



OFFICE OF THE INSPECTOR GENERAL
City of Chicago



REPORT OF THE INSPECTOR GENERAL'S OFFICE:

***REVIEW OF THE MINORITY AND WOMEN-OWNED BUSINESS
ENTERPRISE PROGRAM***

MAY 2010

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To the Mayor, Members of the City Council, the City Clerk, the City Treasurer, and the residents of the City of Chicago:

Enclosed is a review of the City's minority and women-owned business enterprise program.

1. Background

Mayor Harold Washington began an affirmative action program for City contracts in 1985 by executive order. The minority and women-owned business enterprise (MWBE)¹ program was continued through successive mayoral administrations and an ordinance codifying the City's program into law was passed in 1990. The scope of the MWBE program is extremely large. Since 1991, the City has reported over \$9.5 billion in awarded contracts to MWBEs, an average of over \$500 million a year.

2. Summary of Findings

Over the past several years, the IGO has conducted numerous investigations examining fraud, abuse, and mismanagement in the MWBE program. Recently, the IGO conducted a program review to analyze how actual participation in the program compares to the participation statistics that are reported to the City Council and the public.

Our investigations and analysis have revealed broad and pervasive deficiencies in the administration of the City's MWBE program and that the City cannot determine whether or not the program is achieving its goals. As a result, the program has been beset by fraud and unlawful brokers, and MWBE participation is likely far less than the publicly reported participation statistics. Specifically, the IGO found that:

- Fraud, abuse, and mismanagement are widespread in the MWBE program. Recent sustained or soon to be sustained IGO investigations into the MWBE program have involved contractors that have been awarded over \$1 billion in City contracts since 2003.

¹ In the review we use the term "MWBE program" to refer to the City's affirmative action contracting program and the term "MWBE(s)" to refer to all firms that participate in the program.

- Our analysis of construction contracts that ended in 2008 found that actual payments to MWBEs and Disadvantaged Business Enterprises (DBEs)² were over 15 percent less (more than \$19 million) than the City's publicly reported statistics for the contracts we reviewed. Were the over-reporting for 2008 applied to the over \$2.5 billion in construction contracts reportedly awarded to MWBEs and DBEs since 1995,³ actual participation in all the City's *construction* contracts, between 1995 and 2008, has been \$400 million less than the City's publicly reported participation statistics.
- Non construction contracts comprise the majority (70% of the dollar value) of reported MWBE participation awarded since 1995. For these contracts, due to the historical lack of auditing of non-construction participation, the lack of rigor in the auditing process that was recently put in place, and the prevalence of fraud and abuse in the program, it is likely that actual participation is also significantly lower in non-construction than the publicly reported participation.
- Many of the problems in the MWBE program are attributable to the City's poor administration of the program. Specifically, the administrative deficiencies include:
 - Not collecting, analyzing, or reporting data on actual payments to MWBEs.
 - Lack of cooperation between City departments in administering the program.
 - Failure to track payments to MWBEs as contracts are performed.
 - Mistakes in assessing actual MWBE participation.
 - Laxness in determining eligibility for the program.
 - Insufficient resources devoted to the program's administration.

The City's failure to collect all relevant data, its inconsistent application of the program's rules and regulations, and a lack of cooperation between the user departments and the Department of Procurement Services (DPS)⁴ have all contributed to the program's poor administration. Despite a lawsuit challenging the program's constitutionality and several high-profile scandals involving the program, these failings have not been corrected. The MWBE program requires continuous oversight and analysis, yet the City has failed to successfully address the program's problems as they have arisen.

3. Summary of Recommendations

The failings of the program cannot and should not be blamed on a single person or a single department, and therefore no single policy change can fix the program. First and foremost, the City must collect and report data on actual payments to MWBEs. While better data reporting will help the program better accomplish its goals, the City must also improve the administration of

² Disadvantaged Business Enterprises (DBEs) refers to a federal affirmative action contracting program and is only applicable on certain federally-funded contracts.

³ From 1995 through 2004 this figure includes DBE awards. From 2005 through 2008 DBE awards are excluded.

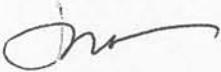
⁴ DPS was the principal program administrator for much of its history. In October 2009, the Mayor transferred most aspects of the program administration and oversight to the Office of Compliance. The analysis period for this report precedes the transfer. However, the problems detailed have not abated since the transfer and, if anything, have grown worse.

the program. The administration needs to rigorously enforce the program's rules and regulations and ensure that participants act in good faith. Specifically, the City must:

- Track and report actual payments to MWBEs.
- Increase cooperation between City departments to properly administer the program.
- Require more detailed documentation of payments to MWBEs.
- Consider directly paying subcontractors.
- Clearly define and consistently apply MWBE regulations.
- Increase resources for program administration.
- Increase enforcement of penalties for non-compliance with MWBE commitments.

Going forward, the City must confront the longstanding problems that plague the program, which is a cornerstone of City economic and social policy. To do this, the City must engage in rigorous, continuous analysis of how the program is administered and of the program's effectiveness and there must be a commitment from all parts of City government to the program's goals, including, most notably, from the user departments that execute the City's contracts. By doing so, the City will ensure that the program is run effectively and efficiently and that MWBE participants are receiving all the benefits of the program to which they are entitled.

Respectfully,



Joseph M. Ferguson
Inspector General
City of Chicago

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EXECUTIVE SUMMARY

1. Background

For nearly 40 years, affirmative action programs in government contracting have been in place in the United States. The purpose of these programs is to remedy the effects of past or current discrimination by establishing a level playing field in the awarding of government contracts. The programs were initially aimed at minority-owned business enterprises (MBEs) and have since grown to include women-owned business enterprises (WBEs) and other “disadvantaged” business enterprises (DBEs). In Chicago, Mayor Harold Washington began an affirmative action program for City contracts in 1985 by executive order. The Minority and Women-owned Business Enterprise (MWBE)¹ program was continued through successive mayoral administrations and an ordinance codifying the City’s program into law was passed in 1990. The scope of the MWBE program is extremely large. Since 1991, the City has reported over \$9.5 billion in awarded contracts to MWBEs, an average of over \$500 million a year.

In response to patterns revealed through several major investigations concerning the City’s MWBE program, the Inspector General’s Office (IGO) analyzed the program’s management and administration. Additionally, the IGO analyzed how actual participation² in the program compares to the participation statistics that are reported to the City Council and the public. Our analysis and findings are described in this report. The analysis is based on IGO investigations that have been conducted over the last several years; reviews of audits conducted by the Department of Procurement Services (DPS); interviews with City employees; reviews of the regulations and ordinances governing the program; and reviews of hundreds of City contract files.

2. Summary of Findings

The following sections detail findings from our investigations and analysis of the MWBE program.

(A) Investigations Have Uncovered Pervasive Fraud and Abuse of the Program

The IGO has uncovered numerous instances of City vendors abusing the MWBE program. Since 2005, IGO investigations have resulted in recommendations that 15 MWBEs be decertified and/or debarred. Currently, the IGO has over 30 open administrative or criminal investigations

¹ In this report we will use the term “MWBE program” to refer to the City’s affirmative action contracting program and the term “MWBE(s)” to refer to all firms that participate in the program. The program includes three separate categories: Minority-owned Business Enterprises (MBEs), Women-owned Business Enterprises (WBEs), and Business Enterprises owned by People with Disabilities (BEPDs). We use the term MWBE because MBEs and WBEs are by far the two largest parts of the City’s program. BEPDs are a small subset of the overall program with only 13 BEPDs currently certified out of a total program size of over 2,500 firms. Disadvantaged Business Enterprises (DBEs) refers to a federal affirmative action contracting program and is only applicable on certain federally-funded contracts.

² In this usage, participation means payments to MWBEs in accordance with the program’s rules and regulations.

related to the MWBE program.³ Recent IGO sustained or soon to be sustained investigations⁴ into fraud, abuse, and mismanagement in the MWBE program involve contractors that were awarded over \$1 billion in City contracts (either as prime contractors or as subcontractors) since 2003.

The investigations have revealed that there are two major ways that MWBE participation is falsified: front companies and pass-throughs. A front company asserts that it is an MWBE, when, in reality, the company and its profits are actually controlled by a non-minority male.

Pass-throughs are situations in which an MWBE gets a City contract (or more often gets a subcontract with a prime contractor) but instead of performing the work themselves, the MWBEs contract with one or several non-MWBEs that carry out the contract. In this way, payments are routed through MWBEs to create the appearance of MWBE participation, but in actuality, non-MWBEs receive the contract dollars.

In addition to front companies and pass-throughs, this office has uncovered abuse of the program by brokers to create the illusion of MWBE participation. Brokers, who are excluded by law from the program, are defined as “a person or entity that fills orders by purchasing or receiving supplies from a third party supplier rather than out of existing inventory, and provides no commercially useful function other than acting as a conduit between a supplier and a customer.”⁵

(B) Actual Payments to MWBEs Are Likely Significantly Lower than Publicly Reported Statistics

The IGO conducted an analysis of the MWBE program to review how actual participation in the program compared to reported participation. DPS⁶ has publicly reported participation in the MWBE program based on awarded contracts and not on payments actually made to MWBEs. DPS has internally audited individual City contracts to determine how much MWBEs are paid, but the results of these audits are not collected or analyzed.

Because of this lack of analysis and data collection, the publicly reported statistics do not accurately represent program results and performance. A 1998 analysis of the City’s program found that actual payments made to MWBEs were less than the amounts promised in the original contracts.⁷ During the 2003 trial in which the constitutionality of the City’s program was challenged, the City’s own lawyer argued that the publicly reported participation statistics overstate the program’s impact.⁸

³ It is important to note that some of these investigations have been referred to the IGO by the administration and further that the administration has initiated certain decertifications and debarments on its own initiative.

⁴ An IGO investigation is sustained when the preponderance of the evidence establishes that misconduct has occurred.

⁵ *Chicago Municipal Code*, secs. 2-92-420 and 2-92-670 (American Legal 2009).

⁶ In October 2009, the Office of Compliance (Compliance) assumed responsibility for most aspects of MWBE program administration.

⁷ Bates, Timothy. “Discrimination and the Capacity of Chicago-Area Minority-Owned Businesses to Participate in Public Procurement.” January 1998. pg. 127.

⁸ Washburn, Gary and Cohen, Lauren. “Aldermen boiling over set-aside disclosures.” *Chicago Tribune*. April 20, 2004.

Our analysis included 66 construction contracts that ended in 2008. Twenty-two of the contracts had DBE requirements, while 44 had MWBE requirements.⁹ The contracts had a combined final value of approximately \$385 million. The DBE contracts had a combined value of \$150 million, while the MWBE contracts were worth \$235 million.

We calculated the publicly reported MWBE participation for this set of contracts and compared it to what DPS’s internal audits determined was the actual participation based on contract spending. Within DPS’s audits, we found a number of mistakes that overstated actual MWBE participation. Correcting for these mistakes, we calculated actual participation using the underlying documentation based on DPS’s rules and regulations.

Our analysis determined that actual participation for construction contracts was over 15 percent less (more than \$19 million) than the publicly reported statistics. Among MBEs, the actual participation was 22 percent lower than award and among WBEs, the actual participation was almost 32 percent lower. In the DBE contracts we reviewed, actual participation was essentially the same as the publicly reported participation. Focusing on the 44 contracts in which the City’s MWBE requirements were applied, actual participation for MWBEs was over 24 percent less than the publicly reported participation statistics.

The chart below compares the MWBE and DBE participation at contract award and the actual participation according to the IGO’s analysis.

Table- MWBE and DBE Participation in Construction Contracts Ending in 2008				
	Participation in \$ Based on Contract Award	Actual Participation in \$ - IGO Analysis	Dollar Value Variance between IGO Analysis and Contract Award	Percentage Variance between IGO Analysis and Contract Award
DBE	\$43,391,312	\$43,563,670	\$172,359	0.40%
MBE	\$62,487,565	\$48,672,259	-\$13,815,306	-22.11%
WBE	\$18,549,931	\$12,646,680	-\$5,903,251	-31.82%
Total	\$124,428,808	\$104,882,610	-\$19,546,198	-15.71%
Source: IGO				

Were the over-reporting for 2008 applied to the over \$2.5 billion in construction contracts awarded to MWBEs and DBEs since 1995,¹⁰ actual MWBE and DBE participation in all the City’s construction contracts, between 1995 and 2008, has been \$400 million less than the publicly reported participation statistics.

The conservatively estimated actual rate of participation of 15 percent less than the publicly reported statistics still probably exaggerates actual MWBE participation. Given the pervasive

⁹ DBE requirements are affirmative action contracting goals that are applied to certain federally-funded contracts, while MWBE requirements are applied to all other contracts, with the exception of sole source and emergency contracts.

¹⁰ From 1995 through 2004 this figure includes DBE awards. From 2005 through 2008 DBE awards are excluded.

fraud and abuse of the program we have observed during the course of our investigations, it is highly likely that actual participation is significantly lower than the reduced participation observed in our review. The laxness in the City's certification and compliance processes makes it likely that our analysis credits participation to ineligible firms that have engaged in yet undiscovered abuses of the MWBE program. Additionally, the documentation - lien waivers - that we used to determine actual participation can easily be and, as revealed in numerous IGO investigations, has been manipulated to overstate participation.

For non-construction contracts, which comprise the majority of program contracts and spending (70% of program dollars), we were unable to estimate actual participation in part because the City has only recently begun attempting to audit such contracts, and is still unable to audit every non-construction contract. Also, the underlying documentation for non-construction audits is less rigorous than for construction audits. In the audits we did review, we found a number of discrepancies.

Although we were unable to estimate actual participation in non-construction, due to the historical lack of auditing of non-construction participation, the lack of rigor in the auditing process that was recently put in place, and the prevalence of fraud and abuse in the program it is likely that actual participation is also significantly lower in non-construction than the publicly reported participation.

(C) Problems with Program Administration

IGO investigations and analysis have identified multiple problems with the way the MWBE program is administered. The Lowry Report, which provided the initial justification for the MWBE program, cautioned that the administration of an affirmative action contracting program "is a hands-on process that requires close scrutiny and instant response to issues before they become major problems."¹¹ The City's program does not meet this standard. Our investigations and analysis have revealed that the MWBE program is poorly administered and the administration cannot determine whether or not it is achieving its goals. One DPS official aptly summed up the program as "a lot of paperwork and pushing paper."¹² The result of this substandard administration is that the program has been beset by fraud and brokers, and MWBE participation is likely far less than the publicly reported statistics.

One of the program's most fundamental problems is that although the City audits individual contracts to examine actual participation, it does not collect and analyze data on actual payments to MWBEs or track actual participation as contracts progress, lending an overall appearance that achieving the program's economic and social goals is not the hallmark of program administration, but rather simply hitting the numbers to meet public reporting requirements. This makes it extremely difficult to analyze the program's true impact and to ensure that City vendors maintain their commitments to the MWBE participation goals.

¹¹ James H. Lowry & Associates. Study of Minority and Women-Owned Business Enterprise Procurement Programs for the City of Chicago. March 1985. pg 6-1.

¹² Interview #1.

The practice of reporting participation based on contract awards has resulted in inaccurate and unrealistic projections and promotion of the program's achievement. Because the participation statistics are the main criteria by which the program is evaluated by the City Council and the public, the success of the MWBE program is judged by the public and the City Council on a set of metrics that are currently unreliable.

The documentation that the administration uses to audit actual payments to MWBEs is often insufficient and can be easily manipulated to overstate MWBE participation. For construction contracts, the lien waivers that are used to document payments that are going to MWBE subcontractors are often unreliable. Recent investigations have revealed instances where MWBEs submitted lien waivers that made it appear that they received payments far in excess of what they actually received. MWBEs may do this because prime contractors, which exercise control (and thus leverage) over the size and timing of payments to their subcontractors, make it a requirement of payment or in exchange for a fee.

For non-construction contracts, payments are verified through the attestations of prime contractors and MWBEs. However, affidavits from prime contractors and subcontractors are susceptible to exploitation by contractors that want to overstate participation. Like the problems with the lien waiver process described above, MWBEs could be easily influenced to overstate how much they were paid by prime contractors, who could make this overstatement a condition of payment. The fact that DPS has accepted what a prime contractor reports if the MWBE subcontractor itself does not report how much it was paid makes it even easier for prime contractors and/or subcontractors to overstate participation. Prime contractors could overstate participation in what they report to DPS, while MWBE subcontractors could simply not respond and DPS would conclude that the prime contractor's reported payments are accurate.

There is little cooperation between City departments in administering the program. This problem stems from a pervasive belief in the user departments¹³ that the MWBE program is solely the responsibility of DPS. The limited cooperation between DPS and the user departments has contributed to a lack of access to timely information, a failure to monitor actual MWBE participation as contracts are performed, duplicative data collection, and a greater administrative burden for the City's vendors. It also has made it less likely for the administration to uncover front companies, brokers, and pass-throughs.

In the course of our investigations and program analysis, we have found glaring mistakes in how firms are certified.¹⁴ During one firm's application process for the MWBE program, a site visit by a DPS certification officer revealed that the firm was likely a broker.¹⁵ However, the certification officer's site visit report concludes by saying "as I mentioned to [the firm's owner], put a strong paperwork package together for [the certification officer]."¹⁶ The implication of this report is that despite strong evidence that the applicant firm is a broker; DPS will certify the firm anyway provided it can make itself look legitimate on paper. The firm went on to be certified, and has since received tens of millions of dollars in City contracts. In the certification process for

¹³ User departments refer to the departments that manage project work performed under contract with the City.

¹⁴ Certified means that the firm was given MWBE status.

¹⁵ Per the City's Municipal Code, Sec. 2-92-480, brokers are not allowed to participate in the MWBE program.

¹⁶ Certification File. Site Visit Report.

another firm, we uncovered mistakes in how a firm's annual gross receipts¹⁷ were calculated. These mistakes led to the continued certification of this firm although it should have graduated¹⁸ from the program. Due to this mistaken certification, this firm has been credited with tens of millions of dollars of participation that should have gone to eligible MWBEs.

In auditing payments to MWBEs, we found numerous instances of DPS over-counting participation. Although documentation revealed that firms were acting as pass-throughs, DPS compliance officers nevertheless counted these firms' participation. Program compliance officers also often over-counted the participation of MWBE suppliers in construction contracts in contradiction of the program's regulations. In one contracting area, the compliance officer did not use the proper documentation to audit payments to MWBEs. Instead, this officer relied on documentation that other DPS officials view as unreliable. As a result, DPS was unable to uncover massive shortfalls in participation on one of the City's largest contracts.

Part of the reason for these mistakes is the administration has not complied with and meaningfully enforced its own rules and regulations regarding the program. In certain areas, the administration has issued incomplete regulations that lead to confusion among City personnel about how to administer the program. In interviewing DPS personnel, we sometimes received different, often contradictory, interpretations of the program's regulations.

For construction and non-construction contracts, we found that the City does not typically set contract-specific MWBE goals, but rather applies the same MWBE goals to each contract. This practice ignores the varying availability of MWBEs in different industries and variations in subcontracting opportunities on different contracts. Thus, unrealistically high goals are set on some contracts, while inadequate goals are set on others.

While the construction and non-construction ordinances give the City the authority to charge penalties to firms that fail to meet MWBE participation commitments, the major contracting departments do little to enforce unmet MWBE commitments, and consequently, there appear to be few repercussions for contractors that fail to meet their commitments. In response to data requests, the City's major construction contracting departments all reported that they had no record of penalties being charged from the beginning of 2005 through May 2009. In the past, a City department assessed penalties based on underutilization of MWBEs. However, the IGO has been informed by a City employee¹⁹ that in 2001 the Department of Law directed this department to stop assessing penalties related to the MWBE requirements.²⁰

Lastly, we found that the 2010 budget of the Office of Compliance (Compliance), which was transferred responsibility for most aspects of the program's administration in October 2009, does

¹⁷ This is a key criterion for MWBE certification. Firms that exceed an annual gross receipts limit are ineligible for the program.

¹⁸ Graduation from the MWBE program occurs when either a firm's annual gross receipts or the personal net worth of the firm's owner, exceed the program's eligibility criteria.

¹⁹ Interview #4.

²⁰ The IGO requested documents from the Department of Law (Law) relating specifically to advice provided to DPS not to collect penalties for non-participation. Law invoked attorney-client privilege, thus leaving the IGO without adequate information to assess the basis of the directive to DPS to suspend pursuit of ordinance-prescribed penalty assessments.

not provide sufficient resources to administer the program. Program administration under Compliance is being attempted with 7 budgeted positions and a half-million dollar contract budget to conduct all MWBE certifications and all post-contract award MWBE compliance. By comparison, in 2009, DPS was budgeted 12 positions in certification alone. The history of the program makes clear that with this limited budget and staffing, Compliance will not be able to: properly scrutinize firms that attempt to become MWBE (or DBE) certified, conduct any meaningful assessment of actual MWBE participation on City contracts, or address any of the major deficiencies in the program's administration detailed above. A recent interview with a City official confirmed that Compliance is struggling to simply keep up with the volume of MWBE certification-related work, let alone improve the City certification process, and has only one staff member assessing actual MWBE participation on all the City's contracts. Given the resources allocated to Compliance in the 2010 budget, the fraud, abuse, and mismanagement that have plagued the program since its inception are all but assured to continue unabated.

3. Summary of Recommendations

The failings of the program cannot and should not be blamed on a single person or a single department, and therefore no single policy change can fix the program. Rather, what are needed are both a rigorous program administration and a commitment from all parts of City government to the program's goals, including, most notably, from the user departments which manage the City's contracts. In the following sections, we offer a series of recommendations to help the program better fulfill its mission.

(A) Improvements in Data Collection and Reporting

The City must make a number of improvements in the collection and reporting of data regarding the MWBE program. Compliance²¹ must begin tracking actual payments to MWBEs and all subcontractors and report this data to the City Council and the public. DPS was already conducting audits of contracts to determine actual participation. However, it did not collect or analyze this data. Instead, each audit was stored individually in the files associated with each contract. Compliance must collect and report the results of the audits it conducts. Finally, the user departments must begin electronically filing documents related to contracts in order to provide the compliance officers, who assess MWBE participation as contracts progress, with timely access to information.

(B) Improvements in Administration

The City must take several steps to improve the administration of the program. First, the City's leadership and the officials who administer the program must not view the MWBE program as merely "pushing paper", but rather as a means of achieving the program's important social and economic policy objectives.

