructure to the provision of security and landscaping services; the program also applies to contracts covering the provision of professional services, from accounting to architecture, and the provision of consumer goods to the contracting agencies.

MWBEs must perform “commercially useful function[s]”⁵ on the projects on which they are employed. They may not act as mere conduits through which funds flow to create the appearance that an MWBE has performed valuable work, when in fact it has not done so. Unfortunately, in too many instances, MWBEs merely purport to do the work or provide the materials, when the reality is quite different.

CORRUPTION OF MWBE PROGRAMS

The evidence presented revealed three fraudulent schemes involving MWBEs in the construction industry.

In many instances, the MWBE was engaged as a subcontractor to provide services (such as electrical or plumbing work) needed by the prime contractor or other subcontractors. The MWBE did not perform the work, however. Instead, it functioned as a “pass-through.” The MWBE’s role was limited in such cases to billing for work done by non-certified businesses, receiving the payments, and funneling payments to the entity that performed the work that was supposed to have been done by the MWBE. The MWBE, in effect, rented its name and provided billing services to the non-MWBE entity.

⁵ See New York City Administrative Code §6-129(a)(8) and 5 NYCRR §140(f).

The entity doing the work was either the prime contractor itself or a non-MWBE subcontractor. Often the MWBE had few, if any, employees and did not even own the equipment required to perform the contract.⁶

Another form of MWBE fraudulent scheme is similar to the first, except that it involved the MWBE as a purported supplier of materials. Rather than supply the materials, however, the MWBE simply acted as a conduit. Typically, the prime contractor would contract for materials with a large, established, non-MWBE supplier, but the paperwork documenting the shipment and delivery of the materials would falsely reflect that an MWBE had provided the materials. In fact, the MWBE had never taken possession of the materials, and in many instances the identified MWBE had no inventory, storage facility, or means of transporting the materials.

To effectuate the scheme, the non-MWBE supplier would provide an invoice to the MWBE, who would use it to generate a second invoice – similar to the first, except that it added a fee to be paid to the MWBE – for submission to the contracting agency. Once again, the MWBE would appear to perform the contractual service or provide the materials, but in fact it served as a mere conduit without any substantive duties or business.

⁶ In some instances, to conceal the fraud, employees of the company doing the contracted work were placed temporarily on the payroll of the MWBE. Although the employees were compensated by the non-MWBEs, their payroll checks were drawn from the account of the MWBE to make the paper trail more plausible. When the work was finished, the employees return to the payrolls of the actual employer. This activity is known as “flip-flopping.”

The final step in both pass-through schemes was the prime contractor's filing of documents with the contracting agency falsely representing that the MWBE had performed services or provided materials. The amount of money that the prime contractor claimed for the services or materials purportedly provided by the MWBE was the sum of the amount owed to the non-MWBE that performed the job plus the "fee" for the pass-through MWBE. The fees typically range from 2% to 4% of the value of the work performed or materials supplied.

The third fraudulent scheme requires the certified MWBE to obtain a contract as a prime contractor, but then operate only as a "front" company for a non-MWBE business. A common scenario entails a male-owned construction company arranging for a woman, who is a friend or relative or a principal of the non-MWBE, to obtain WBE certification for an entity that the woman purportedly owns or operates. The non-MWBE performs the contract, but the paperwork and requests for payments are generated by the "front," making it appear that a WBE performed the work.

These fraudulent schemes hurt *bona fide* MWBEs because they lose opportunities to win contracts, make money, and gain valuable experience. They also hurt the public generally because the contracting agencies pay the prime contractors for the work of the non-MWBEs and the "fee" charged by the non-functioning MWBE that lends its name and shuffles paper, purporting to do the contractually-required work.

RECOMMENDATIONS

The following recommendations, if enacted, will deter prime contractors from enlisting MWBEs in illegal schemes, or at least expose their efforts. When fraud occurs, grand juries and prosecutors will have a greater ability to charge these criminals with offenses that reflect the magnitude of these abuses.

Recommendation One

Effective deterrence and successful prosecution require the contracting agencies to hold both the prime contractor and the MWBEs on any job accountable for fulfilling the MWBE goals in the awarded contract. The following steps should be taken to achieve this goal:

- A representative with knowledge from the prime contractor should be required to certify under penalty of perjury to the contracting agencies that the MWBEs on the job *in fact* performed the services or provided the materials that they were contracted to perform or provide. At present, virtually none of the State or City agencies with MWBE programs requires the prime contractor to certify under oath to the contracting agency that the MWBE actually performed the work or provided the supplies for which the prime contractor is receiving MWBE credit. The ESDC and SBS should collaborate to provide the contracting agencies with a standard, unambiguous, certification under penalty of perjury that must be complete as a condition precedent to the prime contractor's being paid.

- A representative with knowledge from the MWBE should also be required to make a certified statement under penalty of perjury that the MWBE *in fact* provided the work sought under the contract. The language should be similar to that described above. Again, the provision of such a certification under penalty of perjury would be a condition precedent to the MWBE's being paid.

These measures would establish personal accountability for responsible individuals at both the prime contractors, who might be tempted to avoid using MWBEs, and at the MWBEs themselves, who might be tempted to allow their names to be used for a fee without performing substantive work.

Recommendation Two

There are over 3,700 MWBEs certified by the SBS and at least 7,600 MWBEs certified by the ESDC. The MWBE programs might be made substantially more efficient through coordination among the certifying and contracting agencies, and the increased use of technology.