²¹ We assume for the purpose of our analysis, notwithstanding the recent transfer of Hiring Compliance from the Office of Compliance (Compliance) to our office, that MWBE certification and post-award contract compliance will remain situated in Compliance. Our recommendations apply regardless of where the City decides to base MWBE program administration from this point forward.

I. Improved Payment Verification

In order to properly verify actual payments to MWBEs, the administration has to collect better documentation from the City's vendors. Currently, the verification process often relies on documentation that can easily be and has been manipulated to overstate MWBE participation. At a minimum, the administration must require contractors to submit canceled checks to verify what MWBEs are actually paid.

In lieu of improved verification from the contractors, the City should consider directly paying subcontractors which would eliminate most of the uncertainty about how much MWBEs are being paid, which would in turn decrease the administrative burden on the grossly understaffed MWBE compliance unit. Direct payment of subcontractors would also ensure that MWBEs and other small firms would get paid faster. This is especially important for MWBEs, which often have limited access to credit and are, on average, smaller than their non-MWBE counterparts. Finally, direct payment would have the further benefit of reducing the ability of prime contractors to withhold payments from subcontractors, which is sometimes used as leverage by unsavory prime contractors to induce over-reporting of MWBE participation.

II. More Inter-Departmental Cooperation

In order for the MWBE program to improve, it must be better integrated into the City's contracting process. The program and its various components (certification, contract-specific goal setting, and assessing actual participation) cannot function if they are operated in a vacuum, disconnected from all other aspects of contract administration. Rather, each component of the MWBE program needs to rely on information and expertise from the personnel who let and manage the City's contracts.

Specifically, Compliance and DPS need greater cooperation from the City's user departments, which must play a greater and more substantively engaged role in the administration of the program. Greater collaboration between the user departments, DPS, and Compliance would enable the administration to more quickly identify shortfalls in MWBE participation and more accurately assess the validity of MWBE participation as contracts are performed.

The user departments should monitor and report on MWBE participation as contracts are performed. Because of their day-to-day management of City contracts, user departments are best suited to fulfill this role. Another way to increase the involvement of user department contract managers would be to have them certify that, to the best of their knowledge, the documents that contractors submit to detail MWBE participation accurately reflect the work each subcontractor performed. This requirement will help establish that the user departments are partly responsible for the program's administration.

A more far-reaching step would be to embed MWBE compliance officers in each major user department. These officers could train contracting personnel on MWBE issues and help them better identify MWBE problems as they arise. Rather than have these MWBE compliance officers report to the user department, these officers could report directly to the head of MWBE compliance in the Compliance department. This would better ensure that the officers all have a

uniform understanding of the MWBE regulations and that MWBE administration is standardized across departments.

III. Consistently Apply Program Regulations

Compliance must improve the certification and compliance functions of the program. Currently, certification officers are more focused on ensuring that firms simply complete all the required documentation rather than scrutinizing and assessing the validity of this documentation. Going forward, certification officers must more thoroughly review the legitimacy of applications for the program. The compliance unit assessing MWBE participation needs to have a better understanding of the contracts it monitors and be able to better validate the information that firms submit. In both certification and compliance, the administration needs to more consistently apply the rules and regulations that govern the program.

IV. Increase Contract Specific Goal Setting

For construction and non-construction contracts, the City must set MWBE goals on a contract-specific basis. Different City contracts allow for varying degrees of MWBE participation, yet the City generally applies the same contracting goals to every contract. This ignores industry differences in MWBE availability and variations in subcontracting opportunities on different contracts. In order to ensure a program that better conforms to actual MWBE contracting opportunities, the City must set MWBE goals for individual contracts based on the availability and capacity of MWBEs in individual industries.

V. More Resources for Program Administration

To properly oversee the program substantially more resources must be devoted to its administration. Although the City is under great fiscal strain, if more resources are not devoted to MWBE administration, the almost certain result is the continued fraud and misadministration of millions of dollars that should be directed to the service of the important social and economic goals of the program.

VI. Changes in Regulations

The administration must change several specific regulations of the program. Currently, the treatment of spousal income in determining a firm's eligibility creates a loophole that can easily be and has been abused by front companies or by wealthy owners who hide assets in their non-eligible spouse's name. This loophole should be closed by including a full accounting of spousal income in the personal net worth calculation.

Additionally, the City has been ineffective at preventing brokers from participating in the program. The City should follow the lead of the State of Illinois and amend its broker policy so that it allows brokers to participate in the program but only count their commissions as MWBE participation. By only counting broker commissions as participation, the City can reduce its own, as well as non-MWBE firms' incentive to use brokers.

4. Conclusion

Our investigations and analysis have revealed that the MWBE program is poorly administered and that the City cannot determine whether or not the program is achieving its goals. Part of the result of this substandard administration is that the program has been beset by fraud and brokers, and MWBE participation is likely far less than the publicly reported statistics.

The City's failure to collect relevant data, its inconsistent application of the program's rules and regulations, and a lack of cooperation between the user departments and DPS have all contributed to the program's poor administration. Despite a lawsuit challenging the program's constitutionality and several high-profile scandals involving the program, these failings have not been corrected. The MWBE program requires continuous oversight and analysis, yet the City has not successfully addressed the program's problems as they have arisen.

Going forward, the City must confront the problems that plague the program. To do this, there must be a commitment from all parts of City government to the program's goals and rigorous, continuous analysis of how the program is administered and of the program's effectiveness.

A. CHICAGO'S MWBE PROGRAM

1. Initial Program

The City's inaugural foray into affirmative action in government contracting began in 1983, when Mayor Harold Washington "established a goal of at least 25 percent combined M/WBE participation on all city contracts."²² In 1985, through an executive order, this goal was formally mandated and the City's Minority and Women-owned Business Enterprise (MWBE) program was created.²³ The rationale for the program's creation was that "there exists a statistically significant disparity between the minority and female populations of the City of Chicago and both the number of minority-owned and women-owned businesses in the City and the number of such businesses being awarded City contracts."²⁴ This disparity was attributed to "long standing social and economic barriers impairing women and minorities."²⁵ The Order defined minorities as "blacks; Hispanics, regardless of race; Asian-Americans and Pacific Islanders; American Indian and Alaskan Native."²⁶ A Minority-owned business (MBE) or Women-owned business (WBE) was defined as "a business which is at least 51% owned" by minorities or women and "whose management and daily operations are controlled" by minorities or women.²⁷ In order to rectify this disparity, the City established "a goal of awarding not less than 25% of the annual dollar value of all City contracts to qualified MBEs and 5% of the annual dollar value of all City contracts to qualified WBEs."²⁸

When Mayor Richard M. Daley took office in April 1989, he re-issued the Executive Order. However, in that same year, in the *City of Richmond v. J.A. Croson Co*²⁹, the Supreme Court ruled an affirmative action contracting program unconstitutional because the City of Richmond did not provide enough evidence to justify its program [For more on this decision, See Appendix A- History of Affirmative Action in Government Contracting]. This ruling threatened to invalidate programs around the country, including the Chicago program. In response to the Court's decision in *Croson*, Mayor Daley appointed a blue-ribbon panel to study the City's program. In March 1990, the panel concluded that "the city's existing set-aside goals were 'appropriate and sustainable' under the *Croson* decision."³⁰ In 1990, after a series of hearings that marshaled evidence for the program's existence, the City Council passed an ordinance that made the MWBE program law. The ordinance kept in place the same goals that were enacted by Mayor Washington's initial executive order. The ordinance was passed "shortly before U.S. District Court Judge Milton I. Shadur was expected to declare the program unconstitutional."³¹

²² James H. Lowry & Associates. Study of Minority and Women-Owned Business Enterprise Procurement Programs for the City of Chicago. March 1985. pg 2-4.

²³ City of Chicago. Executive Order 85-2.

²⁴ *Id.*

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.*

²⁹ *City of Richmond v. J. A. Croson Co*, 488 U.S. 469, 509 (1989).

³⁰ Sundman, Helena. "City, Indians Clash on Contracts." *Chicago Reporter* July 1993.

³¹ *Id.*

Because the lawsuit was based on the initial executive order, the City Council “passage of the ordinance made the court case moot.”³²

2. Builders Association of Greater Chicago v. City of Chicago

In 1996, the Builders Association of Greater Chicago (BAGC) challenged the constitutionality of the City’s MWBE program as it related to construction contracts. In 2003, a federal court held that Chicago’s program did not meet the constitutional standard set forth by the Supreme Court’s *Croson* decision. The court found that while the City had a compelling interest to remedy past racial discrimination in the construction industry, the program was no longer “narrowly tailored” to simply remedy the effects of that discrimination. The court cited a number of factors that made the City’s program too broad: it did not sunset; few firms graduated from the program; and few waivers from the goals were granted.³³ While the court found the City’s program unconstitutional, court implementation of the decision was stayed for six months to give the City time to create a more narrowly tailored program.

3. The 2004 Revision of the Construction Program

In response to the *Builders* decision, the City convened a Task Force to recommend how to change the program. In March 2004, the Task Force held public hearings “during which over 60 witnesses from community groups, businesses, associations and other interested parties, testified.”³⁴ “The Task Force was responsible for reaching out to constituents affected by the program and recommending the best ways to improve it.”³⁵ The City also conducted a statistical study in order to examine the extent of the discrimination in the Chicago construction industry and to determine what the contracting goals of the program should be, based on the availability of minority and women-owned firms.

This study outlined the criteria by which the City should judge whether discrimination exists in the construction (or any other) industry. Through a statistical regression analysis, the study calculated the advantage/penalty to the owner of a construction firm who had certain racial and gender characteristics. An owner of a construction firm was defined as anybody who was self-employed in the industry. The study found that, when controlling for all other characteristics, being African American, Hispanic or a woman, had a negative effect on the earnings of the self-employed in construction in Chicago. The author of the study concluded that this statistical analysis is “the concrete measure of the penalty imposed on those who are not non-minority males.”³⁶

In addition to establishing this concrete measure of discrimination, the study used census data to calculate the availability of minority and women-owned construction firms in Chicago. First, the study calculated the percentage of the self-employed who were African American or Hispanic in

³² Sundman, Helena. “City, Indians Clash on Contracts.” *Chicago Reporter* July 1993.

³³ *Builders Association of Greater Chicago v. City of Chicago*, 298 F. Supp.2d 725, (N.D. Ill. 2003).

³⁴ Shefsky and Froelich. “Chicago’s Minority and Women Business Enterprise Program in Construction: A Constitutional Challenge: A Report to the City Council Budget Committee on the *BAGC v. City of Chicago* Trial. April 2004. pg. 89.

³⁵ *Id.*, pg. 89.

³⁶ Bates, Timothy. “New Evidence Applicable to City of Chicago Procurement Policies.” April 20, 2004. pg. 57.

Chicago construction. Second, it adjusted this initial estimate of availability upwards because African American and Hispanic owned firms rely more heavily on government sales than their white-owned counterparts.³⁷ Because the study sought an availability estimate for MWBEs attempting to sell to the government, it believed it was appropriate to make this adjustment. After this adjustment, the study calculated the availability, and thus the goal, of minority-owned firms at 24.2 percent. For women-owned firms, the study simply took the self-employment percentage of women, 3.9 percent, and did not adjust this figure.³⁸

In June 2004, the City passed an amended ordinance that changed the MWBE program as it applied to construction contracts. The program as applied to other City contracts had not (and still has not) been challenged in court and thus was not amended. Based on the study discussed above, the goals were set at 24 percent for minority-owned firms and 4 percent for women-owned firms. The legislation implemented a personal net worth limit of \$750,000 for owners of certified firms and an annual gross receipts limit for certified firms based on the Small Business Administration's (SBA) small business size standards. The ordinance was amended in 2006 to raise the personal net worth threshold to \$2 million dollars (since increased to \$2.04 million due to inflation).³⁹ Also, the ordinance was amended so that it would sunset after five years, in December 2009.

4. The 2009 Reauthorization of the Construction Program

After the revamped ordinance was adopted, the City was required to review the program periodically and to continue to examine ongoing statistical evidence for the program's goals. In 2009, before the City Council debated a reauthorization of the MWBE construction ordinance, the City commissioned another statistical analysis of the City's construction industry. This study found the City's construction industry largely unchanged from five years earlier. All else equal, there remained a penalty attached to being a minority or a woman in construction self-employment.

Instead of using census data, the availability calculation in this study was based on Dun and Bradstreet (D&B) data and found a much smaller number of minority and women-owned firms in construction. The author believed that this is partly a result of the D&B data not always labeling the racial and gender characteristics of firms.⁴⁰ After adjusting for this mislabeling, the study found the availability of minority-owned construction firms to be 13.3 percent and 11.8 percent for women-owned firms.⁴¹ The study then made two adjustments to the minority-owned firm availability. Like the previous study, it adjusted the number upwards for the greater reliance of African American and Hispanic-owned firms on sales to the government. This resulted in a MBE figure of 14.6 percent.⁴²

³⁷ Bates, Timothy. "New Evidence Applicable to City of Chicago Procurement Policies." April 20, 2004. pg. 49.

³⁸ *Id.*, pg. 48.

³⁹ City of Chicago. "Chicago City Council Approves Ordinance to Help Eliminate Barriers for Minority and Women Owned Enterprises." November 1, 2006.

⁴⁰ Blanchflower, David. "Report on the City of Chicago's MWBE Program." June 10, 2009. pg. 89.

⁴¹ *Id.*, pg. 89.

⁴² *Id.*, pg. 102.

The second adjustment was a “but-for” adjustment, which attempted to determine the availability of minority-owned firms if there had not been past discrimination in the industry. This adjustment was only applied to the African American and Hispanic availability figures because the author believed there was not statistical evidence to warrant an adjustment for women or other minority-owned firms.⁴³ The result of the “but-for” adjustment was a large increase in the MBE availability to 24 percent.⁴⁴

While the author determined that the availability of women-owned firms was 11.8 percent in the construction marketplace in Chicago, he argued that the WBE goal should remain at its previous level of 4 percent. The author’s rationale for setting the WBE goal at 66 percent less than the availability estimate was that he did not find strong statistical evidence that women-owned construction firms experience discrimination in Chicago.

On July 29, 2009, the City Council reauthorized the program through 2015. The only changes to the program were the addition of Native Americans as a disadvantaged group and an interim review scheduled for 2012.

5. Non-construction Program

While the construction component of the City’s MWBE program has undergone changes and revisions due to the *Builders* case, the program as it applies to non-construction contracts has largely been unchanged since its inception in 1990. The largest subsets of non-construction contracts are work services, commodities, and professional services. The ordinance establishes an overall goal in non-construction contracts of 25 percent for MBEs and 5 percent for WBEs.⁴⁵ While construction is the largest single area of MWBE participation, taken together the different types of non-construction contracts accounted for over 63 percent of the total dollar amount of MWBE participation reported in 2008, in terms of contract awards.

There are several differences between the construction and non-construction program. While non-construction limits the annual gross receipts a participating firm can receive, this limit is generally higher than the limit in construction. The limit in non-construction was set at \$27 million in 2000 and is adjusted annually for inflation (it is almost \$34 million for 2010), while the construction program’s limit is based on the SBA small business size standards, which for most construction industries is lower.⁴⁶ There is no personal net worth limit for participation in the non-construction program. There is a target market program in non-construction, while there is not one in construction.⁴⁷ The chart below highlights the differences between the two programs.

⁴³ Blanchflower, David. “Report on the City of Chicago’s MWBE Program.” June 10, 2009. pg. 103.

⁴⁴ *Id.*, pg. 104.

⁴⁵ *Chicago Municipal Code*, sec. 2-92-430 (American Legal 2009).

⁴⁶ For some industries, the SBA size standards rely on employee headcounts rather than annual gross receipts.

⁴⁷ After the 2004 revision to the construction ordinance, the Target Market program was ended in construction contracts.

Table 1- Comparing the Construction and Non-construction MWBE programs		
	Construction	Non-construction
<i>Program Characteristics</i>		
MBE Goal	24 percent	25 percent ⁴⁸
WBE Goal	4 percent	5 percent
Limit on firm owner's personal net worth	\$2.04 million	None
Limit on firm's annual gross receipts	SBA small business size standards by industry (Generally, \$14 million for specialty trade contractors and \$33.5 million for building and civil construction)	Nearly \$34 million in 2010. Adjusted annually for Inflation
Time period over which to calculate gross receipts	5 years	3 years
Reserve contracts for MWBEs (Target Market)	No	Yes
Goals based on statistical evidence	Yes	No
Sunset Provision	Yes	No

(A) *Target Market Program*

Within non-construction contracts, the City has a Target Market program, which directs contracts to MWBEs. This program reserves a percentage of the City’s contracts and limits participation to MWBEs.⁴⁹ Contracts are not eligible for the program unless “there are at least three qualified MBEs or WBEs interested in participating in that type of contract.”⁵⁰ Through the Target Market program, DPS has a goal of awarding 10 percent of all City non-construction contracts to MBEs and 1 percent to WBEs.⁵¹ This program was formerly in place for construction contracts but was discontinued in 2004 when the MWBE construction program was revamped.

The table below shows the amount of contracts that were awarded through the Target Market program from 1993-2004.

⁴⁸ This MBE goal and the WBE goal on the line below are the Citywide MWBE goals for non-construction contracts. The individual contracting goals inserted in the contract language of each non-construction contract are a minimum of 16.9% for MBEs and 4.5% for WBEs.

⁴⁹ *Chicago Municipal Code*, sec. 2-92-460 (American Legal 2009).

⁵⁰ *Id.*, 2-92-460.

⁵¹ *Id.*, 2-92-420.

Year	Contracts awarded to MBEs thru Target Market in \$	Contracts awarded to WBEs thru Target Market in \$	Contracts awarded to MWBEs thru Target Market in \$
1993	\$19,954,071	\$3,926,393	\$23,880,464
1994	\$38,191,137	\$4,995,926	\$43,187,063
1995	\$40,843,479	\$11,894,337	\$52,737,816
1996	\$24,040,765	\$9,840,803	\$33,881,568
1997	\$49,798,732	\$7,640,192	\$57,438,924
1998	\$39,917,079	\$10,734,772	\$50,651,851
1999	\$54,688,487	\$9,176,745	\$63,865,232
2000	\$109,135,104	\$18,584,215	\$127,719,319
2001	\$94,613,498	\$38,790,070	\$133,403,568
2002	\$171,211,359	\$24,343,469	\$195,554,828
2003	\$146,246,903	\$44,816,880	\$191,063,783
2004	\$75,559,058	\$18,844,425	\$94,403,483
Source of 1995-2004 data: DPS MWBE Fact Sheets			
Does not include pending TM awards			

B. SCOPE OF CHICAGO'S MWBE PROGRAM

The table below details the broad scope of the MWBE program. Since 1991, the administration has reported that over \$9.5 billion in City contracts has been awarded to MWBEs.⁵² Over this period, the reported MWBE participation has averaged 36 percent of the total value of the contracts awarded, although it has fluctuated from an annual low of 30 percent to a high of 45 percent.

It is important to note that these figures exclude Public Building Commission and Tax-Increment Financing (TIF) funded contracts. Also, there are no MWBE requirements on sole source and emergency contracts.⁵³ Therefore, the City does not count the value of these contracts when it calculates the percentage of contract dollars going to MWBEs.

⁵² Data prior to 2005 include DBE participation. Data from 2005 through 2008 does not include DBE participation.

⁵³ City spending via direct vouchers (spending not attached to a City contract) also does not have MWBE requirements. A recent May 2010 IGO audit found that City spending via direct vouchers rarely went to MWBEs. (http://www.chicagoinspectorgeneral.org/pdf/igo_audit_direct-vouchers.pdf last accessed May 19, 2010)

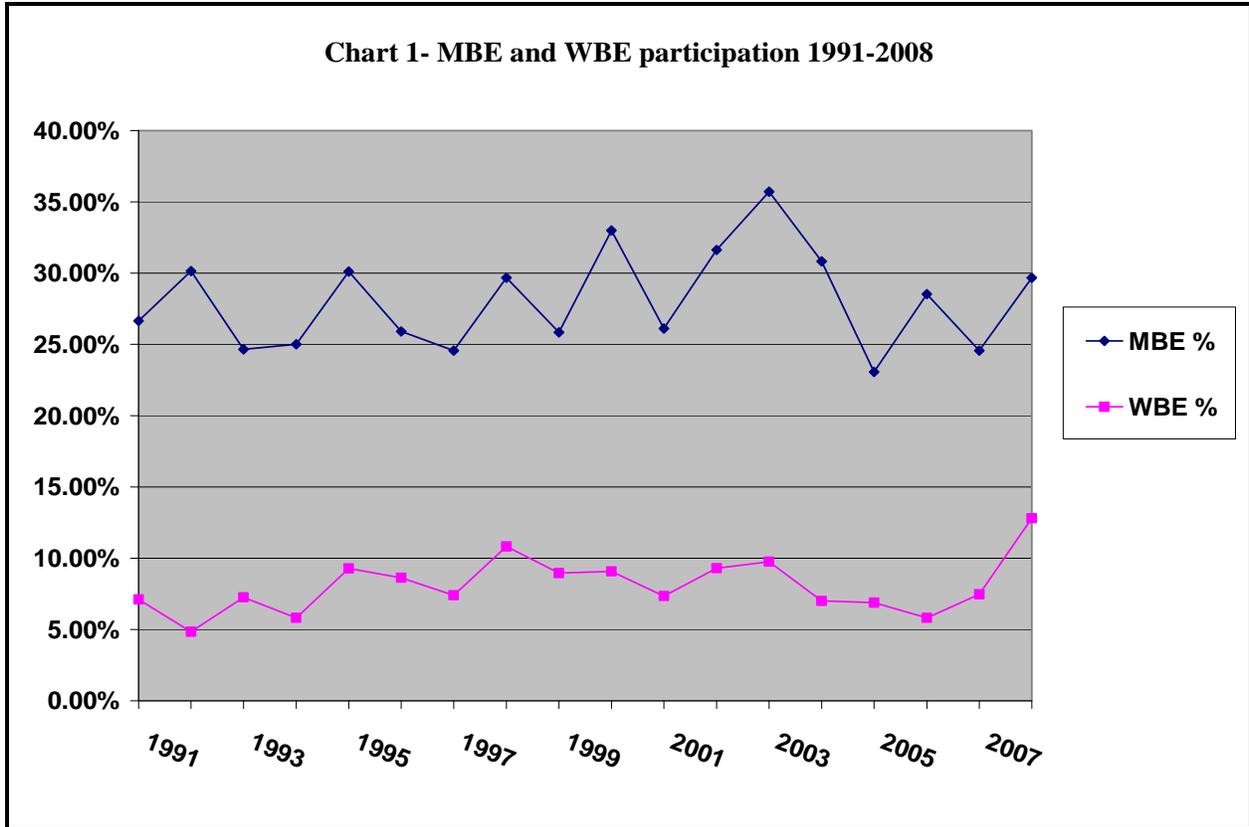
Table 3- Contracts Awarded to MWBEs 1991-2008

Year	Contracts Awarded in \$	Contracts Awarded to MBEs in \$	MBE %	Contracts Awarded to WBEs in \$	WBE %	Contracts Awarded to MWBEs in \$	MWBE %
1991	\$598,534,397	\$159,497,925	26.65%	\$42,488,075	7.10%	\$201,986,000	33.75%
1992	\$583,342,997	\$175,781,712	30.13%	\$28,207,092	4.84%	\$203,988,804	34.97%
1993	\$864,877,697	\$213,178,649	24.65%	\$62,701,650	7.25%	\$275,880,299	31.90%
1994	\$798,284,700	\$199,601,200	25.00%	\$46,462,700	5.82%	\$246,063,900	30.82%
1995	\$681,258,600	\$205,142,600	30.11%	\$63,284,500	9.29%	\$268,427,100	39.40%
1996	\$1,050,738,400	\$272,238,500	25.91%	\$90,640,800	8.63%	\$362,879,300	34.54%
1997	\$1,043,112,300	\$256,158,700	24.56%	\$77,199,700	7.40%	\$333,358,400	31.96%
1998	\$1,480,495,300	\$439,260,700	29.67%	\$160,130,300	10.82%	\$599,391,000	40.49%
1999	\$1,982,993,600	\$512,459,100	25.84%	\$177,503,400	8.95%	\$689,962,500	34.79%
2000	\$1,147,369,900	\$378,455,200	32.98%	\$104,186,400	9.08%	\$482,641,600	42.07%
2001	\$1,912,152,100	\$499,265,000	26.11%	\$140,264,700	7.34%	\$639,529,700	33.45%
2002	\$1,513,257,072	\$478,425,596	31.62%	\$140,700,067	9.30%	\$619,125,663	40.91%
2003	\$1,289,576,213	\$460,458,388	35.71%	\$125,726,475	9.75%	\$586,184,863	45.46%
2004	\$911,558,749	\$280,926,249	30.82%	\$63,842,526	7.00%	\$344,768,775	37.82%
2005	\$2,016,981,666	\$465,072,670	23.06%	\$138,858,000	6.88%	\$603,930,670	29.94%
2006	\$3,150,950,174	\$876,788,972	27.83%	\$205,159,351	6.51%	\$1,081,948,323	34.34%
2007	\$2,941,915,658	\$722,678,127	24.56%	\$219,585,886	7.46%	\$942,264,013	32.03%
2008	\$2,437,266,418	\$722,934,714	29.66%	\$312,153,681	12.81%	\$1,035,088,395	42.47%
Total	\$26,404,665,941	\$7,318,324,002	27.72%	\$2,199,095,303	8.33%	\$9,517,419,305	36.04%
Source: DPS MWBE Fact Sheets and Miscellaneous DPS Records; Figures may not sum to total due to rounding							
The Contracts Awarded in \$ does not include certain contracts that are excluded from the MWBE participation statistics. Most notably, sole-source and emergency contracts are not included in these values.							

While the above figures represent contract awards and not actual payments, they demonstrate that the MWBE program is one of the City's largest economic development tools. By comparison, the 2010 budget for the Department of Community Development, which is the City department primarily tasked with promoting economic development, is \$354 million.⁵⁴

The chart below plots MBE and WBE participation as a percentage of all contract dollars awarded from 1991 to 2008. The chart demonstrates the fluctuations in participation in both categories over the 18-year period.

⁵⁴ City of Chicago. Annual Appropriation Ordinance for 2010. pg. 441. This does not include TIF spending.



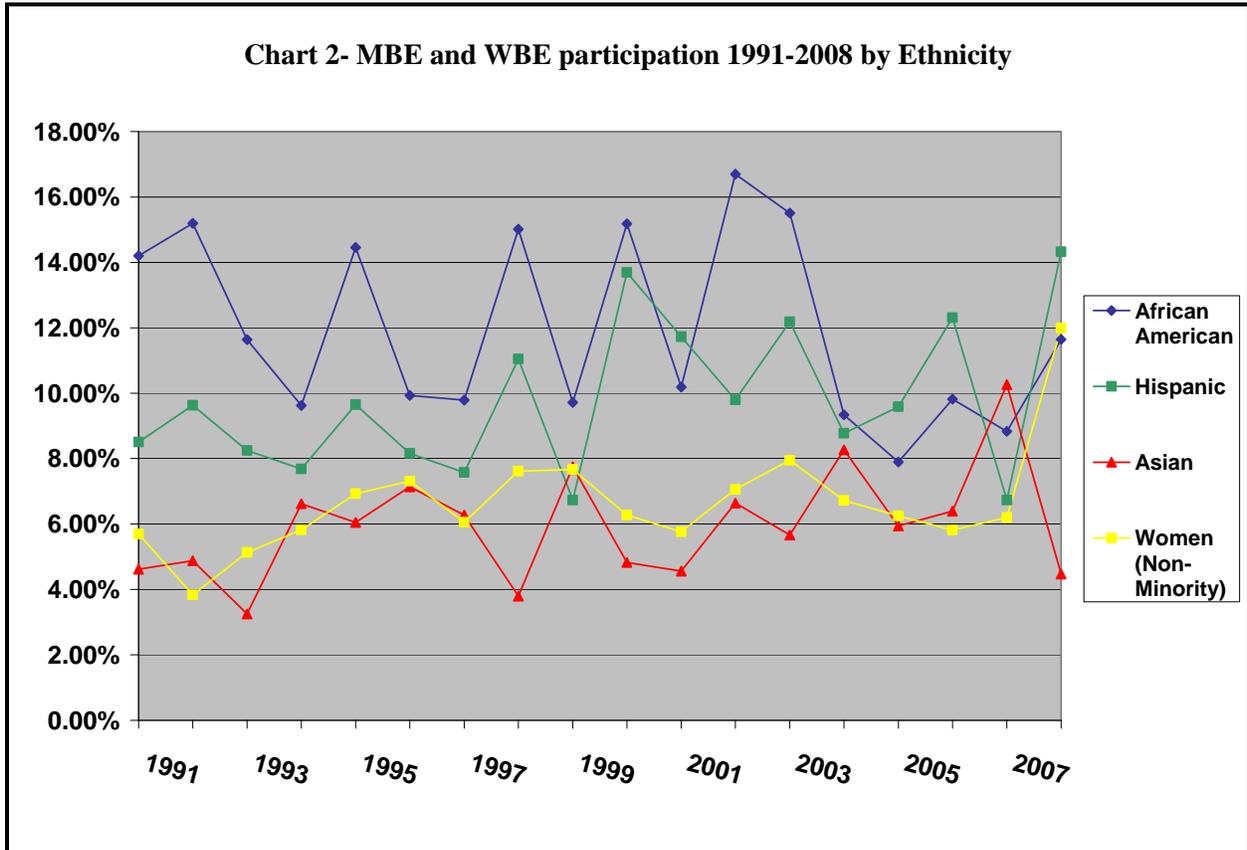
1. Participation by Ethnicity

The table below shows the average MWBE participation in terms of contract awards by ethnicity since 1991.

Ethnicity/ Category	Dollar Value of Contracts Awarded	Percentage of Value of Total Contracts Awarded
African American	\$2,990,271,768	11.32%
Hispanic	\$2,662,645,211	10.08%
Women (Non-Minority)	\$1,836,092,958	6.95%
Asian	\$1,652,397,791	6.26%
DBE	\$266,038,726	1.01%
Non-Designated/Other	\$109,976,726	0.42%
TOTAL	\$9,517,423,181	36.04%
Source: DPS Fact Sheets; Figures may not sum to total due to rounding		
Prior to 2005, DPS's statistics for the DBE program were not broken down by ethnicity. Thus, in this table all DBE awards appear as a single line. Data from 2005-2008 does not include DBE data.		
Note: Due to several minor discrepancies in DPS Fact Sheets, the total contract value shown in Table 4 does not reconcile to the total contract value in Table 3. The difference is \$3,876.		

While African Americans have the highest share of MWBE participation over the last 18 years, their share of awarded contracts has declined in recent years. The chart below shows the

percentage of MWBE participation by ethnicity. As the chart demonstrates, the participation of African American firms peaked in 2001 and then declined over the next several years before rebounding somewhat in 2008. Hispanic participation has fluctuated significantly but reached its peak in 2008. Asian participation has trended upwards over the last 18 years although there was a significant drop off in 2008. Non-minority women participation has remained fairly consistent but increased dramatically in 2008.



2. Participation in Construction

Construction is the largest contract area of the MWBE program. The table below details MWBE participation in awarded construction contracts from 1995-2008 broken down by ethnicity. The table shows that in percentage terms Hispanics have accounted for over a third of the program’s total participation over the last 14 years.

Table 5- Construction Contracts Awarded to MWBEs 1995-2008 by Ethnicity/ Category

Ethnicity/ Category	Dollar Value of Construction Contracts Awarded	Percentage of Total Construction Contracts
Hispanic	\$920,346,586	14.16%
African American	\$594,479,418	9.14%
Women (Non-Minority)	\$461,923,658	7.10%
Asian	\$447,134,590	6.88%
DBE or Non-Designated	\$130,279,478	2.00%
TOTAL	\$2,554,163,730	39.28%
Source: DPS Fact Sheets. Data before 1995 was unavailable; Figures may not sum to total due to rounding		
Note: Prior to 2005, DPS's statistics for the DBE program were not broken down by ethnicity. Thus, in this table all DBE awards appear as a single line. Data from 2005-2008 does not include DBE data.		

3. Participation in Non-Construction

Non-construction contracts account for two-thirds of the City’s procurement dollars. The table below shows MWBE participation in non-construction contracts from 1995 through 2008. In non-construction, African Americans have accounted for over one-third of the total MWBE participation over the last 14 years.

Table 6- Non-construction Contracts Awarded to MWBEs 1995-2008 by Ethnicity/ Category

Ethnicity/ Category	Dollar Value of Construction Contracts Awarded	Percentage of Total Construction Contracts
African American	\$2,044,630,695	11.99%
Hispanic	\$1,502,460,454	8.81%
Women (Non-Minority)	\$1,226,848,314	7.19%
Asian	\$1,068,187,841	6.26%
DBE or Non-Designated	\$193,208,845	1.13%
TOTAL	\$6,035,336,149	35.38%
Source: DPS Fact Sheets. Data before 1995 was unavailable; Figures may not sum to total due to rounding		
Note: Prior to 2005, DPS's statistics for the DBE program were not broken down by ethnicity. Thus, in this table all DBE awards appear as a single line. Data from 2005-2008 does not include DBE data.		

C. RESEARCH ON THE IMPACT OF CHICAGO’S MWBE PROGRAM

Research on the impact of Chicago’s MWBE program has been limited. There are several reasons for this including, difficulties isolating the program’s impact on the broader economy, data on payments to subcontractors not being collected, and the lack of formal program evaluations. A discussion of the program’s impact is discussed below. [For a discussion of research on the impact of affirmative action in government contracting nationally, see Appendix B.]

1. Research on Benefits

The MWBE program's goal is to remedy the effects of past discrimination by establishing a level playing field in the awarding of government contracts. This is accomplished by directing City contracts to MWBEs, which, in turn, is supposed to generate demand for MWBEs, which will "spur their creation and enhance their success."⁵⁵

(A) Increase in Contracts Awarded to MWBEs

The MWBE program has likely increased the share of contracts being awarded to MWBEs. In 1984, the year before the program began, 19.2 percent of the dollar value of all City contracts was awarded to MWBEs.⁵⁶ In 2008, the City awarded over 42% of the dollar value of its contracts to MWBEs. In construction, MBE participation at contract award in 1984 was 11.3 percent.⁵⁷ Today, it stands at over 40 percent. Even though these data reflect contract awards and not actual payments, it is highly likely that a larger portion of the City's contract dollars are going to MWBEs today than when the program began.

(B) Program's Impact on Economic Development of Minority and Women-Owned Businesses Is Unclear

In terms of spurring the creation of MWBEs, data show that the self-employment rates of African-Americans, Hispanics, and white women has grown relative to the self-employment rates of white men. In all lines of business, between 1989 and 1999, the self-employment rates for African-Americans, Hispanics, and white women in the Chicago area grew while the rates for white men declined.⁵⁸ In the construction industry, the self-employment rates of African-Americans and Hispanics grew substantially, while for white men there was only a slight increase. The self-employment rate of white women in construction in the Chicago-area barely changed between 1989 and 1999.⁵⁹

The increase in relative self-employment rates points to the increased business formation of MWBEs. Since these gains occurred while the MWBE program was in place, the data is consistent with the hypothesis that by directing contracts to MWBEs the program "is encouraging small-business formation and self employment entry among groups targeted by the preferences."⁶⁰ However, "there is no way of proving this linkage with the existing data."⁶¹ This reduction in self-employment disparity could be explained by broader economic factors and researchers have not yet isolated the impact of the MWBE program on these changes in relative self-employment rates.

⁵⁵ City of Chicago. Journal of Proceedings of the City Council. Reports of Committees – Committee on Budget and Government Operations. July 31, 1990. pg. 19319.

⁵⁶ James H. Lowry & Associates. Study of Minority and Women-Owned Business Enterprise Procurement Programs for the City of Chicago. March 1985. pg. 3-3.

⁵⁷ *Id.*, Exhibit 3-4.

⁵⁸ Bates, Timothy. "Discrimination in the Chicago-Area Construction Industry Handicaps Minority-Owned Firms" *Review of Black Political Economy* Summer 2006. pg. 21.

⁵⁹ *Id.*, pg. 21.

⁶⁰ *Id.*, pg. 22.

⁶¹ *Id.*, pg. 22.

2. Criticism of the Program

(A) Publicly Reported Statistics Overstate Participation

A criticism of the program is that the administration's practice of reporting contract award data as opposed to actual payment data overstates MWBE participation. In the *Builders* trial, the City's own lawyer argued "that the city's publicly announced figures on minority contracting should be 'greeted with great skepticism' and 'do not accurately portray the real economic impact' of the program."⁶² A 1998 study by a City consultant tracked actual payments to MWBEs, who were prime contractors and had been awarded contracts in 1992. The study found that "discrepancies between reported awards and actual payouts work to reduce the MBE and WBE share of procurement spending."⁶³ While conducted in 1998, this study was not revealed to the City Council until 2004 during the debate over reforming the MWBE construction program.⁶⁴ In response some aldermen called for reporting payout information. However, the City still reports participation based on contract awards.

(B) Fraud and Abuse of the Program Has Been Widely Reported

Since its inception, a problem with the City's program has been the existence of front companies. Even before Mayor Washington's Executive Order was issued, the Lowry report noted that as the Washington administration instituted an increased focus on MWBE participation a number of questionable firms certified themselves as MWBEs.⁶⁵ In 1989, the Better Government Association released a study that showed rampant fraud throughout the program and despite the official statistics far less money was going to minority and women-owned businesses. Scandals in the 1990s continued to trouble the program.⁶⁶ Over the past several years, there have been several prominent instances of firms abusing the City's MWBE program. In 2005, the United States Attorney charged that "the politically connected Duff family used its matriarch and a trusted black associate to pose as fronts for phony women- and minority-owned businesses in a massive, dozen-year fraud that garnered more than \$100 million in contracts from the City of Chicago."⁶⁷ Two years later, Duff pleaded guilty to charges of racketeering and was sentenced to nine years in prison.⁶⁸

⁶² Washburn, Gary and Cohen, Lauren. "Aldermen boiling over set-aside disclosures." *Chicago Tribune*. April 20, 2004.

⁶³ Bates, Timothy. "Discrimination and the Capacity of Chicago-Area Minority-Owned Businesses to Participate in Public Procurement." January 1998. pg. 127.

⁶⁴ Washburn, Gary and Cohen, Lauren. "Aldermen boiling over set-aside disclosures." *Chicago Tribune*. April 20, 2004.

⁶⁵ James H. Lowry & Associates. Study of Minority and Women-Owned Business Enterprise Procurement Programs for the City of Chicago. March 1985. pg. 3-14.

⁶⁶ Spielman, Fran. "Daley plans to check up on minority contractors." *Chicago Sun-Times*. December 30, 1999.

⁶⁷ O'Connor, Matt and Gibson, Ray. "Duffs charged in contract probe." *Chicago Tribune*. September 25, 2003.

⁶⁸ Associated Press. "Duff gets 9-plus years for city scam." *Crain's Chicago Business*. May 18, 2005.

D. ADMINISTRATION OF MWBE PROGRAM

The City's MWBE program was until recently administered by the Department of Procurement Services (DPS). In October 2009, the Office of Compliance (Compliance) assumed responsibility for the majority of the program's administration.⁶⁹ However, because the program also relates to the City's other contract management functions, the user departments⁷⁰ have played and will continue to play a role in its administration. Compliance will now certify firms for the program and monitor post contract-award compliance with the MWBE goals. DPS will retain responsibility for MWBE goal setting and compliance at contract award. The administrative process described in this section also applies to the DBE program⁷¹ that the City administers. This section describes the administration of the program as it is supposed to occur under the program's rules and regulations. Deficiencies in the conduct of the program administration are detailed in Section G.

1. Initial Certification of Firms

The certification unit is tasked with certifying firms for the City's MWBE program, as well as for the federal DBE program. In order to be certified as an MWBE, an applicant firm must meet several criteria. First, it must establish that the majority ownership and day-to-day control is held by a member of a disadvantaged group as defined by the MWBE ordinance or demonstrate that individually the owners have been socially disadvantaged through prejudice.⁷² A firm must demonstrate that it is independent, viable, and has the expertise to perform the work in the area it is seeking certification. To participate in the construction program, an applicant owner must document that his or her personal net worth is under \$2.04 million and that the firm's gross receipts do not exceed the small business size standards set forth by the SBA.⁷³ For non-construction contracts, there is no personal net worth limit and the annual gross receipts limit is nearly \$34 million for 2010.⁷⁴

The certification process begins with an applicant firm submitting detailed documentation to prove that it meets the program's requirements. These documents include tax records for the firm and the owner, banking, payroll, and loan information, office and equipment leases, agreements with manufacturers (if the applicant wants to supply materials), and other records. Certification officers review these documents to determine whether an applicant meets the program criteria. In addition to document reviews, the certification officers may, at their discretion, interview applicant owners and conduct site visits at the firms' places of business.

2. Annual Recertification

Once certified, a firm's certification remains valid for five years. However, each year the firm must annually submit documentation to demonstrate that it remains eligible for the program. If

⁶⁹ The analysis period for this report precedes the transfer.

⁷⁰ User departments refer to the departments that manage project work performed under contract with the City.

⁷¹ The DBE program is applicable on certain federally-funded contracts.

⁷² *Chicago Municipal Code*, sec. 2-92-670 (American Legal 2009).

⁷³ *Id.*, 2-92-670.

⁷⁴ *Id.*, 2-92-420.

nothing that would affect the firm's certification has happened over the preceding year, a firm submits a "No Change Affidavit" where it states that "no changes in the circumstances of (firm's name) affecting it's [sic] ability to meet the minority and/or women and/or disabled owned status, ownership or control of requirements of... the amended Municipal Code."⁷⁵ Owners are also required to annually submit both their firm's and their personal tax returns to show that they continue to meet the personal net worth limit, where applicable, and gross receipts requirements.

3. MWBE Compliance at Contract Award

The other administrative component of the MWBE program is contract compliance. During the contract award process, compliance officers work to ensure that the contract complies with the MWBE participation goals.

Each City contract has several documents related to the City's MWBE program (or DBE program if the contract is funded by the U.S. Department of Transportation). The Schedule C-1 details a prime contractor's commitment to use specific MWBE subcontractors on the contract. If the prime contractor is itself an MWBE, a Schedule C-1 is still completed. It describes what service the MWBE will perform on the contract and what dollar value it is estimated to receive for these services. Attached to this schedule is a current certification letter from the City that documents that the MWBE is currently certified and lists the services for which it is certified. A separate Schedule C-1 is completed for each MWBE. The Schedule C-1s are completed and signed by the MWBEs.

The Schedule D-1 summarizes the prime contractor's commitment to all the MWBEs that will work on the contract. It lists each MWBE and an estimate of what it will be paid and is completed and signed by the prime contractor. The document adds up the estimate of what will be paid to MBEs and WBEs and calculates the MWBE percentages based on the overall contract value. It is these percentages that form the basis of the MWBE participation numbers that DPS reports to the City Council and the public. The compliance officers review these documents to ensure "that the work for which the subcontractors have been identified is within their area of specialty, and that their certification is current."⁷⁶

While the majority of the responsibility for the program was transferred to Compliance, DPS retains the responsibility for goal setting and analyzing compliance at contract award. DPS also retains responsibility for identifying Target Market solicitations and evaluating MWBE waiver requests.⁷⁷

⁷⁵ City of Chicago. MBE/WBE/BEPD No Change Affidavit.

⁷⁶ Shefsky and Froelich. "Chicago's Minority and Women Business Enterprise Program in Construction: A Constitutional Challenge: A Report to the City Council Budget Committee on the *BAGC v. City of Chicago* Trial. April 2004. pg. 55.

⁷⁷ Boswell, Anthony and Rhee, Jamie. Memo to All City of Chicago Department Heads. "Transfer of Certification and Contract Compliance Functions to the Office of Compliance." October 28, 2009.

4. Tracking Actual Participation

Once contract performance begins, user departments are supposed to monitor the ongoing participation of MWBEs on City contracts.⁷⁸ Payments to MWBEs are supposed to be tracked using Subcontractor Payment Certifications (Certification forms), which are submitted with each invoice by prime contractors to the user departments.⁷⁹ These documents detail how much money will be paid to all subcontractors (including MWBEs) on each invoice and are the basis of the subcontractor payment information that is reported on DPS's contract payment website.⁸⁰

In addition to the Certification forms, on construction contracts, prime contractors are also required to submit Status Reports of MBE/WBE Subcontract Payments (Status Reports) with each monthly invoice. Although these documents are submitted to user departments, the procurement manual provides that contractors will not be paid "until the current Status Report has been filed with DPS".⁸¹

One difference between the Certification forms and the Status Reports is that the Status Reports only detail payments to MWBEs, while the Certification forms detail payments to all subcontractors. Another difference is that the Certification forms contain only the amount each subcontractor will be paid on the particular invoice to which the form is attached, while the Status Reports contain the same information (for each MWBE) and in addition provide a cumulative total of how much each MWBE has been paid to date under the contract.