Each certifying agency has its own application and procedures. An electronic version of all applications and annual updates would ease the process for applicants and, more important, would create a useful, searchable, database. That would allow the relevant agencies to view all documents provided by the MWBE for certification or re-certification. These documents are not currently universally digitally maintained. Sharing information in this way would allow the certifying agency to see whether

applicants have been denied certification by other agencies and the reason for the denial. The database could also include all documents submitted during the life of the contract in support of payment to the MWBE. This would provide greater detail about the work that the MWBE was actually paid to perform.

Some contracting agencies have already implemented a system containing a module to capture details pertaining to the certification and a module to track all contract payments. That system may provide a platform for expansion for the other agencies.

Agencies should also be given the resources to acquire software with predictive analytics that could be used to expose the fingerprints of MWBE fraud schemes. This tool would enhance the oversight, investigation, and prosecution of this type of misconduct.

In addition to bureaucratic coordination and the employment of technology, enhanced auditing procedures would also deter fraud in the MWBE programs. The first tier of scrutiny should be a thorough vetting of each MWBE applicant at both the certification and re-certification stage. Agencies should be given ample personnel to conduct an onsite inspection of the MWBE's place of business, warehouse, or storage facility to confirm the existence of a workforce, equipment, and supplies. These measures would ensure that MWBEs have the capacity to perform the type of work for which they have been certified, providing contractors with confidence in the list of qualified MWBEs.

Enhanced auditing would catch or deter a significant amount of fraud. Moreover, spot-checks at the job site to see who is actually performing the work, and inspections of MWBE's financial records for signs that it is functioning as a pass-through or as a front, would serve a similar prophylactic purpose.

The audit function should also be conducted at the completion of the contract. Some of these audit functions could be outsourced to entities with specialized investigative skills, such as private certification entities, professional audit firms, "integrity monitors," or independent private sector inspectors general.

The certifying and contracting agencies should promote "whistleblowers" who can reveal wrongdoing in connection with MWBE programs. The State and City false claims statutes,⁷ patterned after the federal statute, allow for recovery by whistleblowers who bring frauds to light. These statutes are powerful tools to recover monies to the defrauded contracting agencies. The federal government has used its false claim act in a similar effort to combat MWBE fraud.

Recommendation Three

MWBE fraud must be charged as a scheme-to-defraud under New York Penal Law §190.65, which, at its highest level, is a class E felony. Section 190.65 contains no gradation for the size of the fraudulent scheme. For example, a scheme to defraud a victim of \$10,000,000 is punishable to the same extent as a scheme to defraud a victim

⁷ Finance Law §§187-194 and New York City Administrative Code §§7-801 through 7-810, respectively.

of \$10,000. Both schemes to defraud are class E felonies, which are the lowest class of felony.

The scheme-to-defraud statute should be amended to include graduated degrees, distinguished by monetary thresholds, so that a defendant's offense would accurately reflect the magnitude of its wrongdoing. Under the felony larceny statute theft in excess of just \$3,000 is a class D felony, in excess of \$50,000 a class C level, and in excess of \$1,000,000 a class B felony, pursuant to Penal Law §155.35, §155.40, and §155.42, respectively. The crime of scheme to defraud should be modified to include class D, C, and B felonies at the same levels.⁸ The amount of the wrongdoing is equivalent to the amount that should have been paid to the MWBE under the contract. This amendment change would empower prosecutors to proceed in a manner proportionate to the scope and magnitude of the crime.

Recommendation Four

The criminal fine provisions of the Penal Law provide for a fixed dollar amount of \$5,000 for each felony perpetrated by an individual, and \$10,000 for each felony perpetrated by a corporation.⁹ As discussed above, fixed penalties do not reflect the seriousness of the crimes. Just as the class of felony should be enhanced to distinguish the more serious crimes, so should the criminal fine be enhanced.

⁸ Larceny is not applicable in these cases because the contractor has completed the work required by the contract, albeit not in the manner required by the contract.

⁹ Penal Law §80.00(1)(a) and §80.10(1)(a), respectively.

This goal may be accomplished either by increasing the absolute dollar amounts of fines, or by allowing the judge to impose a fine that is proportional to the amount of money involved in the scheme to defraud. A similar approach is used in other statutes.¹⁰ The amount of money could be the equivalent or some multiple of the amount that was supposed to be paid to the MWBE for *bona fide* work or materials. Some portion of the enhanced fines could be applied to software acquisition, or to employ personnel to audit, investigate, or prosecute MWBE fraud. Fines could also underwrite MWBE programs to assist minority and women owners to develop sustainable businesses.

CONCLUSION

The health of New York's economy is linked to the success of our small businesses, and diversity is a business imperative, not an option. The MWBE programs can help minority-owned and woman-owned businesses gain ground in the marketplace that would otherwise be denied to them. However, the programs are hampered when fraud intervenes.

The actions the Grand Jury recommends will assist certifying agencies in maintaining the integrity of the MWBE lists, require prime contractors to be explicit about their arrangements with MWBEs, deter those tempted to undermine the MWBE

¹⁰ See, e.g., Penal Law §470.25 (money laundering statute providing for a criminal fine up to double the amount of the proceeds of the crime) and Tax Law §1800(c)(1) (double the amount of the unpaid tax liabilities).

programs, and impose appropriate penalties on those who nonetheless cheat the agencies, the real MWBEs, and the public.

WE THE GRAND JURY OF THE SUPREME COURT, STATE OF NEW YORK, FIRST JUDICIAL DISTRICT, PURSUANT TO THE PROVISIONS OF CRIMINAL PROCEDURE LAW SECTION 190.85 (1)(C), BASED UPON OUR STATED FINDINGS, SUBMIT THIS REPORT RECOMMENDING LEGISLATIVE, EXECUTIVE, AND ADMINISTRATIVE ACTION IN THE PUBLIC INTEREST.