On non-construction contracts, the procurement manual directs contractors to submit DBE/MBE/WBE Utilization Reports (Utilization Reports) at least on a quarterly basis.⁸² These reports detail the amount paid to date to each MWBE (or DBE in the case of certain federally-funded contracts) and what service each MWBE (or DBE) is performing. These documents are supposed to be submitted to DPS's (now Compliance's) compliance unit.⁸³

5. Auditing of Construction Contracts

When it was responsible for assessing actual MWBE participation, the compliance unit in DPS maintained a compliance file on each contract containing information relating to MWBE compliance. This included correspondence between the compliance unit and prime contractors and subcontractors, the initial compliance plan, and in the case of construction contracts, lien waivers. The files also contained the MWBE audits that determine if contractors are in compliance with the MWBE goals at the end of contracts.

⁷⁸ City of Chicago. "Procurement Policy and Process Manual. pg. 28, 35, 41, 47, 53, 60.

⁷⁹ City of Chicago. "Instructions: Subcontractor Payment Certification".

(http://www.cityofchicago.org/content/dam/city/depts/dps/SubcontractorPayments/HelpTextSubcontractorPaymentForm_1.pdf last accessed April 28, 2010)

⁸⁰(<http://webapps.cityofchicago.org/VCSearchWeb/org/cityofchicago/vcsearch/controller/agencySelection/begin.do> last accessed April 28, 2010)

⁸¹ City of Chicago. "Procurement Policy and Process Manual. pg. 97.

⁸² *Id.*, pg. 99.

⁸³ *Id.*, pg. 99.

For the City's construction projects, as for any construction project in Illinois, contractors and laborers who work on the project are entitled to place a mechanic's lien on a project in order to ensure payment for their work.⁸⁴ Once contractors and laborers are paid, they give lien waivers as a receipt documenting that they have been paid and waive their right to place a lien on the project. These lien waivers establish a paper trail of actual monies received by each firm on a construction project.

Lien waivers form the basis of the compliance unit's audits of actual MWBE participation. These audits consist of analyzing the lien waivers on each construction project to determine how much MWBEs have been paid on a given project and if these amounts conform to the percentages that the prime contractor committed to at the beginning of the contract.

6. Evaluating MWBE Participation on Construction Contracts⁸⁵

To be credited for MWBE participation, a firm must provide a commercially useful function in relation to the project work being performed.⁸⁶ "A MBE or WBE does not perform a commercially useful function if its role is limited to that of an extra participant in a transaction, contract, or project, through which funds are passed in order to obtain the appearance of MBE or WBE participation."⁸⁷ Specifically, the regulations state that:

"If a MBE or WBE does not perform or exercise responsibility for at least 30 percent of the total cost of its contract with its own work force, or the MBE or WBE subcontracts a greater portion of the work of a contract than would be expected on the basis of normal industry practice for the type of work involved, it is presumptively not performing a commercially useful function."⁸⁸

Once it has been established that a firm is providing a commercially useful function, the compliance unit must determine how much actual participation each MWBE has achieved. Particularly in construction contracts, MWBEs often enter into business relationships with non-MWBE firms (e.g., supplier agreements or subcontracts) and these business relationships must be evaluated by the compliance unit in calculating MWBE participation. These regulations apply whether the MWBE is a prime contractor or subcontractor. When an MWBE is itself a subcontractor and subcontracts with other firms, these other firms are referred to as 2nd tier (or further) subcontractors. (They are referred to as 2nd tier (or further) because they are two (or more) contracting levels away from the prime contractor.)

The overarching principle of these regulations is that only the work actually performed by the certified firm's own forces should be counted toward participation.⁸⁹ The regulations dictate that leased equipment, supplies, and materials that an MWBE purchases and uses itself should count

⁸⁴ Illinois Compiled Statutes. Mechanics Lien Act.

⁸⁵ The City's MWBE regulations governing construction contracts are based on the federal DBE program's regulations.

⁸⁶ City of Chicago. "Special Conditions Regarding Minority Business Enterprise Commitment and Women Business Enterprise Commitment in Construction Contracts." Section IV- G.

⁸⁷ *Id.*, Section IV- G-2

⁸⁸ *Id.*, Section IV- G-3

⁸⁹ *Id.*, Section IV- A.

as participation.⁹⁰ However, any work that an MWBE subcontracts to a non-MWBE firm should not count as participation.⁹¹

(A) *Supplier Participation*

The regulations also define compliance standards for firms that act solely as regular dealers or suppliers, that is, firms that only provide goods and perform no labor on a contract. In this instance, 60 percent of the cost of materials or supplies purchased from an MWBE supplier should be counted toward MWBE goals.⁹² However, if an MWBE manufactures the products it is supplying then 100 percent of the value of the goods it is providing should be credited to MWBE participation.

7. Auditing of Non-Construction Contracts

The assessments of non-construction contracts rely on less complete documentation. Because lien waivers are not used on non-construction contracts, compliance officers request affidavits from both prime contractors and subcontractors in order to determine MWBE participation. Compliance officers reconcile the payments that prime contractors report to the payments that MWBE subcontractors report receiving. If there is a disagreement, officers follow up with both parties and make a determination. However, if compliance officers do not receive a response from subcontractors they accept what the prime contractor reports, generally without scrutiny. Once they have established how much MWBEs received, the officers determine if there is a shortfall between the MWBE commitment made at the beginning of a contract and the actual payments made to MWBEs.

(A) *Indirect Participation*

One of the differences between construction and non-construction contracts is that in non-construction, firms sometimes meet the MWBE requirements through indirect participation. Indirect participation allows City contractors to achieve MWBE participation on City contracts by purchasing goods or services from MWBEs that are not directly funded by the City contracts. However, the goods and services purchased from the MWBE must be related to the City contract, in that the contractor would not need these goods or services if he/she had not won the City contract. Indirect participation is commonly used to purchase vehicles, janitorial, and accounting services.

(B) *Supplier Participation*

In the non-construction program, the participation of MWBE suppliers or dealers is treated differently than in the construction program. In construction, the participation of MWBE

⁹⁰ City of Chicago. "Special Conditions Regarding Minority Business Enterprise Commitment and Women Business Enterprise Commitment in Construction Contracts." Section IV- A. For example, a MWBE certified painting company will receive credit for the purchase of paint and related supplies that it utilizes on the contract.

⁹¹ *Id.*, Section IV- C.

⁹² *Id.*, Section IV- D.

suppliers is counted at 60 percent of the overall value of the goods obtained. However, in non-construction DPS counts 100 percent of an MWBE’s supplier’s contract as MWBE participation.

Table 7- Evaluating MWBE Participation in Construction vs. Non-construction		
	Construction	Non-construction
Documentation submitted to DPS to verify participation	Lien Waivers	Comparing affidavits of prime and subcontractors
Indirect participation	No	Yes
Treatment of supplier participation	Count 60 percent of value of contract	Count 100 percent of value of contract

8. Consequences of Non-participation

If a contractor fails to meet the MWBE goals to which it has agreed, both the construction and non-construction ordinances⁹³ give the City the right to collect penalties from the contractor equal to the amount of the shortfall between the amount committed to MWBEs and the amount actually paid.⁹⁴

An additional consequence of non-participation is that, in the event of a shortfall, the compliance officer notifies the prime contractor in writing that it has not achieved the MWBE commitment and that the subcontractor has a right to arbitration to collect the difference between the committed amount and the amount actually paid. Letters are sent to the MWBE subcontractors informing them of the shortfall and their right to arbitration.

9. Improvements to MWBE Administration

In 2009, DPS began to implement a web-based system, called Certification and Compliance (C2), to help in the administration of the MWBE program. The goals of C2 are to streamline the administrative burden of the program and make the monitoring process less paper intensive. Currently, monitoring compliance involves mailing documents to prime contractors and subcontractors. In turn, DPS, when it was responsible for monitoring MWBE compliance, received information from prime contractors and subcontractors almost exclusively in paper format. This meant that DPS must manually enter almost all the data it uses to track MWBE compliance.

C2 will enable Compliance (which now has responsibility for monitoring MWBE compliance) to better monitor reported MWBE compliance on an ongoing basis by having prime contractors enter their payments to subcontractors online. Once entered an email will be automatically generated and sent to the subcontractor for it to confirm that the prime contractor’s reported

⁹³ By non-construction ordinance, we are referring to the section of the ordinance from section 2-92-420 through 2-92-570. This section of the ordinance governs the MWBE program as it applies to all non-construction contracts, while section 2-92-650 through 2-92-780 governs the MWBE program as it applies to construction contracts.

⁹⁴ *Chicago Municipal Code*, sec. 2-92-445 (American Legal 2009).

payment is accurate. Administration officials believe that this will help to ensure better auditing of non-construction contracts in particular because it will increase the responsiveness of subcontractors. C2 will collect the results of reported payments to MWBEs in a single database, which should allow Compliance to report actual payments to MWBEs. Currently, the audits that track actual payments are stored individually with each contract and not analyzed or collected.

10. Transfer of MWBE Administration to Compliance

In October 2009, the City transferred the administration of the MWBE program from DPS to Compliance.⁹⁵ The transfer made Compliance “responsible for all post-award contract monitoring and the City’s M/WBE Certification Program.”⁹⁶ However, DPS continues “to evaluate compliance at the Bid submittal and pre-award contract stage.”⁹⁷

The 2010 budget outlines the resources that Compliance has to administer the program. The table below compares the 2009 appropriation for DPS to administer the entire program and the 2010 budget for Compliance to administer the majority of the program. While DPS retained the pre-award MWBE compliance functions, it is unclear from the 2010 Budget how many staff are devoted to these functions.

	2009 Appropriation	2010 Budget
Funding (all funds)	\$2,195,864	\$1,067,496
Total Funded Salaries	\$1,914,084	\$563,496
Funded Salaries as a Percentage of Total Budget	87%	53%
Budgeted Positions	26	7
Source: 2009 and 2010 Program and Budget Summary		
Source: 2010 Budget Recommendations		
Note: Funded salaries do not include reductions in personnel spending due to furloughs and partial government shut down days		

The table shows that the administration gave Compliance half the resources allocated to DPS in 2009, while being assigned responsibility for the majority of the administrative functions of the program. Compliance has a staff of 7 and a contract budget of \$500,000 to administer all of certification and post-award compliance monitoring. By comparison, in 2009, DPS was budgeted 12 positions in MWBE certification alone.

⁹⁵ City of Chicago. “Mayor appoints three new cabinet members.” Press release. August 13, 2009.

⁹⁶ Boswell, Anthony and Rhee, Jamie. Memo to All City of Chicago Department Heads. “Transfer of Certification and Contract Compliance Functions to the Office of Compliance.” October 28, 2009.

⁹⁷ *Id.*

E. EXAMPLES OF FIRMS EVADING MWBE PARTICIPATION⁹⁸

The IGO has uncovered numerous instances of City vendors abusing the MWBE program. Since 2005, IGO investigations have resulted in recommendations that 15 MWBEs be decertified and/or debarred. Currently, we have over 30 open administrative or criminal investigations related to the MWBE program. Our investigations have revealed that there are two major ways that MWBE participation is falsified: front companies and companies acting as “pass-throughs”, which we define as MWBEs that transfer the vast majority of their contracts to non-MWBEs. In addition, companies acting as brokers overstate MWBE participation on certain contracts. The investigations also have illustrated that these schemes are often orchestrated by prime contractors.

IGO investigations, while anecdotal, speak to a larger pattern of abuse of the City’s program because they have not involved small contracts nor are they confined to one department. Recent IGO sustained or soon to be sustained investigations⁹⁹ of fraud, abuse, and mismanagement in the MWBE program involve contractors that have been awarded over \$1 billion in City contracts (either as prime contractors or as subcontractors) since 2003. Several of these investigations are detailed below.

1. Front Companies

Probably the most widely reported type of MWBE fraud is front companies. An MWBE front is a company that certifies it is an MWBE with a minority or a woman both as the owner and in control of the day-to-day operations of the company. However, in reality the minority or woman is an owner in name only and the company and its profits are actually controlled by a non-minority male. The Duff case referenced above is an example of a front company.

Another example of a front company, revealed through an IGO investigation, was a WBE that held a contract to provide technical services to the City. The investigation showed that the ex-husband of the woman who allegedly owned and operated the company actually had day-to-day control over the business, while the woman lived out of the state for most of the year. For years, the company maintained its WBE certification while the ex-husband managed nearly all aspects of the business.

2. Pass-throughs

A second way that companies evade the MWBE participation requirements is by using MWBEs as pass-throughs. In these situations, an MWBE gets a City contract (or more often gets a subcontract with a prime contractor) to perform a certain service. Instead of providing the service, the MWBE contracts with one or several non-certified firms, which actually perform the work. The MWBEs perform “no commercially useful function” and payments are routed through them to achieve the appearance of MWBE participation. The pass-throughs that IGO

⁹⁸ The examples detailed in this section are descriptions of IGO investigations that, due to the confidential nature of IGO investigations, do not reveal the identity of the subjects being investigated.

⁹⁹ An IGO investigation is sustained when the preponderance of the evidence establishes that misconduct has occurred.

investigations have uncovered are largely done at the direction of non-MWBE prime contractors. There are also more nuanced pass-through relationships where MWBEs perform some small portion of the work they are supposed to provide but subcontract the bulk of the work to non-certified firms. Four IGO investigations that uncovered pass-throughs are detailed below.

An investigation showed that an MBE was utilized by a non-MWBE prime contractor for the purpose of generating fictitious minority participation. The MBE firm's owner stated that this company was hired by a prime contractor to provide structural materials on a large construction project, but his company also was directed to subcontract a significant portion of its contract to non-certified firms which had been pre-selected by the prime contractor. Many of the services contracted through the MBE were those for which the MBE was incapable of providing. A review of lien-waivers submitted to the City by the MBE indicates that a vast majority of the payments provided to the MBE were eventually disbursed to non-certified firms. The documentation shows that the MBE retained less than 10% of the original subcontract's value.

A different investigation revealed that a company certified to perform several services, subcontracted nearly all of its work out to non-certified companies and did little more than act as a pass-through between prime contractors and non-certified subcontractors. This company subcontracted over 90 percent of its contracts and had no staff to perform in one of its certification areas. For example, a prime contractor would pay this MWBE for a given service. The firm would then subcontract most of the work to non-certified companies, while the prime contractor would claim MWBE utilization for everything paid to this firm regardless of how much was routed to non-certified subcontractors.

Another IGO investigation showed that a WBE owner won a large subcontract although it lacked the expertise and labor force required to perform the proposed work. The WBE was asked by the prime contractor to submit the bid and told that the actual work was going to be performed by a non-certified firm. The WBE was told to add several thousand dollars to the bid price before submitting its bid to the City. This incremental value was intended to be the WBE's fee for serving as a pass-through. During the course of the construction project, the WBE transferred 100% of the money that her company received from the prime contractor to the non-certified firm and did not retain any amount.

An additional investigation revealed that an MWBE served as a conduit to pass payments from the prime contractor to non-certified suppliers. The MWBE provided administrative services only, such as collecting paperwork and distributing payments, and it was not actively involved in ordering products or making other significant decisions. It did not take delivery of any products and all materials were shipped directly to the prime contractor. The non-MWBE suppliers had no business relationship with the MWBE except to receive product orders and payment.

3. Brokers

IGO investigations have revealed a number of City contracts in which MWBEs act as brokers. The City's regulations do not allow the use of brokers, which are defined as "a person or entity that fills orders by purchasing or receiving supplies from a third party supplier rather than out of existing inventory, and provides no commercially useful function other than acting as a conduit

between a supplier and a customer.”¹⁰⁰ Typically, MWBEs act as brokers on commodities contracts. In these situations, MWBEs win a contract (or a subcontract) to provide a commodity and do not supply the commodity themselves but instead simply order the goods from a non-MWBE who delivers the product to the City (or prime contractor). Three examples of brokers are detailed below.

An IGO investigation identified a WBE that was used as supplier on several City contracts. In this arrangement, the City would place an order with the prime contractor, who would in turn pass the order to the WBE, who would order the goods from a non-MWBE and direct that the goods be directly shipped to the City. This WBE had no employees, trucks, contracts with the prime contractor, warehouse, or inventory. While providing no useful function, this WBE would add a broker fee of 100% of the contract value in exchange for using its name for WBE credit.

An additional investigation revealed that a non-MWBE had a contract to provide a commodity to the City. Upon the expiration of the contract, DPS decided to attach Target Market status to the next letting of this contract. Because of the contract’s Target Market status, the non-MWBE could not bid on it, but had worked with an MBE in the past. The MBE successfully bid on the new contract. The non-MWBE was not listed as a subcontractor by the MBE on its bid documents, yet it performed all of the work on the contract. When the City needed more of this commodity, it contacted the non-MWBE, not the MBE (the company that was actually awarded the Target Market contract). The MBE was paid a set percentage of each invoice for its efforts. The scheme fell apart when the owner of the MBE died.

Another investigation involved a Target Market contract for a highly specialized, federally-regulated product. For several years, the City purchased the product directly from the manufacturer, one of only four authorized manufacturers of this product, none of which were MWBE certified. In 2003, the City decided to make the contract a Target Market contract. The MWBE firm which won the contract did nothing more than pass along the City’s orders to the manufacturer. The manufacturer still produced the product and shipped the orders directly to the City using its own trucking contracts. For shuffling paper, the MWBE firm added on about 5% to the price of the product, a cost that was ultimately borne by the City and its taxpayers.

F. REVIEW OF ACTUAL MWBE PARTICIPATION

Because IGO investigations have revealed that on certain contracts actual payments to MWBEs are less than the publicly reported statistics, we conducted a review of a set of contracts to develop an estimate of the actual payments going to MWBEs.

1. Analysis of Construction Contracts

To determine actual participation for construction contracts, we obtained a list from DPS of 75 construction contracts that ended in 2008. Eight of these contracts were target market contracts that were either not audited or only partially audited. This made it difficult to determine what payments contractors received and thus these contracts were excluded from our analysis. In addition, one of these contracts was an emergency contract and thus did not have MWBE

¹⁰⁰ *Chicago Municipal Code*, secs. 2-92-420 and 2-92-670 (American Legal 2009).

participation requirements so it was also excluded. This left 66 contracts for our review. We examined DPS's audits for each of these contracts and calculated the total actual MWBE participation. While most of the work and spending on these contracts happened between 2005 and 2007, this was the most recent set of contracts that DPS's compliance unit had audited.

The 66 contracts had a combined final value of approximately \$385 million and were concentrated in the Departments of Aviation, Transportation, and Water Management. Twenty-two of the contracts had DBE requirements, while 44 had MWBE requirements.¹⁰¹ The DBE contracts had a combined value of \$150 million, while the MWBE contracts were worth \$235 million. Because the review includes both MWBE and DBE contracts, in this section, we will use the term MWBE to encompass firms that participated on the DBE contracts, as well as the MWBE contracts.

(A) *Publicly Reported MWBE Participation*

The first step of the analysis was to determine what participation had been reported publicly by DPS for this set of contracts. As discussed above, the participation reported by DPS is based on the Schedule D that details the MWBE commitments at the beginning of each contract. To determine citywide MWBE participation, DPS uses a database that aggregates the MWBE percentages for each city contract. These percentages are applied to each individual contract's value at contract award and an amount of MWBE participation is calculated. In addition to the value at contract award, the database adjusts participation to reflect contract modifications as contract work progresses. Thus, if modifications reduce or increase the value of a contract, MWBE participation on that contract is reduced or increased. On a monthly basis, DPS totals up the MWBE participation based on contract awards and modifications and divides this by the total value of awards and modifications to arrive at the citywide participation percentages that are reported publicly.

Using records from this database, we analyzed the reported participation for the 66 contracts in our analysis. For 43 of the contracts, we were able to determine what participation was reported during the entire course of contract performance.¹⁰² While participation generally reflected the percentages on the Schedule Ds, in several instances, we discovered variations between what was reported through the database and the Schedule D percentages.

The most common mistake was when the prime contractor was an MWBE. For these contracts the database typically reported MWBE participation at close to 100%. This was despite the fact that the Schedule Ds and compliance plans for these contracts showed participation at often significantly lower levels. In two instances, the compliance plans showed that the participation of the MWBE prime contractor would be below 30 percent. However, in each of these cases

¹⁰¹ DBE requirements are applied to certain federally-funded contracts, while MWBE requirements are applied to all other contracts, with the exception of sole source and emergency contracts.

¹⁰² For some of the contracts, there were small variations between the final contract values reported in DPS's contract files and the contract values contained in the database. To correct this problem, we calculated the participation percentage reported through the database and applied it to the final contract values in the contract files to calculate the publicly reported MWBE participation.

MWBE participation was recorded and reported at or near 100 percent of the contract, grossly inflating the proposed participation.

We also observed less systematic mistakes. On one of the largest contracts we reviewed, a mistake in the database resulted in MWBE participation being severely underreported. While the Schedule D for this contract listed MBE participation at 24 percent, the database credited MBE participation for the contract at less than 10 percent. On two contracts, mistakes caused DPS's database to credit participation at over 100 percent of the value of each contract.

Because the database's records only go back to the beginning of 2005, the full record for 23 of the contracts was not in the database. For these contracts, we used the original Schedule D percentages as the basis for the publicly reported participation. We applied these percentages to the final contract values to calculate the publicly reported MWBE participation.

(B) Actual MWBE Participation Based on Payment Data

After calculating the reported MWBE participation we compared it to the actual payments to MWBEs. For the group of contracts as a whole, DPS's audits show that actual participation was higher than participation projected at contract award. This suggests that although DPS does not systematically track or report actual MWBE participation, actual participation is higher than the contract award numbers that it does report. There are some differences in the separate participation categories, but overall DPS audits found actual participation numbers to be somewhat higher than the publicly reported participation at contract award. However, our analysis found that the DPS audits contained a number of mistakes, and that the actual participation was over 15 percent less than the reported participation.

While our review sought to analyze what DPS determined actual participation to be, we also reviewed their calculations by looking at the underlying documentation, lien waivers, of the audits to see how participation was counted. We found a number of participation determinations in DPS audits that overstated actual MWBE participation. Correcting for these mistakes, we calculated actual participation using the underlying documentation based on DPS's rules and regulations.¹⁰³

The table below compares the results of our analysis and the reported participation for the 66 contracts. Our analysis determined that actual participation was over 15 percent less than the publicly reported participation. For MBEs, the actual participation is over 22 percent lower than award and for WBEs, the actual participation is almost 32 percent lower. In the DBE contracts we reviewed, actual participation was essentially the same as the reported participation. In terms of dollars, our analysis showed that MWBEs were paid over \$19 million less than what the City reported. Focusing on the 44 contracts with the City's MWBE requirements (not the federal DBE

¹⁰³ Our analysis of actual participation is based on information contained in DPS's compliance files. It is important to note some caveats concerning the information in these files. These files contained DPS's audits that show how DPS compliance officers calculated actual participation. However, it was not always clear what the DPS audits concluded regarding participation levels. Further, the compliance files did not always contain the lien waivers for 2nd tier subcontractors which meant it was not possible to trace every contract dollar to its final recipient. Lastly, it was sometimes difficult to determine when firms were eligible for the program and if the work they were performing was within their certification areas.

requirements), actual participation for MWBEs was over 24 percent less than the publicly reported participation statistics.

	Participation in \$ Based on Contract Award	Actual Participation in \$ - IGO Analysis	Dollar Value Variance between IGO Analysis and Award	Percentage Variance between IGO Analysis and Contract Award
DBE	\$43,391,312	\$43,563,670	\$172,359	0.40%
MBE	\$62,487,565	\$48,672,259	-\$13,815,306	-22.11%
WBE	\$18,549,931	\$12,646,680	-\$5,903,251	-31.82%
Total	\$124,428,808	\$104,882,610	-\$19,546,198	-15.71%

Source: IGO

For the group of contracts as a whole, participation was reported at 32 percent. We determined that actual participation was 27 percent. The chart below compares the MWBE and DBE participation at contract award and the actual participation according to our analysis as a percentage of the total contract values.

	Participation Based on Contract Award	Actual Participation - IGO Analysis	Percentage Variance between IGO Analysis and Contract Award
<i>Participation Percentage of the Total Value of contracts</i>			
DBE	29.09%	29.21%	0.40%
MBE	26.42%	20.58%	-22.11%
WBE	7.84%	5.35%	-31.82%
Total	32.27%	27.20%	-15.71%

Source: IGO

Note: The DBE percentages are calculated using the total value of contracts where DBE requirements apply, while the MBE and WBE percentages are calculated using the total value of contracts where MWBE requirements apply.

(C) *How DPS’s Audits Overstate Participation*

Based on our review, we found a difference of over \$26 million between DPS’s audits and our analysis. The table below shows the difference between DPS’s audits and our analysis broken down by participation category.

	Participation in \$ Based on DPS Audits	Actual Participation in \$ - IGO Analysis	Dollar Value Variance between IGO Analysis and DPS Audits
DBE	\$48,589,858	\$43,563,670	-\$5,026,188
MBE	\$64,207,354	\$48,672,259	-\$15,535,095
WBE	\$18,257,579	\$12,646,680	-\$5,610,899
Total	\$131,054,792	\$104,882,610	-\$26,172,182
Source: IGO			

There were several different scenarios that account for the difference between DPS’s audits and our analysis. The table below shows the categories that make up the difference. Each category is further detailed in the following sections.

Reason	Total
Pass-Throughs	\$14,499,723
Front company	\$3,776,187
Over-counted participation of MWBE prime contractors	\$2,688,419
Other	\$2,196,399
Improperly certified firm	\$1,680,108
Over-counted supplier participation	\$1,331,346
Total	\$26,172,182
Source: IGO	

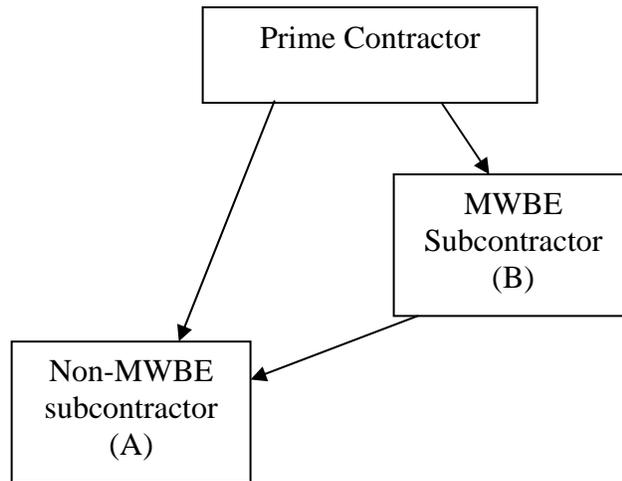
I. Pass-Throughs

The largest reason for the difference is that our review determined that several of the MWBE subcontractors acted as pass-throughs, which accounted for approximately 55 percent of the difference between DPS’s audits and our analysis.

a. Prime Contractor Has Direct Relationship with Second Tier Subcontractor

There are several different types of pass-throughs in the contracts we analyzed. One form of pass-through relationship involves an MWBE subcontractor subcontracting a large portion (at least 69 percent in each of the contracts in which we observed this relationship) of its contract to one or multiple 2nd tier suppliers, with which the prime contractor has a direct relationship on the contract. In several instances, the prime contractor purchased materials directly from a non-MWBE supplier and MWBE subcontractors purchased the same types of materials from the same supplier.

DIAGRAM OF PASS-THROUGH ARRANGEMENT WHERE PRIME CONTRACTOR HAS RELATIONSHIP WITH NON-MWBE 2ND TIER SUBCONTRACTORS



This is an example of a pass-through relationship. It does not make economic sense for a prime contractor to purchase some materials from firm A (the non-MWBE firm) directly and also contract with firm B (the MWBE firm) which then purchases the same type of materials from firm A. The MWBE regulations state that “a MBE or WBE does not perform a commercially useful function if its role is limited to that of an extra participant in a transaction, contract, or project, through which funds are passed in order to obtain the appearance of MBE or WBE participation.”¹⁰⁴ It appears that the major purpose of this relationship is to route payments through an MWBE in order to achieve the participation goals set forth by the City.

Through our review, we identified several contracts in which this relationship was present. By deducting all the payments that flow to 2nd tier non-MWBE subcontractors, with whom prime contractors have contractual relationships, MWBE participation was reduced by \$7.2 million from DPS’s audit figures.

b. Large Subcontracts Routed Through MWBE Subcontractors

Another type of pass-through is where MWBEs subcontract large portions of contracts to non-MWBEs. In these pass-throughs, the MWBE subcontractor received a minimal percentage of the dollars spent, with the vast majority of the dollars being further subcontracted to a non-MWBE firm. In the most egregious example, a nearly \$2 million subcontract was given to an MWBE, but of the \$2 million, only \$50,000 ended up with the MWBE while the rest was subcontracted to non-MWBEs. We observed these types of relationships on two contracts and deducted the subcontracts to non-MWBEs from the participation total. This resulted in a reduction of \$4 million from DPS’s audit figures.

¹⁰⁴ City of Chicago. “Special Conditions Regarding Minority Business Enterprise Commitment and Women Business Enterprise Commitment in Construction Contracts.” Section IV- G-2.

c. Subcontracting Labor Services to Non-MWBEs

A further pass-through relationship we observed was the subcontracting of labor to non-MWBEs by MWBEs. The regulations are clear that the subcontracting of labor to non-MWBEs should not be counted as participation. Yet in numerous contracts we reviewed, DPS's compliance unit counted 100 percent of the money going to an MWBE, although the MWBE firm subcontracted a portion of its labor to non-MWBEs. In accordance with DPS's rules and regulations, we deducted all payments for labor to non-MWBEs, which resulted in a \$1.8 million reduction from DPS's audit figures.

d. MWBE Contract Performance Through Use of non-MWBE Prime Contractor Personnel

In two of the contracts we observed an additional type of pass-through relationship. After reviewing a DPS analysis of payroll records, we observed that an MWBE was performing nearly its entire contract with a non-MWBE prime contractor's personnel. On one contract, it appeared that 12 of the 17 workers on the MWBE's payroll had worked for the prime contractor on this very same contract. Of the 5 workers who had not also worked for the prime contractor on this contract, 4 of the workers had worked for the prime contractor on other City contracts. The regulations state that "the value of the work actually performed by the MBE's or WBE's own forces shall be counted towards the contract specific goals."¹⁰⁵ In this case, the MWBE appears to be using the non-MWBE prime contractor's labor to perform its work and thus this participation was not counted in our analysis.

In addition to using non-MWBE labor, this MWBE was also purchasing materials from a company with whom the prime contractor had a relationship, the pass-through relationship described above. Based on the observation of two types of pass-through relationships, we concluded that the MWBE was not performing a commercially useful function and should not have had any of its participation counted by DPS. This resulted in a \$650,000 reduction in participation from DPS's audit figures.

e. Large Materials Purchase Routed through MWBEs

The final pass-through relationship observed in this set of contracts is where an MWBE subcontractor performed a small amount of labor on a contract but purchased a large amount of materials from a non-MWBE subcontractor. In two contracts we reviewed, the MWBE subcontractor kept a small percentage of the dollars spent, with the majority of the dollars being used to purchase materials from a non-MWBE firm.

In one contract, an MWBE received a subcontract for electrical work from a non-MWBE who was also an electrical contractor. Forty four percent of the total value of the MWBE's contract was used by the MWBE to purchase materials and perform work on the contract. The remaining 56 percent of the contract was used to purchase materials from a non-MWBE electrical

¹⁰⁵ City of Chicago. "Special Conditions Regarding Minority Business Enterprise Commitment and Women Business Enterprise Commitment in Construction Contracts." Section IV- A.

company. Payroll records show that the non-MWBE electrical contractor who subcontracted with the MWBE, employed five times as much labor on the contract, in terms of labor hours worked, but spent roughly the same amount on materials. With two companies performing similar work, it is highly unlikely that a company that performs one-fifth as much work as another company would use the same amount of materials as the company doing five times as much work.

The documents associated with this contract demonstrate an unrealistic business relationship. What appears to be happening on this contract is that the larger non-MWBE routed materials purchases through the MWBE and then used those materials for its own work on the project. In purchasing the extraneous materials, the MWBE appears to not perform a commercially useful function and we thus discounted the 56 percent of the contract that went to the non-MWBE electrical company. We identified an additional contract where this occurred and deducted the payments that went to non-MWBEs. These two reductions resulted in a decrease of almost \$800,000 from DPS's audit figures.

II. Front Company

One of our investigations revealed that one of the companies that is frequently utilized in the contracts we reviewed is a front company. This company was certified as an MWBE to provide a variety of materials. The MWBE has a number of City contracts, but in actuality a non-MWBE company provided the materials the MWBE was contracted to supply. Therefore, its participation was discounted, which resulted in a reduction of \$3.8 million in actual participation from DPS's audit figures.

III. Over-counting of MWBE Prime Contractor Participation

Another source of the difference between DPS's audits and our analysis is that in ten contracts where the prime contractor was an MWBE, compliance counted 100 percent of the contract as MWBE participation. However, according to the MWBE regulations, it is necessary to subtract out payments to non-MWBE subcontractors that are not materials purchases that are consumed by the labor of the MWBE's own workforce.¹⁰⁶ Subtracting payments to non-MWBE firms on these contracts resulted in a reduction in actual participation of over \$2.7 million from DPS's audit figures.¹⁰⁷

¹⁰⁶ City of Chicago. "Special Conditions Regarding Minority Business Enterprise Commitment and Women Business Enterprise Commitment in Construction Contracts." Section IV- C.

¹⁰⁷ In reviewing these contracts, it was sometimes difficult to determine exactly how much money ended up with the MWBE prime contractor because DPS did not audit these contracts as fully as contracts in which the prime contractor is a non-MWBE. For these contracts, we used the documentation available, which were the Status Reports that detailed how much the MWBE prime contractor subcontracted to non-MWBEs. In some of these contracts, we did not have the Status Reports that detailed the full amount that was spent with non-MWBEs. In these instances, we assumed that the actual payments to the non-MWBE subcontractors mirrored the subcontract prices that were documented on partial Status Reports. We also tried to corroborate the information on the Status Reports with information from affidavits of availability that the prime contractors had submitted on other City contracts. Affidavits of availability are submitted by prime contractors on City contracts. They detail what other work the prime contractor is engaged in. For each contract the prime contractor has it lists all subcontracts. By reviewing affidavits of availability from other City contracts, we were able to generally corroborate the subcontracting information in the contracts that were part of our analysis.

IV. Crediting an Ineligible Firm

One firm receiving a significant amount of credit for participation in the contracts we reviewed should not have been certified on two of the contracts.¹⁰⁸ In one case, the MWBE was decertified as a DBE one month before it was listed as a participant on a new contract. This was a simple failure of a compliance officer to check if this firm's certification was current. With this finding, we discounted the firm's DBE participation on this contract and another contract that it was awarded after it had been decertified. This resulted in a reduction of \$1.7 million in participation from DPS's audit figures.

V. Over-counting of Suppliers¹⁰⁹

According to the program regulations, the participation of MWBE subcontractors who act as suppliers or distributors should be counted at 60 percent of the contract value. In a number of instances in the contracts we reviewed, MWBE suppliers were counted at 100 percent by DPS. In all these instances, the firms' Schedule C-1s stated that only 60 percent of the contract values should be applied to MWBE participation. Correctly counting these suppliers at 60 percent reduces the actual participation for the group of contracts by \$1.3 million from DPS's audit figures.

2. Actual Participation in Non-construction Contracts

While we attempted to calculate actual participation in non-construction contracts, ultimately we were unable to do so, due to several factors. First, DPS only recently began auditing every non-construction contract, so audits of some contracts were unavailable. Second, audits of non-construction participation often rely on incomplete documentation. Lastly, we observed inconsistencies in the few audits we were able to review.

(A) *Non-construction Contract Audits Have Only Recently Begun*

In analyzing the audits of non-construction contracts and through interviews with DPS officials, we found that DPS only began attempting to audit all non-construction contracts within the last five years. However, there are still non-construction contracts not being audited. During the period of our review, there was no compliance officer assigned to Architecture and Engineering contracts due to vacant positions within the compliance unit, so these contracts were not being audited.

¹⁰⁸ It appeared that in DPS's audits, a firm was considered eligible if they were certified at the time the contract was awarded. If firms became ineligible for the program during the course of the contract, their participation was still credited. Our review relied on the same convention.

¹⁰⁹ It is important to note that counting MWBE suppliers at 60 percent does not appear in the City's MWBE construction ordinance. However, it has been included in DPS regulations and is the practice by which DPS analyzes supplier participation on construction contracts. For DBE contracts, there is no question that suppliers must be counted at 60 percent per the federal regulations.

(B) *Audits Rely on Incomplete Documentation*

In non-construction, DPS compared prime contractor and subcontractor affidavits to determine MWBE participation. These affidavits are statements from prime contractors and subcontractors attesting to how much the MWBE subcontractors were paid on a given contract. If there was a disagreement between what the prime contractor and subcontractors report, compliance officers sought additional documentation such as canceled checks to reconcile the disagreement. If DPS did not receive a response from the MWBEs, compliance officers assumed that the prime contractor's reported payments to the MWBEs were accurate.

In some audits, MWBEs did not respond to the compliance officers and so the audits simply accepted what the non-MWBE reported paying the MWBE. This seems to contradict DPS's policy regarding the Subcontractor Payment Certification forms in construction contracts. As discussed above, these forms are reports from prime contractors that state how much has been paid to MWBEs. DPS officials do not believe the information on these forms to be reliable because it is not verified by subcontractors.¹¹⁰ Therefore, in auditing participation at the end of construction contracts, DPS required prime contractors to submit lien waivers from subcontractors as proof of payment to MWBEs. Yet, in non-construction, DPS accepted what prime contractors report, often without confirmation from MWBE subcontractors.

When both the non-construction prime contractors and subcontractors responded but disagreed on the amount of payment, DPS was supposed to seek further information, such as canceled checks in order to reconcile the disagreement. While we did observe DPS seeking follow up information to resolve some disagreements on non-construction contracts, we also reviewed several audits where there were large unresolved disagreements between what prime contractors and subcontractors reported they were paid.

(C) *Audits Contain Inconsistencies*

In reviewing DPS audits of MWBE participation in non-construction, we found inconsistencies. In several audits we reviewed, firms were credited with participation that was greater than the total dollars spent on the contract. This problem was generally seen when firms were claiming indirect participation, but was also observed on several contracts involving direct participation. One audit credits \$4.3 million in direct participation to a MWBE on a contract for which total expenditures are \$1.5 million.

Since it is impossible for an MWBE to receive more money from a contract than the total value of a contract, this reporting mistake appears to occur in part because contractors are unclear on what contracts DPS was seeking information. Often, MWBEs have multiple City contracts with the same prime contractor and when DPS asked for payment information, MWBEs reported all payments they have received from a given prime contractor, without differentiating between individual contracts. Prime contractors will make similar reporting mistakes about payments that they make to MWBEs. This confusion led to reported payments that appear inflated. In the audits we reviewed, DPS sometimes did not resolve this inflated payment reporting. The reporting mistakes made by prime contractors and subcontractors and DPS's incomplete efforts to correct

¹¹⁰ Interview #2.

them point to a lack of resources available to conduct these audits and a lack of rigor in MWBE compliance audits.

3. Extrapolation from the Results of Our Analysis

(A) Construction Contracts

Our review of audits of construction contracts concluded in 2008 conservatively found that actual MWBE participation was more than 15 percent less than the publicly reported statistics for these contracts. Based on DPS statistics, the City has awarded over \$2.5 billion in construction contracts to MWBEs since 1995.¹¹¹ Assuming that actual MWBE participation for all of the City's construction contracts since 1995 has been on average 15 percent less than award, the result is that between 1995 and 2008 actual MWBE participation in construction has been \$400 million less than the publicly reported participation statistics.

However, the conclusion that participation is 15 percent less than the publicly reported statistics still probably exaggerates MWBE participation. For several reasons, it is highly likely that actual participation is significantly lower than the reduced participation observed in our review. First, our analysis was based on lien waivers that document how much MWBEs were paid on given contracts. As detailed in the next section, there are serious concerns with the accuracy of this information. IGO investigations and testimony during the *Builders* trial have illustrated that lien waivers can easily be and have been manipulated to overstate participation. An analysis that verified the accuracy of the information contained in the lien waivers would likely show a further reduction in participation.

Second, given the prevalence of fraud and abuse in the MWBE program and the laxness in the City's certification process (discussed below), it is likely that our analysis credits participation to ineligible firms that have engaged in yet undiscovered abuses of the MWBE program.

Finally, an underreporting mistake in participation at contract award in the contracts we reviewed, led to a smaller discrepancy between actual participation and participation at contract award than would have otherwise been observed. As discussed above, the most systemic mistake we identified in the database DPS uses to calculate the publicly reported participation statistics was the over-reporting of MWBE participation when an MWBE was the prime contractor. This occurred because subcontracts to non-MWBE firms were not subtracted from the MWBE prime contractor's participation. Yet, a singular mistake we uncovered *undercounted* MBE participation on one of the 66 contracts we reviewed by over \$5 million. If this underreporting mistake had not occurred our analysis would have shown actual participation to be over 19 percent less than the publicly reported statistics, making the overstatement of MWBE participation during this period nearly \$25 million.

Given that the more systemic mistakes we uncovered in the DPS database resulted in participation being over-reported, it is likely that the large, underreporting mistake in these 66 contracts, which led to less of a discrepancy in actual participation than would have otherwise been observed, is an outlier. Thus, if we were to review the actual MWBE participation in all the

¹¹¹ From 1995 through 2004 this figure includes DBE awards. From 2005 through 2008 DBE awards are excluded.

construction contracts that have been awarded since 2005, when DPS began using the MWBE database to calculate awarded participation, it is likely that we would observe far less (relative) underreporting of participation. In turn, if our review of actual participation in these 66 contracts is representative of actual participation since 2005, then we would likely observe a larger discrepancy between reported participation and actual payments to MWBEs.

(B) *Non-construction Contracts*

For non-construction contracts, we were unable to calculate actual participation in part because the administration only recently began auditing non-construction contracts and still does not audit every contract.

Although we were unable to calculate actual participation in non-construction, due to the historical lack of auditing of non-construction participation, the lack of rigor in the auditing process that was recently put in place, and the prevalence of fraud and abuse in the program it is likely that actual participation is also significantly lower in non-construction than the publicly reported participation.

G. PROBLEMS WITH MWBE ADMINISTRATION

Through IGO investigations and our analysis of actual MWBE participation, we have identified multiple problems with the way the MWBE program is administered. The Lowry Report¹¹² cautioned that the administration of an affirmative action contracting program “is a hands-on process that requires close scrutiny and instant response to issues before they become major problems.”¹¹³ The City’s program does not meet this standard. The picture that has emerged from our analysis is of a poorly administered program that does not know whether or not it is achieving its goals. One DPS official aptly summed up the program as “a lot of paperwork and pushing paper.”¹¹⁴

Part of the result of this poor administration is that the program has been beset by fraud and brokers, and MWBE participation is likely far less than the participation levels that the City annually reports. The specific administrative problems we have identified are detailed below.

1. The Administration Does Not Report Data on Actual Payments to MWBEs

When it was responsible for the program, DPS audited individual contracts to examine actual participation, but the department did not collect and analyze data on actual payments to MWBEs. Therefore, DPS could report what the actual participation was on any one contract, but could not report what participation was for the City as a whole. This failure to track actual participation is the reason that DPS was unable to calculate any statistics on actual participation and instead based its public reports on projected participation when contracts were awarded.

¹¹² Provided the initial justification for Mayor Washington’s Executive Order that began the MWBE program.

¹¹³ James H. Lowry & Associates. Study of Minority and Women-Owned Business Enterprise Procurement Programs for the City of Chicago. March 1985. pg 6-1.

¹¹⁴ Interview #1.

The administration's practice of reporting participation based on contract awards has overstated the impact of the program and created an unrealistic idea of what the program is achieving. Because the participation statistics are the main criteria by which the program is evaluated by the City Council and the public, the MWBE program is primarily evaluated with analytically suspect data. This, in turn, makes a comprehensive analysis of the program's impact impossible.

Another consequence of reporting participation based on contract award, is that it has undercut administrative incentive to fully monitor actual payments to MWBEs through the course of a contract. This lack of scrutiny on MWBE participation during contract performance means that it is more likely for participation to be reduced through modifications and the non-usage of MWBE subcontractors. It also makes it more likely for front companies or pass-throughs to abuse the program because they have a smaller chance of being uncovered.

2. Insufficient Documentation in DPS Audits of Actual Participation

In both the construction and non-construction programs, the documents used to verify payments to MWBEs have serious flaws.

(A) Inadequate Payment Verification in Non-construction

In non-construction (again when DPS was responsible for monitoring actual MWBE participation), DPS compared prime contractor and subcontractor affidavits to determine MWBE participation. These affidavits are statements from prime contractors and subcontractors attesting to how much they were paid on a given contract. If there was a disagreement between what was reported, compliance officers sought additional documentation such as canceled checks to reconcile the disagreement. If DPS did not receive a response from the MWBEs, compliance officers assumed that the prime contractor's reported payments to MWBEs were accurate.

This verification process was not sufficient to make determinations of actual participation. Affidavits from prime contractors and subcontractors are susceptible to exploitation by contractors that want to overstate participation. Like the problems with the lien waiver process described below, MWBEs could be easily influenced to overstate how much they were paid by prime contractors, who could make this overstatement a condition of payment and/or future contracts. The fact that DPS accepted what a prime contractor reported if the subcontractor did not respond made it even easier for prime contractors and/or subcontractors to overstate participation. Prime contractors could overstate participation in what they report to DPS, while MWBE subcontractors could simply not respond and DPS would conclude that the prime contractor's reported payments are accurate.

This also seemed to contradict DPS's policy regarding the Subcontractor Payment Certification forms in construction contracts. As discussed above, these forms are reports from prime contractors that state how much has been paid to MWBEs. DPS officials do not believe the information on these forms to be reliable because it is not verified by subcontractors.¹¹⁵ Yet, for non-construction contracts, DPS allowed payments to MWBEs to be verified without confirmation from MWBE subcontractors.

¹¹⁵ Interview #2.

DPS in part recognized problems with their verification process and hoped to remedy it through the implementation of the C2 system. C2 is a web-based system where prime contractors and subcontractors will report the payments that MWBEs receive. When prime contractors report how much they have paid an MWBE, the system will automatically generate a letter or email to the MWBE so that they can verify what the prime contractor reported. If implemented properly, the system will streamline the verification process and make it easier for both prime contractors and subcontractors to report payments to MWBEs.

However, while C2 will make it easier for prime contractors and subcontractors to report payment data to Compliance, which is now responsible for assessing participation, it will not address the underlying deficiencies in how payments to MWBEs are verified. C2 will still not prevent prime contractors and subcontractors from overstating MWBE participation because Compliance will still be relying on the attestations of prime contractors and subcontractors to verify payments. Thus, the problem of MWBE subcontractors overstating what they have been paid or simply not responding to the City's inquiries is unaddressed by C2.

(B) *Abuse of Lien Waivers in Construction*

While lien waivers better document the payments that are going to MWBE subcontractors, there are also problems with the reliability of lien waivers. In the *Builders* trial, a DPS compliance officer testified that he “has observed prime contractors abusing lien waivers to the detriment of MBE’s and WBE’s.”¹¹⁶ While lien waivers are supposed to document what subcontractors have been paid, the compliance officer testified that “prime contractors require subcontractors to sign lien waivers prior to getting paid because the contractor has advised the subcontractor that the City would not pay the prime until the City has the waivers.”¹¹⁷ By having the subcontractors sign lien waivers before they receive payment, “the subcontractor has lost their leverage.”¹¹⁸ This testimony was corroborated by an owner of a construction company who testified that his company “generally sets its contracts up on public jobs so subs get paid after [his company] is paid.” However, the company “is required to submit lien waivers from its subs. So subs are required to give lien waivers before they are paid.”¹¹⁹

If subcontractors have to sign lien waivers before they receive payment, then there is a great potential for abuse of the lien waiver process. An IGO investigation revealed that some companies engage in a process of over-liening. In over-liening, MWBEs submit lien waivers that make it appear that they receive payments that satisfy the MWBE goals. In actuality, the MWBEs receive far less in payment than the lien waivers represent. MWBEs may over-lien because prime contractors make it a requirement of payment. We have also seen instances where MWBEs, in exchange for a fee, provide lien waivers to non-MWBEs that claim the MWBEs have worked on a contract, when in actuality the work has gone to non-MWBEs.

¹¹⁶ Shefsky and Froelich. “Chicago’s Minority and Women Business Enterprise Program in Construction: A Constitutional Challenge: A Report to the City Council Budget Committee on the *BAGC v. City of Chicago* Trial. April 2004. pg. 59.

¹¹⁷ *Id.*, pg. 59.

¹¹⁸ *Id.*, pg. 59.

¹¹⁹ *Id.*, pg. 60.

3. Lack of Cooperation between DPS and User Departments

One of the program's most fundamental problems has been the lack of cooperation between the user departments and DPS. This problem stems from a pervasive belief in the user departments that the MWBE program is solely the responsibility of DPS (and now Compliance). The limited cooperation between DPS and the user departments has contributed to a lack of user department accountability for MWBE contracting goals, a lack of DPS access to timely information, a collective failure to monitor actual MWBE participation as contracts are performed, duplicative data collection, and a greater administrative burden for the City's vendors. It also has made it less likely for the administration to uncover front companies, brokers, and pass-throughs.

(A) *Lack of Information and Document Sharing*

DPS and the user departments do not share documents and information related to the administration of MWBE program.

For instance, in construction contracts, MWBE compliance is assessed using lien waivers. User departments maintain the complete set of lien waivers for any contract because prime contractors must submit lien waivers with each invoice in order to receive payment. However, when DPS was responsible for assessing MWBE compliance, its compliance officers did not get the lien waivers from the user departments but rather requested them directly from prime contractors. This resulted, on the one hand, in contractors having to submit two copies of the same documents to two different City departments and, on the other, in DPS having to expend time and resources securing information and documents already held in other City departments.

With regard to contract modifications, a DPS official expressed frustration that DPS often did not receive documents related to contract modifications from the user departments until well after they have been approved, even though modifications often impact MWBE participation.¹²⁰

Lack of information sharing has led to over-crediting of MWBE participation at contract award by DPS because compliance officers often only focus on the Schedule C-1 and D-1 forms, while ignoring contradictory disclosures easily found in other contract documents. A recent IGO investigation illustrates this problem.

An MBE was awarded a multi-million dollar professional services contract and on the Schedule D-1, the MBE disclosed the participation of two WBE firms, totaling about 5% of the contract's value. The MBE did not disclose, nor did the Schedule D-1 specifically request the disclosure of, non-certified subcontractors.¹²¹ However, the MBE subcontracted out a substantial portion of the contract to non-certified firms, a fact that would have been obvious to the DPS compliance officers had they looked at other documents related to the contract, rather than just the Schedule C-1s and Schedule D-1.

¹²⁰ Interview #1.

¹²¹ This in contrast to the Schedule D-1 for construction contracts, which requests the disclosure of non-certified subcontractors.

For example, the user department made at least one extensive and detailed PowerPoint presentation regarding the project to other procurement officials. The presentation clearly identified several non-certified firms that would be involved. Had the compliance officials attended the presentation, reviewed the PowerPoint slides, or even just communicated with the user department personnel assigned to the project, they could have easily determined that the Schedule D-1 did not accurately describe the MWBE participation on the contract.

Additionally, the MBE submitted (in the same packet of documents that included the Schedule C-1s and the Schedule D-1) an Economic Disclosure Statement (EDS). The EDS included a disclosure of "Retained Parties." There, the MBE disclosed all of the non-certified subcontractors that would work on the project. Again, if the compliance officers had just looked at the EDS, they would have discovered that the Schedule D-1 overstated MWBE participation.

(B) User Department Failure to Monitor MWBE Participation as Contracts are Performed

According to the City's procurement manual, the user departments are supposed to monitor MWBE compliance as contracts are performed.¹²² However, in reviews of hundreds of contract files and in various interviews with user department staff, we could identify little effort by the user departments to track MWBE compliance on an on-going basis.

After the professional services contract referenced in the previous section commenced, the MBE submitted Certification forms to the user departments that disclosed subcontractor payments. The MBE accurately listed the name of and amount paid to all of its subcontractors, including the non-certified ones. If the user department had been reviewing these payments and compared them to the Schedule D-1, it would have realized that the Schedule D-1 significantly overstated the actual MWBE participation on the contract.

In another investigation, we found that a contract manager for a user department observed several MWBEs who appeared to be operating as pass-throughs on a large construction contract. At the same time, the compliance officer in DPS responsible for monitoring this contract was unaware of these relationships. The contract manager did not communicate these observations to DPS because he/she viewed DPS as the department ultimately responsible for monitoring MWBE compliance.¹²³

When DPS was responsible for post-award MWBE compliance, it was supposed to receive quarterly Utilization Reports for non-construction contracts. But, DPS only received these if they explicitly asked vendors to submit them. In practice, the only assessment of MWBE participation was done by DPS after a contract ended. By not tracking compliance through the course of contracts, the City did not uncover participation shortfalls until contracts had been completed. This made it impossible for the administration to address problems in MWBE participation during contract performance.

¹²² City of Chicago. "Procurement Policy and Process Manual. pg. 28, 35, 41, 47, 53, 60

¹²³ Interview #3.

(C) *No Cooperation in Making Compliance Determinations*

In order to assess MWBE participation, particularly on construction contracts, a detailed understanding of the work being performed on a contract is often needed. As described above, counting participation often hinges on specific details of contracts such as which subcontractors count as suppliers and how responsibility for different parts of a contract is organized. However, a DPS official rightly pointed out that on construction contracts DPS (now Compliance) compliance officers have a limited connection to what is happening on a jobsite.¹²⁴

The user departments, which are responsible for the day-to-day management of contracts, are in a position to assist DPS (now Compliance) with assessing participation. However, we could find little evidence of the user departments and DPS working together to examine the intricacies of MWBE participation.

4. City Does Not Follow Its Own Policy

In many parts of the MWBE program, the City incorrectly applies its own written policies and procedures.

(A) *Mistakes in Assessing MWBE Compliance*

In construction, our analysis discovered inconsistencies in how DPS assesses MWBE compliance. As detailed above, our analysis of audits of construction contracts revealed numerous instances of DPS compliance officers not closely examining lien waivers, and as a result not identifying pass-throughs and crediting more MWBE participation than actually occurred. In addition, we found numerous instances of DPS over-counting supplier participation in direct violation of the program's regulations. Further, in the 66 contracts we reviewed, we found instances of a firm that was not certified being credited with participation.

(B) *Not Using Lien Waivers to Assess Participation*

For certain construction contracts, DPS did not use lien waivers to verify actual participation. Instead, the compliance officer relied on the Status Reports, which are not verified by subcontractors. Because of this practice, DPS did not realize that a firm that was being credited with tens of millions of dollars of MWBE participation was in actuality serving as a pass-through and receiving less than 10 percent of a contract's value. One look at the lien waivers would have revealed this pass-through relationship, but because DPS did not review lien waivers for certain construction contracts, DPS only realized what was happening when the IGO brought this to its attention.

(C) *Laxness and Mistakes in Certifying MWBEs*

In reviewing MWBE certification files, we found a glaring laxness in the City's certification process. In one instance, a DPS certification officer's report on a site visit of an applicant firm states that the owner of the firm "said that she is a GC [general contractor] and she subbed out

¹²⁴ Interview #1.

[subcontracted] 100% of two different projects.”¹²⁵ The site visit report then rightly asks “is she a GC or simply an experienced broker of services?”¹²⁶ However, the certification officer’s report concludes by saying “as I mentioned to [the firm’s owner], put a strong paperwork package together for [the certification officer].”¹²⁷ The implication of this report is that despite strong evidence that the applicant firm is a broker, DPS would certify the firm anyway provided it could make itself look legitimate on paper. This firm went on to be certified and has been awarded tens of millions of dollars in City contracts over the last several years.

In addition, we found mistakes in the way that personal net worth and gross receipts were calculated. In one instance, a calculation mistake resulted in allowing a firm to remain in the program for an extra two years (this firm is one of the largest MWBE participants). In this instance, DPS moved to decertify the firm because it believed its gross receipts exceeded the limit established for the program. However, the firm challenged DPS’s finding on the grounds that it had misinterpreted the SBA regulations. Although DPS had interpreted the regulations correctly, it backed down and allowed the firm to remain certified.

The IGO has encountered numerous situations in which an applicant artificially reduced their net worth below the limit by titling assets in the name of their non-eligible spouse, or by placing assets in revocable trusts or similar vehicles. For example, an applicant for WBE certification in the construction field failed to disclose a \$700,000 vacation home. When confronted by the IGO, the applicant stated that she did not disclose the home because it was titled in her non-eligible spouse’s name. But the applicant conceded that the home was purchased partly with income generated by her, and that she regularly used the home.

In another example, an applicant for Airport Concessions Disadvantaged Business Enterprise (ACDBE)¹²⁸ certification failed to disclose numerous substantial assets held in revocable trusts for the benefit of her children. Revocable trusts, as opposed to irrevocable trusts, can be revoked by the settlor (here, the applicant) at any time and usually for any reason. (In contrast, an irrevocable trust forever alienates the trust assets from the settlor in favor of the trust’s beneficiaries.) Because the applicant still controlled the assets in the trusts, the value of those assets should have counted towards her personal net worth.

(D) *Little Contract-Specific Goal Setting*

The construction ordinance states that while the City’s overall goals are to award 24 percent of all contracts to MBEs and 4 percent of all contracts to WBEs, the City may apply different goals to different contracts based on the availability of MWBEs, “the scope of the contract”, and “normal industry practice.”¹²⁹ This provision recognizes that it is impractical to assume that MWBE participation will be uniform on each construction contract. However, in our analysis of

¹²⁵ Certification File. Site Visit Report.

¹²⁶ *Id.*

¹²⁷ *Id.*

¹²⁸ Similar to the DBE program, this is a federal program that requires affirmative action in government contracting for airport concessionaires. As part of its responsibilities in operating O’Hare and Midway airports, the City operates an ACDBE program.

¹²⁹ *Chicago Municipal Code*, sec. 2-92-700 (American Legal 2009).

actual participation and during the course of our investigations, we have observed little contract-specific goal setting in the City's construction contracts.

Although the non-construction ordinance sets a minimum MBE and WBE percentage for each contract, these percentages can be raised on individual contracts. Just as in construction, in our analysis and investigations of non-construction contracts, we observed little contract-specific goal setting with the same MBE and WBE percentages included in nearly all non-construction contracts.

By rarely setting contract-specific goals, the City has created situations where unrealistically high goals are applied to some contracts and inadequate goals are applied to others. In establishing unrealistically high goals on some contracts, the City encourages firms to engage in fraud and abuse of the program. By setting goals that are too low on other contracts, the City is not maximizing MWBE participation in some areas. The City lets a wide variety of construction and non-construction contracts and applying the same numerical goals to each contract does not reflect the reality of the opportunity for MWBE participation in the City's contracts.

(E) Contractors Face Few Consequences For Not Meeting MWBE Participation Commitments

While the construction and non-construction ordinances give the City the authority to charge penalties to firms that fail to meet MWBE participation commitments, it appears that over the last several years, the City has rarely used this authority. We requested data from the City's major construction contracting departments on the exact amount of MWBE penalties that they had charged from the beginning of 2005 through May 2009. All responded that they had no record of penalties being charged.

In the past, a City department assessed penalties based on underutilization of MWBEs. However, the IGO has been informed by a City employee that in 2001 the Department of Law directed this department to stop assessing penalties related to the MWBE requirements.¹³⁰ This was corroborated by a DPS official, who also stated that penalties cannot be charged for failure to meet MWBE commitments.¹³¹ The IGO requested documents from the Department of Law (Law) relating to advice provided to DPS not to collect penalties for non-participation. Law invoked attorney-client privilege, thus leaving the IGO without adequate information to assess the basis of the directive to suspend ordinance-prescribed penalty assessments.

Instead of assessing penalties in the context of the contract closing process at which time the user department can collect on such assessments by drawing against retainage¹³², DPS simply notifies MWBE subcontractors of their right to seek arbitration to collect the difference between the committed amount and the amount actually paid. In practice, few subcontractors seek arbitration likely due to a desire not to offend prime contractors from whom they will likely seek business in

¹³⁰ Interview #4.

¹³¹ Interview #1.

¹³² Retainage is a percentage of the dollar value of each contract that is held by the user department until the contract is closed to ensure that a vendor's performance is in accordance with the specifications of the contract.

the future. As a result there appears to be little financial penalty assessed on non-compliant firms.

Additionally, the City's procurement manual has a section on Vendor Performance Evaluations, which are used "to improve the quality of our vendor pool and will become one of the tools to measure vendor responsibility."¹³³ While these evaluations are supposed to be used to track MWBE participation, among other measures of vendor quality, in practice, the MWBE information is never entered into the evaluations. This prevents DPS from evaluating the MWBE compliance of City vendors, which could help identify vendors who consistently do not meet their participation goals.

In short, the City does little to enforce unmet MWBE commitments, and consequently, there are effectively no repercussions for contractors that fail to meet their commitments.

5. Confusion Regarding MWBE Regulations

Our investigations and analysis have revealed that there was confusion within DPS about the MWBE program's rules and regulations. In several interviews with DPS staff regarding the certification requirements for suppliers, we received different interpretations from different personnel. Under the current regulations suppliers of bulk items do not need to maintain an inventory in order to be certified. DPS employees differed in their definitions of what constitutes a bulk item. One employee provided different definitions of bulk items in separate interviews. None of these interpretations were based on written rules but rather on the individual employees' experience. The lack of consistency in how regulations are applied undermined DPS's certification decisions.

6. Vague Description of MWBE Work

The Schedule C-1 forms detail what services MWBEs will perform on a City contract. Too often, these forms do not provide a detailed description of services that MWBEs will perform. In numerous contracts we reviewed, the description of service on these forms is a mere four or five words to explain hundreds of thousands of dollars in spending. These short descriptions make it difficult for compliance officers to have a good understanding of the work that MWBEs are supposed to be performing. This, in turn, makes it difficult for compliance officers to determine whether MWBEs are capable of providing the services outlined on the Schedule C-1s. Also, if compliance officers do not have a clear, detailed understanding of what services MWBEs are supposed to provide, it is hard to assess the validity of MWBE participation as contracts progress.

7. The City's 2010 Budget Does Not Provide Sufficient Administrative Resources for the MWBE Program

The 2010 Budget provides Compliance with 7 budgeted positions and a contract budget of \$500,000 to conduct all MWBE certifications and monitor all post-contract award MWBE compliance. The historical record makes clear that it is simply impossible for Compliance to

¹³³ City of Chicago. "Procurement Policy and Process Manual. pg. 108.

properly administer the program with these limited resources. With this limited budget and staffing, Compliance will not be able to: properly scrutinize firms who attempt to become MWBE (or DBE) certified, conduct any meaningful assessment of actual MWBE participation on City contracts, or address any of the major deficiencies in the program's administration detailed above.

With 7 budgeted positions and a small contract budget, Compliance will not be able to monitor MWBE compliance on each contract on an ongoing basis. Once C2 is fully implemented, City vendors will enter payments to MWBEs into a centralized database, which will enable the reporting of actual payments to MWBEs. However, C2 does not address the underlying deficiencies in how payments to MWBEs are documented. C2 will still rely on the payments that prime contractors and subcontractors report without validating the information. With limited resources, Compliance will not be able to comprehensively assess the validity of the payment information reported through C2.

Compliance will not be able to perform the certification functions of the MWBE program. The program's 2,500 certified firms each submit annual No Change Affidavits and have to recertify every five years. Additionally, new firms will continue to apply for certification. The resources provided to Compliance will make it impossible to adequately handle this workload. This workload will be even more difficult to contend with if Compliance hopes to improve the City's lax certification process, by instituting a more rigorous examination process prior to approving a firm's certification.

A recent interview confirmed that the resources allocated to Compliance are nowhere near sufficient to administer the MWBE program. In the interview, a City worker with knowledge of Compliance's administration of the MWBE program related to the IGO that there are currently 5 staff members in Compliance working on the MWBE program. Under the direction of a supervisor, there are 3 certification officers working on certification applications. In addition, there are 6 part-time consultants who assist the certification officers by conducting site visits of applicant firms.¹³⁴ These 3 certification officers and 6 part-time consultants are responsible for maintaining the certification files of the 2,500 currently certified firms as well as scrutinizing and assessing the certifications of new applicants. Compliance is struggling to simply keep up with the volume of work and has no capacity to improve the City's certification process.¹³⁵

The interview also revealed that there is one compliance officer now evaluating actual MWBE participation on all City contracts. This compares to the 10 compliance officers in DPS when it was responsible for post-award compliance.¹³⁶ With 10 compliance officers, DPS could not adequately evaluate actual MWBE participation. By allocating Compliance only a single compliance officer, the administration has effectively eliminated any comprehensive review and/or analysis of actual MWBE participation on City contracts.

¹³⁴ Interview #5

¹³⁵ *Id*

¹³⁶ *Id*

Given the resources allocated to Compliance in the 2010 budget, the fraud, abuse, and mismanagement that have plagued the program since its inception are all but assured to continue unabated.

H. RECOMMENDATIONS TO IMPROVE DATA COLLECTION AND REPORTING

The failings of the program cannot be blamed on a single person or a single department, and therefore no single policy change can fix the program. Rather, what are needed are both a rigorous program administration and a commitment from all parts of the City to the program's goals. In the following sections, we offer a series of recommendations to help the program better fulfill its mission.

1. Track and Report Actual Payments to MWBEs

In the past, DPS reported MWBE participation based on the contracts and subcontracts that are awarded to MWBEs. This data does not reflect the actual payments to MWBEs. As our analysis above shows, there is likely a large discrepancy between the amount of contract dollars awarded to MWBEs and the payments actually made to MWBEs. The statistics that the administration reports to the City Council and the public likely substantially overstate the program's impact. This creates an inaccurate perception in the City Council and with the public about the amount of money going to MWBEs. Because contract awards are the main criteria by which the program is judged it has lessened the focus on contract monitoring and oversight during the course of contracts.

The C2 system will allow Compliance to more efficiently collect and report payments to MWBEs. However, C2 does not address the underlying deficiencies in how payments to MWBEs are documented. Relying on the data that contractors report through C2, without assessing the validity of this data, will likely result in continued substantial overstatement of the program's impact.

Compliance must be given the resources necessary to evaluate the accuracy of the reported payments to MWBEs. Only after this data is validated, must it then be reported to the City Council and the public. Collecting and reporting valid data on actual payments will allow the administration, the City Council, and the public to better evaluate the program's true impact.

2. File Contract Data Electronically

Currently, on both construction and non-construction contracts, subcontracting disclosures are made separately, on different documents, and are reviewed by different City officials. The result is often that a MWBE compliance officer, looking solely at Schedule C-1s and Schedule D-1s, believes that a MWBE is self-performing on a contract, whereas the user department (which reviewed the project initially, supervises it as it goes along and authorizes payment) and the DPS contracts officer (who reviewed the project proposals, the bids/proposals, and the EDS) knows that the MWBE is subcontracting to non-certified firms. This blinkered approach should be changed.

In order to better monitor all aspects of the MWBE program, the City must centralize all documents related to subcontractors by developing an electronic filing system for its contracts. With contract monitoring being conducted by multiple people in multiple departments, a single electronic repository for all files relating to each individual contract will streamline the contract monitoring process. An electronic repository would allow DPS and Compliance to better access contract documents and thus allow them to make compliance determinations in a timelier manner. Because the user departments are the prime recipients of contract documents, they should be responsible for electronically filing all documents related to contracts. Documents could either be uploaded to a dedicated website or to a network shared drive to which user departments, DPS, and Compliance have access.¹³⁷ A further step would be to centralize a detailed subcontractor disclosure in the C2 system, to ensure that all contract data is transparent and accessible to all personnel involved in administering a contract.

I. RECOMMENDATIONS TO IMPROVE MWBE ADMINISTRATION

While better data reporting will help the program better accomplish its goals, the City must also improve the administration of the program. In interviewing the DPS officials who previously administered the MWBE program, we have encountered a program that is focused on “pushing paper” rather than on ensuring that the program is achieving its goals. The administration needs to rigorously enforce the program’s rules and regulations and ensure that participants act in good faith. To achieve this, the administration of the program has to be “a hands-on process that requires close scrutiny and instant response to issues before they become major problems.”¹³⁸

1. Ensure More Detailed Documentation of Payments to MWBEs

In both construction and non-construction, the documentation that DPS used to audit actual payments to MWBEs was insufficient. While lien waivers in construction provide extensive documentation about who has been paid, IGO investigations and testimony during the *Builders* trial illustrate the ease with which lien waivers can be used to overstate payments to MWBEs. In non-construction, simply having MWBEs attest to how much they have been paid without additional documentation creates even more potential for abuse.

In both programs, Compliance must at a minimum require canceled checks to verify what MWBEs are actually paid. Canceled checks are harder to manipulate than the lien waivers and attestations that compose the current payment verification process. Requiring contractors to submit cancelled checks to demonstrate payment to MWBE firms would also address the problem of verifying indirect participation. When indirect participation is claimed for the same firm, the check numbers of canceled checks could be reconciled to ensure that the same payment is not being counted twice.

¹³⁷ We recognize that there may be some privacy concerns with access to data, but these should be minimal since most of the documents do not contain sensitive information. Also, while this may slightly increase the administrative burden on the user departments, electronically filing all contract documents should require minimal effort.

¹³⁸ James H. Lowry & Associates. Study of Minority and Women-Owned Business Enterprise Procurement Programs for the City of Chicago. March 1985. pg 6-1.

(A) *Direct Payment of Subcontractors*

A more far-reaching step would be for the City to directly pay all subcontractors¹³⁹, which was recommended by the 2004 Task Force that studied the program.¹⁴⁰ The direct pay of subcontractors would eliminate most of the uncertainty about how much MWBEs are being paid, which, in turn, would decrease the administrative burden on Compliance's compliance unit.¹⁴¹ A further benefit is that this would ensure that MWBEs would get paid faster. This is especially important for MWBEs who often have limited access to credit and are, on average, smaller than their non-MWBE counterparts. Finally, direct payment would have the further benefit of reducing the ability of prime contractors to withhold payments from subcontractors, which is sometimes used as leverage by unsavory prime contractors to induce over-reporting of MWBE participation.

While there are benefits to directly paying subcontractors, there are also potential problems. Paying subcontractors directly could increase the City's liability by establishing a contractual relationship between the City and subcontractors. It could also increase the administrative burden on the user department's finance staff and the Department of Finance (DOF) as the City would have to issue more payments.

2. Increase Cooperation Between User Departments, DPS, and Compliance

In order for the MWBE program to improve, it must be better integrated into the City's contracting process. The program and its various components (certification, contract-specific goal setting, and assessing actual participation) cannot function properly if operated in a vacuum, disconnected from all other aspects of contract administration. Rather, each component of the MWBE program needs to rely on information and expertise from the personnel who let and manage the City's contracts.

Because user departments are responsible for day-to-day oversight of the City's contracts, they should play a greater role in the administration of the MWBE program. Greater collaboration between the user departments, DPS, and Compliance would enable the administration to more quickly identify shortfalls in MWBE participation and more accurately assess the validity of MWBE participation. By electronically filing documents related to City contracts discussed in the previous section, the user departments can ensure that Compliance has timely access to the information needed to assess MWBE participation. In addition, the City should consider taking three additional steps.

¹³⁹ In 2000, the City Council passed an ordinance that empowers the City to directly pay subcontractors, but, to the best of our knowledge, the City has not exercised this authority.

¹⁴⁰ Testimony of Colette Holt. Chicago City Council Budget Committee. April 26, 2004.

¹⁴¹ We recognize that there is still potential for abuse as MWBEs could turn around and write checks to non-MWBEs. However, this would be less likely than in the current system.

(A) *User Departments Should Monitor and Report MWBE Compliance on an On-going Basis Throughout the Performance of Contracts*

In the past, DPS generally only determined MWBE compliance at the end of contracts. The purpose of the program is to remove barriers to MWBEs receiving City contracts and if deficiencies are uncovered during a contract it may be possible to correct them by having an MWBE perform a greater portion of the work remaining on the contract. By determining compliance at the end of a contract, the City ensures that if a deficiency is discovered it is impossible to rectify because the contract has already been performed.

Therefore, the City must monitor actual MWBE participation on at least a quarterly basis. Multi-stage compliance reporting would be more likely to uncover shortfalls in actual MWBE participation and also identify front companies, brokers, and pass-throughs. According to the City's procurement manual, the user departments are responsible for monitoring MWBE compliance during contract performance. The user departments receive Certification forms (and lien waivers for construction contracts) with each invoice that detail how much each subcontractor is being paid. The user department should use this information to monitor and report on MWBE participation as contracts are performed.

(B) *Project Managers Should Attest that Documents Submitted by Contractors Related to MWBE Compliance Are Accurate*

The documentation that is currently collected to assess MWBE participation is insufficient, in part, because MWBE compliance officers have difficulty determining whether the representations made by contractors in these documents are accurate. Many of the decisions that need to be made to determine MWBE compliance concern specific details of City contracts. Through the day-to-day management of the contract, user department contract managers are often in the best position to know what work MWBEs are actually performing.

One way to increase the involvement of user department contract managers in assessing MWBE compliance would be to have them certify that, to the best of their knowledge; the documents (lien waivers, Status Reports of MBE/WBE Payments, etc.) that contractors submit to detail MWBE participation accurately reflect the work each subcontractor performed. This requirement will help establish that the user departments are partly responsible for the program's administration.

(C) *MWBE Compliance Officers Could Be Embedded in Each Department*

A more far-reaching step to increase user department involvement in assessing MWBE participation would be to embed MWBE compliance officers in the major contracting departments. These officers could train contracting personnel on MWBE issues and help them better identify MWBE problems as they arise. Rather than have these MWBE compliance officers report to the user department, these officers could report directly to the head of MWBE compliance in the Compliance department. This would better ensure that the officers all have a uniform understanding of the MWBE regulations and that MWBE administration is standardized

across departments. In addition, through such deployment, the program officers would become more familiar with department and industry idiosyncrasies that would come to inform contract-based goal setting in the future (see below).

3. Increase Contract-Specific Goal Setting

For construction and non-construction contracts, the City must set MWBE goals on a contract-specific basis. Different City contracts allow for varying degrees of MWBE participation, yet the City generally applies the same contracting goals to every contract. This ignores industry differences in MWBE availability and differences in subcontracting opportunities on different contracts. In order to ensure a program that better conforms to actual MWBE contracting opportunities; the City must set MWBE goals for individual contracts based on the availability and capacity of MWBEs in individual industries.

4. Consistently Apply MWBE Regulations

DPS failed to consistently apply the MWBE program's rules and regulations to effectively monitor MWBE certification and compliance. Going forward, Compliance must train its staff on clearly defined rules and regulations and interpretive guidance relating to the certification and compliance monitoring aspects of the program. These should include specific rules defining the certification requirements for suppliers, distributors and dealers; a clear definition of what is and what is not subcontracting; and regulations regarding how subcontracting affects participation. Compliance must then rigorously apply these and its previously written rules to the administration of the program.

5. Increase Penalty Collection from Non-compliant Firms

The City has the authority, under both the construction and non-construction ordinances, to collect penalties from firms that do not meet their MWBE commitments. Yet, the City has discontinued the practice of collecting penalties as part of the contract closing process, at which point the City is able to draw against retainage. Instead, the City notifies MWBE subcontractors of their right to seek arbitration to collect the difference between the committed amount and the amount actually paid. In practice, few subcontractors seek arbitration likely due to a desire not to offend prime contractors from whom they will likely seek business in the future.

In order to increase MWBE compliance, the City should systematically collect penalties from firms that do not meet their MWBE commitments. Currently, non-MWBE firms face few consequences for not meeting their participation commitments and thus have less of an incentive to subcontract to MWBEs. By collecting penalties, the City can better enforce the MWBE ordinances and ensure greater MWBE participation.

6. More Resources for MWBE Certification and Compliance

The 2010 Budget provides Compliance with 7 budgeted positions and a \$500,000 contract budget to administer the MWBE program. For a unit that is now responsible for monitoring the MWBE compliance of 2,000 city contracts and contract modifications that the City lets each

year, as well as the certification files of 2,500 firms, these resources are clearly not sufficient to adequately administer the program.

If the MWBE program were to be better integrated into the City's contract management process and the user department's played a greater role in administering the program, the burden on Compliance could be partially alleviated. While we strongly advocate a greater role for the user departments, even if this were to occur, Compliance would still need greater resources to administer the program properly.

The IGO is aware that given the City's current budget problems, increasing resources for the MWBE program will be difficult to achieve. However, the MWBE program aims to direct hundreds of millions of dollars to MWBEs each year, and in order to accomplish its goals it will need more resources.

(A) *Prioritize Certification for Firms Most Likely To Do Business with the City*

Currently, firms certify for the City's program even though they have little chance of winning City contracts because the City does not often contract for goods or services in the firm's industry. For instance, 27 firms are certified as staffing agencies or employment placement firms, even though the City is unlikely to contract with these companies due to the restrictions on City hiring imposed by the *Shakman* consent decree. Given the limited resources devoted to certification in the 2010 budget, Compliance should prioritize its resources so that it processes certifications based on the likelihood of an applicant firm doing business with the City. To do this, Compliance could group applicants by their North American Industry Classification System (NAICS) codes and compare a firm's NAICS code with the percentage of City contracts that fall into that code. Based on this comparison, Compliance can then separate firms based on their chances of doing business with the City. Compliance should then prioritize the certification applications of firm's most likely to do business with the City.

7. Responsibilities and Duties of Compliance Staff

More resources alone will not solve the MWBE program's problems. In the past, DPS viewed the administration of the program as merely "pushing paper". This view of the program is partly attributable to the fact that DPS had little power to enforce MWBE commitments and because the program seems to receive little support from the rest of City government. Changing this culture will require a more transparent accounting of the program's results discussed above and a greater commitment to the program's success.

In 2005, largely in response to the Duff scandal, DPS attempted to institute a "rigorous new certification process" to determine if companies that participate in the program are legitimately controlled by women and minorities.¹⁴² It is clear that this rigorous new process was not fully implemented by DPS. While more information is now required of applicant firms, DPS was

¹⁴² Spielman, Fran. "City unveils scrutiny of minority firms: Companies must give more detailed info to win certification." Chicago Sun-Times. May 18, 2005.

focused on ensuring that firms simply completed all the required documentation rather than assessing the validity of the documentation.

In the future, Compliance's certification officers must more thoroughly review the legitimacy of applications for the program. Given the numerous front companies and brokers that have plagued the program, the certification unit must be more vigilant when approving firms for the program.

To more accurately assess MWBE participation, Compliance's compliance unit needs to have a better understanding of the contracts they monitor. In construction, properly auditing MWBE participation requires compliance officers to know what is happening on job sites. They need to know what companies are actually working on-site to be able to validate the information in the lien waivers that companies submit. As we have detailed above, simply relying on lien waivers is not sufficient due to the potential for abuse in the lien waiver process. In non-construction, compliance officers need to more thoroughly verify that MWBEs are receiving the payments that prime contractors report.

8. More Detailed Descriptions of MWBEs' Scope of Services

The Schedule C-1 forms that detail what services MWBEs will perform omit critical information. We recommend that the City draft new language for its Schedule C-1 form that would require firms to detail, in greater specificity, the services and products to be provided in the contract. We have reviewed hundreds of Schedule C-1 forms that provided inadequate descriptions of complex services to be delivered by MWBEs. These terse descriptions allow prime contractors and subcontractors to operate in a cloud of uncertainty on City contracts. By making it difficult to determine what work contractors are performing, DPS has difficulty assessing whether MWBEs are capable of performing services before contracts are awarded and Compliance struggles to make actual participation determinations.

We recommend that subcontractors submit the same type of documentation they issue when submitting bids or quotes to the prime contractor. This process would help DPS and Compliance better understand the scope of services being provided by MWBEs. While DPS regulations required that copies of contracts between the prime contractor and subcontractors be submitted to DPS, in our review, only a handful of these documents were in DPS's contract files. Better document collection and a more detailed accounting of the services an MWBE will provide would help ensure that DPS better understands the scope of services MWBEs are supposed to provide and thus can assess whether MWBEs are capable of providing those services. A better understanding of MWBEs' scope of services will also allow Compliance to more accurately assess MWBE participation.

9. Detail Subcontracting to Non-MWBEs on All Schedule D-1's

MWBE firms awarded construction contracts as prime contractors are required to disclose on the Schedule D-1 form the amount of the contract that the firm will subcontract to non-certified firms. This disclosure is crucial for accurately determining MWBE participation because generally an MWBE firm is given credit only for the portion of the contract that it actually

performs.¹⁴³ However, no such disclosure is required on non-construction contracts. The IGO has encountered numerous examples in which an MWBE firm is awarded a non-construction contract, subcontracted out a substantial portion to non-certified firms, yet the City counted 100% of the contract's value towards its MWBE participation. The City should require non-construction MWBE prime contractors to make a detailed disclosure on the Schedule D-1s of the percentage of the contract that is being subcontracted to non-certified firms.

10. Conduct a Rigorous Analysis of the Personal Net Worth of MWBE Applicants

The IGO recommends two changes to the analysis of MWBE applicants' personal net worth; one to the rules and one to the program administration. The current MWBE construction program rules state that "only an individual's share" of "assets jointly held with his or her spouse" count toward a participant's personal net worth.¹⁴⁴ This regulation creates a loophole in that as long as assets are held in a spouse's name they are shielded from the personal net worth limitation. Thus, the spouses of Warren Buffet and Donald Trump would be eligible for the program provided that their wealthy spouses simply did not list them as the owner of any of their assets. The rules allow legal technicalities to obscure common sense and tend to benefit the wealthy, sophisticated applicant at the expense of those who cannot afford lawyers and accountants. The rules should be changed to count all assets that Illinois law would attribute to the applicant. Illinois is an "equitable property" state, and starts from the presumption that all assets of a married couple are jointly held. But unlike a community property state, Illinois allows spouses to demonstrate that certain assets have been acquired outside the marriage and have been maintained separately.

If the rule is changed, the program should require that applicants disclose all marital assets and should count 50% of all assets to the applicant, unless a showing is made that the asset was separately acquired and maintained. One way to accomplish this would be to require both spouses to submit statements of personal net worth. Certification officers should also be trained to better understand personal finance and wealth management tools such as trusts, retirement accounts and closely-held corporations.

The other recommendation is that because the City does not have a personal net worth limit for non-construction MWBEs, the City should discontinue its practice of asking those applicants for personal net worth information. Any additional time and resources spent evaluating the personal net worth for MWBE construction applicants would be more than offset by not requesting and evaluating such information for non-construction MWBEs. This would have the additional benefit of alleviating some of the administrative burden on non-construction MWBEs because they would have to submit less information to the City. Finally, the City would benefit because it would not have to maintain and safeguard as much personal, financial information as it does currently.

¹⁴³ There is a limited and seldom-seen exception for certified general contractors.

¹⁴⁴ *Chicago Municipal Code*, sec. 2-92-670(q) (American Legal 2009).

11. Changes to MWBE Regulations

Through the course of our investigations and analysis of actual participation, we have identified one regulation concerning the MWBE program that we recommend be modified. This recommendation is detailed below.

(A) *Count the Commission of Brokers as Participation*

Our analysis and investigations indicate that the current City policy of excluding brokers from certification has been ineffective in preventing the participation of firms which act as brokers. Through inconsistent application of the MWBE regulations, the City has allowed brokers to become certified as suppliers and participate in the program.

We recommend the City allow brokers to participate in the program but adopt the same approach taken by the state of Illinois and only count a broker's commission on a contract toward participation goals.¹⁴⁵ We recommend a case-by-case analysis to determine what function the MWBE is performing on the contract. If the City determines that a firm is serving as a broker, we recommend that the City count toward participation only the firm's commission or profit as MWBE participation and not the entire value of the contract. This approach should discourage the use of brokers because they will only provide minimal credit toward the MWBE goals.

J. CONCLUSION

Our investigations and analysis have revealed that the MWBE program is poorly administered and that the City cannot determine whether or not the program is achieving its goals. Part of the result of this substandard administration is that the program has been beset by fraud and brokers, and MWBE participation is likely far less than the publicly reported statistics.

The City's failure to collect relevant data, its inconsistent application of the program's rules and regulations, and a lack of cooperation between the user departments and DPS have all contributed to the program's poor administration. Despite the *Builders* lawsuit and several high-profile scandals involving the program, these failings have not been corrected. The MWBE program requires continuous oversight and analysis, yet the City has failed to successfully address the program's problems as they have arisen.

Going forward, the City must confront the problems that plague the program. To do this, there must be a commitment from all parts of City government to the program's goals and rigorous, continuous analysis of how the program is administered and of the program's effectiveness.

¹⁴⁵ State of Illinois. "Counting DBE goal credit."
(<http://www.dot.state.il.us/ucp/counting.pdf> last accessed May 19, 2010)

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METHODOLOGY

For this program review, we consulted a variety of resources. Many of the findings in this report are based on IGO investigations that have been conducted over the last several years. We conducted interviews with DPS staff and reviewed the regulations and ordinances governing the City's MWBE program. We reviewed the compliance audits of hundreds of City contracts and the certification files of dozens of MWBEs. Lastly, we talked to academics and researchers in the field, studied the major court decisions, and reviewed much of the academic literature on affirmative action programs in government contracting.

Appendix A - HISTORY OF AFFIRMATIVE ACTION IN GOVERNMENT CONTRACTING

Affirmative action in government contracting began in the late 1960s. The Small Business Administration (SBA) was the first part of the federal government to experiment with setting aside contracts for eligible firms. The SBA used existing legislative authority to create Section 8(a) “to direct federal procurement contracts to minority-owned small businesses.”¹⁴⁶ This administrative change was made in response “to appeals from the Kerner Riot Commission for special outreach programs to build economic development in the inner cities.”¹⁴⁷ However, the program started slowly because although the new regulations stated that the purpose of the program was to direct contracts to the “socially and economically disadvantaged” it did not define this term until 1973.¹⁴⁸ The SBA then defined five groups as presumptively eligible, meaning that people belonging to these groups did not have to prove that they were disadvantaged to qualify for the program.¹⁴⁹ The five groups were “African Americans, American Indians, Spanish Americans, Asian Americans and Puerto Ricans.”¹⁵⁰

1. The Public Works Employment Act of 1977

In 1977, the U.S. Congress first approved affirmative action in government contracting. The Public Works Employment Act of 1977 included a provision that mandated that 10 percent of the \$4 billion in public works contracts authorized by the Act should go to Minority-Business Enterprises (MBEs). The following year “the Democratic leadership in Congress pushed through a bill that for the first time provided a statutory basis for the SBA 8(a) program.”¹⁵¹

2. The *FULLILOVE* Decision and the Onset of State and Local Programs

In 1980, soon after affirmative action contracting programs were enacted into federal law, the first significant Supreme Court decision regarding affirmative action in government contracting was handed down. In *Fullilove v. Klutznik*, a group of contractors argued that the MBE program enacted by the Public Works Employment Act of 1977 violated the Equal Protection Clause of the constitution because it discriminated against non-minorities.¹⁵² The Supreme Court upheld the program on the grounds that “Congress had abundant historical basis from which it could conclude that traditional procurement practices, when applied to minority businesses, could perpetuate the effects of prior discrimination.”¹⁵³ Because the race-based preferences of the MBE program were intended to remedy past discrimination, the court concluded that Congress had constitutional authority to enact the program. However, the Court cautioned that “any

¹⁴⁶ United States Senate. Hearing of the Committee on Small Business “The Small Business Administration’s 8(a) Minority Business Development Program.” April 4, 1995

¹⁴⁷ Graham, Hugh Davis. “Collision Course: The Strange Convergence of Affirmative Action and Immigration Policy.” 2002 pg 138.

¹⁴⁸ Barlas, Stephen. “At risk. Minority set-aside program.” *Entrepreneur* February 1997

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¹⁵¹ Graham, Hugh Davis. “Collision Course: The Strange Convergence of Affirmative Action and Immigration Policy.” 2002 pg 91.

¹⁵² *Fullilove v. Klutznik*, 448 U.S. 448, 449 (1980).

¹⁵³ *Id.*

preference based on racial or ethnic criteria must necessarily receive a most searching examination to make sure that it does not conflict with constitutional guarantees.”¹⁵⁴

Following the Court’s decision in *Fullilove*, “set aside programs proliferated nationwide to include some 36 states and 190 localities by the late 1980s.”¹⁵⁵ Similarly, the federal government continued to expand its affirmative action contracting program. “The Surface Transportation Assistance Act of 1982 contained the first statutory DBE [Disadvantaged Business Enterprise] provision for federal highway and transit programs, requiring that at least 10 percent of the funds provided be expended with DBEs.”¹⁵⁶ This act changed the name of the program from Minority Business Enterprise to Disadvantaged Business Enterprise, but included the same disadvantaged groups as in the earlier program. The DBE classification was expanded to include women in 1987.¹⁵⁷

3. The *CROSON* Decision and Its Aftermath

In 1989, the Supreme Court decided *City of Richmond v. J.A. Croson Co.*, in which a contractor sued the City of Richmond, Virginia claiming that its minority set-aside program was unconstitutional because it violated the Fourteenth Amendment’s Equal Protection Clause. In its decision, the Court sided with the contractors and “ruled that any affirmative action program implemented by a state or municipal government is subject to strict scrutiny.”¹⁵⁸ Strict scrutiny requires that any government that adopts a program based on racial preferences must first demonstrate a compelling interest in remedying discrimination. The Court rejected Richmond’s use of a general claim of discrimination to establish a compelling governmental interest but rather required that a state or local government must provide evidence of local discrimination in order to justify a program. As an example, the Court stated that “where there is a significant statistical disparity between the number of qualified minority contractors willing and able to perform a particular service and the number of such contractors actually engaged by the locality or the locality’s prime contractors, an inference of discriminatory exclusion could arise.”¹⁵⁹ In addition to demonstrating a compelling interest in remedying discrimination, a government program must be narrowly tailored, “meaning that it did not unduly burden those who do not benefit from the program.”¹⁶⁰

¹⁵⁴ *Fullilove v. Klutznik*, 448 U.S. 448, 449 (1980).

¹⁵⁵ Rice, Mitchell. “Government Set-Asides, Minority Business Enterprises, and the Supreme Court.” *Public Administration Review*. March/April 1991. pg. 114.

¹⁵⁶ General Accounting Office. “Disadvantaged Business Enterprises: Critical Information is Needed to Understand Program Impact.” June 2001. pg. 3.

¹⁵⁷ General Accounting Office. “Disadvantaged Business Enterprises Program” January 1993. pg. 1.

¹⁵⁸ Shefsky and Froelich. “Chicago’s Minority and Women Business Enterprise Program in Construction: A Constitutional Challenge: A Report to the City Council Budget Committee on the *BAGC v. City of Chicago* Trial. April 2004. pg. 5.

¹⁵⁹ *City of Richmond v. J. A. Croson Co.*, 488 U.S. 469, 509 (1989).

¹⁶⁰ Shefsky and Froelich. “Chicago’s Minority and Women Business Enterprise Program in Construction: A Constitutional Challenge: A Report to the City Council Budget Committee on the *BAGC v. City of Chicago* Trial. April 2004. pg. 5.

In the aftermath of the *Croson* decision, there was “a sharp increase in the number of court cases challenging these programs” and many programs were suspended.¹⁶¹ In 1989, before the decision, there were over 230 affirmative action contracting programs in state and local governments across the country. By 2008, the number had dropped to less than 50.¹⁶²

The decision in *Croson* was difficult to reconcile with *Fullilove* because it held state and local affirmative action contracting programs to a different standard than federal programs. That changed in 1996 in the Supreme Court’s decision in *Adarand v. Peña*.¹⁶³ In this decision, the court overruled *Fullilove*, “which held racial classifications to a less rigorous standard.”¹⁶⁴ The Court “concluded that the strict scrutiny standard of review was appropriate for all governmental action based on race.”¹⁶⁵

4. The 1998 Debate over the Federal DBE Program

After the decision in *Adarand*, opponents of affirmative action in federal contracts introduced legislation to end the DBE program.¹⁶⁶ In 1998, as Congress debated the Transportation Equity Act for the 21st Century (TEA-21), the six-year funding bill for federal highway and transportation programs, the debate centered on the DBE program. “The 1998 debate over DBE legislation was the most thorough in which Congress has engaged since the beginning of the program.”¹⁶⁷ Opponents of the program claimed that it was nothing more than a quota and that it discriminated on the basis of race. Proponents countered that the program was flexible and met the criteria set forth by the Supreme Court in *Adarand*. In the end, amendments to eliminate the program were narrowly defeated in both houses and the program was reauthorized with the 10 percent goal intact.¹⁶⁸

Once the DBE program was reauthorized, the Department of Transportation (DOT) adopted new DBE regulations to more narrowly tailor the program to comply with the *Adarand* decision. The changes in these regulations instituted a more rigorous certification process to ensure that only disadvantaged firms were deemed eligible for the program. Also, it instituted a personal net worth limit for program participants, so that wealthy individuals were ineligible for the program. The rule explicitly banned the use of quotas and emphasized that the 10 percent participation of DBEs was a goal.¹⁶⁹

¹⁶¹ Chay, Kenneth and Fairlie, Robert. “Minority Business Set-Asides and Black Self-Employment.” December 1998. pg. 3

¹⁶² Kim, Jin-ah. “City to boost biz deals for minorities, women.” Bay State Banner. May 1, 2008.

¹⁶³ *Adarand Constructors v. Peña*, 515 U.S. 200 (1995).

¹⁶⁴ Rice, Mitchell and Mongkuo, Maurice. “Did *Adarand* Kill Minority Set-Asides?” Public Administration Review. January/February 1998. pg. 85

¹⁶⁵ *Id.*, pg. 84

¹⁶⁶ *Id.*, pg. 85

¹⁶⁷ DBE Final Rule

(<http://www.osdbu.dot.gov/DBEProgram/final/final3.cfm> last accessed May 19, 2010)

¹⁶⁸ Conference of Minority Transportation Officials. Testimony on the US DOT DBE Program. March 26, 2009

¹⁶⁹ DBE Program: What’s new in the new DOT DBE rule?

(<http://www.osdbu.dot.gov/DBEProgram/IssuancesArchives/summary.cfm> last accessed May 19, 2010)

5. Affirmative Action Contracting Programs in the 21st Century

While the *Croson* and *Adarand* decisions threatened to invalidate all government affirmative action contracting programs, several federal court decisions in their aftermath have upheld the federal DBE program. In *Northern Contracting, Inc. v. the Illinois Department of Transportation* and *Sherbrooke Turf v. Minnesota Department of Transportation*, the federal DBE program was held facially to have met both the compelling interest and narrow tailoring test set out in *Adarand*, and the state's implementation of the program was held to be narrowly tailored as applied.¹⁷⁰ In *Western State Paving v. State of Washington Department of Transportation*, the federal government was held to have a compelling interest in establishing a DBE program, but the state's implementation of that program was not narrow tailored "because WsDOT did not offer any evidence of discrimination in the Washington state construction industry."¹⁷¹

At the local level, two decisions in 2003, *Concrete Works of Colorado, Inc. v. City and County of Denver*¹⁷² and *Builders Association of Greater Chicago v. City of Chicago*¹⁷³, found that both Chicago and Denver had a compelling interest in having an affirmative action contracting program to remedy the past effects of discrimination.¹⁷⁴ However, in the *Builders* case, the court found that Chicago's program was not narrowly tailored and gave the City six months to change its program.¹⁷⁵ In 2008, a federal court in North Carolina, upheld that state's affirmative action contracting program finding that the state had a compelling interest and that the program was narrowly tailored.¹⁷⁶

6. Disparity Studies

In response to the *Croson* and *Adarand* decisions, jurisdictions across the country conducted disparity studies to demonstrate that discrimination affected the market for government contracts. Initially, these studies relied heavily on anecdotal evidence of discrimination. This evidence often took the form of interviews with minority and women business owners during which they discussed individual instances of discrimination they had faced.

While courts have considered anecdotal evidence, they have required jurisdictions to also present statistical evidence of discrimination in order to prove a compelling interest. The first step in these studies is often to determine the availability of MWBEs in a jurisdiction. Once availability has been estimated, many studies determine whether MWBEs are being underutilized by calculating a "utilization percentage ratio, or disparity index."¹⁷⁷ The disparity index calculates the percentage of MWBEs in a given area compared to the total number of firms and compares

¹⁷⁰ Blanchflower, David. "Minority self-employment in the United States and the impact of affirmative action programs." National Bureau of Economic Research. April 2008.pg. 8.

¹⁷¹ *Id.*, pg. 8.

¹⁷² *Concrete Works of Colorado, Inc. v. City and County of Denver*, 321 F. 3d 950 (10th Cir. 2003).

¹⁷³ *Builders Association of Greater Chicago v. City of Chicago*, 298 F. Supp.2d 725, (N.D. Ill. 2003).

¹⁷⁴ Martin, Heather et al. "Documenting Disparity in Minority Contracting: Legal Requirements and Recommendations for Policy Makers." *Public Administration Review*. May/June 2007 pg. 514.

¹⁷⁵ *Builders Association of Greater Chicago v. City of Chicago*, 298 F. Supp.2d 725, (N.D. Ill. 2003).

¹⁷⁶ *H.B. Rowe v. Tippet*, 589 F. Supp 2d 587, (E.D.N.C. 2008).

¹⁷⁷ Martin, Heather et al. "Documenting Disparity in Minority Contracting: Legal Requirements and Recommendations for Policy Makers." *Public Administration Review*. May/June 2007 pg. 514.

that to the percentage of government contracts received by MWBEs. The use of the disparity index comes directly from the *Croson* decision, which stated,

“where there is a significant statistical disparity between the number of qualified minority contractors willing and able to perform a particular service and the number of such contractors actually engaged by the locality or the locality's prime contractors, an inference of discriminatory exclusion could arise.”¹⁷⁸

In addition to disparity indices, some studies have used statistical regression analysis to attempt to isolate the effects of race and gender on business ownership. These studies have examined the impact of discrimination by showing that when all other factors are held constant (education, work experience, etc.), there is a penalty attached to being a minority or a woman when predicting business ownership.

In addition to examining whether MWBEs are underutilized, the availability estimates of MWBEs serve as the basis for the numerical goals of an MWBE program. The narrow tailoring requirement of *Croson* and *Adarand* requires a jurisdiction to base availability on MWBEs that are “ready, willing, an able” to contract with government.

(A) Criticisms

Disparity studies have been criticized for not meeting the legal standards required to justify an MWBE program.¹⁷⁹ A report by the U.S. Commission on Civil Rights faulted disparity studies for using “obsolete and incomplete data.”¹⁸⁰ A General Accounting Office (GAO) review of 14 disparity studies regarding transportation contracts, “found that the limited data used to calculate disparities, compounded by methodological weaknesses, create uncertainties about the studies’ findings.”¹⁸¹

One of the central criticisms of disparity studies is that they have failed to consider capacity when determining the availability of MWBEs. Generally, disparity studies have relied on counts of firms, giving the same weight to firms of vastly different sizes. One critic observed that, “the qualified-firm counting approach ignores differences in capacity and deems the single-plant firm to be equally available to serve the government as the multiplant firm.”¹⁸² Because MWBEs are typically smaller than non-MWBEs, this failure to take into account capacity likely overstates the availability of MWBEs. In turn, overstating the availability of MWBEs will lead to a finding of

¹⁷⁸ *City of Richmond v. J. A. Croson Co*, 488 U.S. 469, 509 (1989).

¹⁷⁹ Martin, Heather et al. “Documenting Disparity in Minority Contracting: Legal Requirements and Recommendations for Policy Makers.” *Public Administration Review*. May/June 2007 pg. 518.

¹⁸⁰ U.S. Commission on Civil Rights. “Disparity studies as evidence of discrimination in federal contracting.” May 2006. pg. 76

¹⁸¹ General Accounting Office. “Disadvantaged Business Enterprises: Critical Information is Needed to Understand Program Impact.” June 2001. pg. 29

¹⁸² U.S. Commission on Civil Rights. “Disparity Studies as Evidence of Discrimination in Federal Contracting.” pg. 67.

greater MWBE underutilization when examining the percentage of contracts awarded to MWBEs.¹⁸³

Opponents of the capacity approach argue that “excluding firms from an availability measure based on their ‘capacity’ in a discriminatory market merely affirms the results of discrimination, not remedies them.”¹⁸⁴ This is because “the capacity argument fails to acknowledge that discrimination has prevented the emergence of ‘qualified, willing and able’ minority firms.”¹⁸⁵

Federal courts have disagreed on whether or not disparity studies should consider firm capacity. In *Northern Contracting, Inc. v. the Illinois Department of Transportation*¹⁸⁶ and *Sherbrooke Turf v. Minnesota Department of Transportation*¹⁸⁷, the Seventh Circuit and Eighth Circuit Courts of Appeals, respectively, did not require that disparity studies consider firms’ capacity.¹⁸⁸ Conversely, in *Western State Paving v. State of Washington Department of Transportation*, a Ninth Circuit Court of Appeals rejected the State of Washington’s disparity statistics because they did “not account for factors that may affect the relative capacity of DBEs to undertake contracting work.”¹⁸⁹ Similarly, in 2008, the Court of Appeals for the Federal Circuit invalidated a Department of Defense preferential procurement program partly because the disparity studies used to justify the program failed to take into account the capacity of MWBEs.¹⁹⁰

¹⁸³ General Accounting Office. “Disadvantaged Business Enterprises: Critical Information is Needed to Understand Program Impact.” June 2001. pg. 32.

¹⁸⁴ Wainwright, Jon and Holt, Colette. “The Limited Impact of *Rothe VII* on M/W/DBE Programs. *NERA Economic Consulting*. June 25, 2009. pg. 5.

¹⁸⁵ *Id.*, pg. 5

¹⁸⁶ *Northern Contracting, Inc. v. Illinois Dept. of Transportation*, 473 F.3d 715 (7th Cir. 2007).

¹⁸⁷ *Sherbrooke Turf, Inc. v. Minnesota Dept. of Transportation*, 345 F.3d 964 (8th Cir. 2003).

¹⁸⁸ Wainwright, Jon and Holt, Colette. “The Limited Impact of *Rothe VII* on M/W/DBE Programs. *NERA Economic Consulting*. June 25, 2009. pg. 3.

¹⁸⁹ *Western States Paving v. Washington State Department of Transportation*, 407 F.3d 983, 1000 (9th Cir. 2005).

¹⁹⁰ *Rothe Development Corporation v. Department of Defense*, 545 F.3d 1023, (2008).

APPENDIX B - RESEARCH ON THE IMPACT OF AFFIRMATIVE ACTION IN GOVERNMENT CONTRACTING

While attention has been paid to affirmative action in higher education and employment, comparatively little research has been done on affirmative action in government contracting. Research has in part been limited by the inability of governments to collect relevant data. A discussion of the existing research on the effectiveness of affirmative action contracting programs is discussed below.

1. Research on Benefits

(A) Increase in Contracts Awarded to MWBEs

There is evidence that MWBE programs have increased the amount of contracts and subcontracts being awarded to MWBEs. After the implementation of MWBE goals at the federal level, the share of federal contracts going to MWBEs grew dramatically.¹⁹¹ A recent study of the Federal Highway Administration's DBE program in California found that increased DBE goals led to increased utilization of DBEs.¹⁹² Several analyses have shown that after affirmative action contracting programs are discontinued, there are large drops in the utilization of MWBEs. After Richmond ended its MWBE program, the utilization of MWBEs in city contracts dropped from 30 percent to 4 percent. Similarly, Atlanta saw its utilization of MWBEs drop from 35 percent to 14 percent.¹⁹³ A GAO study of the federal DBE program, as implemented by the 50 states, found that although "limited data prevent a thorough assessment of the impact of the DBE Program... data provided from the remaining two states indicate that discontinuing the federal and nonfederal programs had a negative impact on minority- and women-owned businesses."¹⁹⁴ These analyses strongly indicate that in the absence of MWBE programs, the share of contracting dollars going to MWBEs significantly decreases.

(B) Broader Impact on MWBE Economic Development Is Unclear

Unfortunately, there is little research on how affirmative action contracting programs have impacted the disadvantaged communities they aim to assist. There is some anecdotal evidence that programs have helped produce successful minority-owned firms. A review of the federal government's affirmative action programs, found that "in 1994, 32 of the largest 100 African American owned firms and 17 of the top 100 Hispanic-owned firms were or had been in the 8(a) program."¹⁹⁵ While this suggests that the SBA Section 8(a) program helped these firms, it does not establish that their success was a result of the program.

¹⁹¹ Report to the President. "Affirmative Action Review". 1995.

¹⁹² Marion, Justin. "Affirmative Action and the Utilization of Minority- and Women-Owned Businesses in Highway Procurement." February 2009. Note: Interestingly, this study found that increasing goals did not increase the utilization of WBEs.

¹⁹³ Shefsky and Froelich. "Chicago's Minority and Women Business Enterprise Program in Construction: A Constitutional Challenge: A Report to the City Council Budget Committee on the *BAGC v. City of Chicago* Trial. April 2004. pg. 74.

¹⁹⁴ General Accounting Office. "Disadvantaged Business Enterprises: Critical Information is Needed to Understand Program Impact." June 2001.

¹⁹⁵ Report to the President. "Affirmative Action Review". 1995.

Empirical studies that have tried to determine the effectiveness of these programs have focused on changes in the self-employment rates of disadvantaged groups. These statistics are thought to be an indication of entrepreneurial activity and one of the central goals of affirmative action in government contracting is to spur business formation in disadvantaged communities. One study found that the gap in self-employment rates between white males and white females in construction, the industry where affirmative action contracting programs are most prevalent, has narrowed substantially over the past 25 years.¹⁹⁶ It also found a lesser narrowing of the gap for African Americans and a slight widening of the gap for Hispanics. While this study points to some improvements in the racial and gender disparities in industries where these programs have been concentrated, they have not isolated the role that affirmative action contracting programs may have played in alleviating these disparities.

A 2009 study attempted to isolate the affect of affirmative action contracting programs on self-employment rates by comparing cities that implemented programs with those that did not. The study found evidence that the implementation of local, big-city affirmative action contracting programs increased the self-employment rates of African Americans men compared to white men during the 1980s.¹⁹⁷ It found that “all of the gains in black self-employment were realized in the industries targeted for set-asides such as construction.”¹⁹⁸ The study offers the strongest academic evidence to date that affirmative action contracting programs increase minority business formation.

2. Research on Costs and Problems

(A) Little Evidence of Increased Cost

Critics of affirmative action contracting programs argue that because the programs restrict competition they increase the cost of government contracting. Only a handful of studies have investigated this criticism empirically. In a 1997 study of set-asides for small businesses (that were not disadvantaged) in Army dredging contracts, researchers found no difference in cost when set-asides were in place.¹⁹⁹ While this study did not look at set asides for MWBEs directly, “it suggests that programs that ostensibly restrict competition do not necessarily result in higher prices.”²⁰⁰ A more recent study of California’s affirmative action contracting program for minority contractors found “that a road construction project costs the government 5.6 percent less to complete after the elimination of the affirmative action program in California.”²⁰¹ This

¹⁹⁶ Blanchflower, David. “Minority self-employment in the United States and the impact of affirmative action programs.” National Bureau of Economic Research. April 2008.pg. 15.

¹⁹⁷ Chatterji, Aaron, Chay, Kenneth and Fairlie, Robert. “The Impact of City Contracting Set-Asides on Black Self-Employment and Employment.” June 2009. pg. 19.

¹⁹⁸ *Id.*, pg. 26.

¹⁹⁹ Denes, Thomas. “Do small business set-asides increase the cost of government contracting?” *Public Administration Review*. September/October 1997

²⁰⁰ Holzer, Harry and Neumark, David. “Assessing Affirmative Action.” National Bureau of Economic Research. August 1999.

²⁰¹ Marion, Justin. “How costly is affirmative action? Government contracting and California’s Proposition 209.” October 2007. pg. 23.

suggests that there may be an increase in costs when an affirmative action government contracting program is in place.

(B) *Front Companies and Fraud*

Affirmative action contracting programs at all levels of government have been beset by scandals involving front companies. In New York, “in 1984, the State Commission on Investigation concluded that illegitimate MBE contractors outnumbered legitimate ones.”²⁰² At the federal level in the late 1980s, the Wedtech Corporation, in addition to bribing Congressmen, falsified its minority-owned status in order to win hundreds of millions of dollars in defense contracts.²⁰³ From 2003 to 2008, the federal Department of Transportation’s “Office of the Inspector General (OIG) investigations of DBE fraud have resulted in 49 indictments, 43 convictions, nearly \$42 million in recoveries and fines, and 419 months of jail sentences.”²⁰⁴

Some researchers have uncovered statistical evidence of front companies in MWBE programs. A 1996 study, found that “those MBEs heavily reliant upon government sales are the youngest subset of MBE’s examined in this study.”²⁰⁵ The authors hypothesize that this could be explained by the fact “that some of the young MBEs are front companies.”²⁰⁶ A more recent study on the impact of affirmative action programs in construction indicated that “some white females are fronting firms that are actually being run by their white male spouses.”²⁰⁷

(C) *Contracts Concentrated among a Few Firms*

Critics have lamented that contracts awarded through affirmative action programs are overwhelmingly concentrated in a few participating firms. In a 1981 report on the Section 8(a) program, the GAO found that 31 percent of the program’s contract awards went to only 50 firms.²⁰⁸ Future GAO reports found that this problem persisted in the Section 8(a) program.²⁰⁹ By concentrating contracts in a few select firms, the benefits of the program are not widely dispersed. This in turn makes it less likely that the programs’ broader economic development goals are achieved. Additionally, there is some evidence that minority-owned firms that rely heavily on affirmative action programs are more likely to fail than minority-owned firms that receive less government business.²¹⁰

²⁰² New York State Organized Crime Task Force. “Corruption and Racketeering in the New York City construction industry.” 1990 pg. 133.

²⁰³ Feinberg, Andrew. “The Looting of Wedtech.” *New York Times* July 29, 1990.

²⁰⁴ Statement of Joel Szabat, Deputy Assistant Secretary for Transportation Policy, U.S. Department of Transportation. Committee on Transportation and Infrastructure, House of Representatives. March 26, 2009.

²⁰⁵ Bates, Timothy and Williams, Darrel. “Do preferential procurement programs benefit minority business?” *The American Economic Review* May 1996.

²⁰⁶ *Id.*

²⁰⁷ Blanchflower, David and Wainwright, Jon. “An Analysis of the Impact of Affirmative Action Programs on Self-Employment in the Construction Industry.” National Bureau of Economic Research. November 2005.

²⁰⁸ General Accounting Office. “The SBA 8(a) Procurement Program: A promise unfulfilled.” April 8, 1981 pg. i.

²⁰⁹ General Accounting Office. “Small Business Administration: 8(a) is vulnerable to program and contractor abuse.” September 1995.

²¹⁰ Bates, Timothy and Williams, Darrel. “Do preferential procurement programs benefit minority business?” *The American Economic Review* May 1996.