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The Limited Impact of *Rothe VII* on M/W/DBE Programs

A summary of a recent Federal Circuit Court of Appeals decision striking down the Small Disadvantaged Business program for DOD contracts because it was not based upon sufficient evidence of discrimination before Congress.

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In *Rothe Development Corporation v. U.S. Department of Defense*, the Federal Circuit Court of Appeals struck down the Department of Defense (DOD) program for small disadvantaged businesses (SDBs).[1] The program set an overall annual goal of five percent for DOD contracting with SDBs and authorized various race-conscious measures to meet the goal.

The court held that Section 1207,[2] which, among other remedies, provided a 10 percent bid preference to SDBs, violated strict constitutional scrutiny because Congress did not have a "strong basis in evidence" upon which to conclude that DOD was a passive participant in racial discrimination in relevant markets across the country. The six local disparity studies upon which DOD primarily relied for evidence of relevant discrimination did not meet the compelling interest requirement—and in any event were not "before" Congress when it reenacted the program in 2006—and other statistical and anecdotal evidence did not rise to the heavy constitutional burden.

Procedural History

Rothe VII is the latest iteration of an 11-year-old challenge by a firm owned by a white female to DOD's award of a contract to an Asian American–owned business despite the fact that the plaintiff was the lowest bidder. Since the case began in 1998, Congress has reenacted Section 1207 a number of times, the district court has rendered judgment three times, and the appellate court has remanded the case twice. *Rothe VII* ends this litigation, as DOD did not appeal the judgment. The statute would have expired on its terms at the end of federal fiscal year 2009.

First enacted in 1986, Section 1207 set a goal of expanding five percent of DOD procurement, research and design, construction, and maintenance contracts with small business concerns owned and controlled by "socially and economically disadvantaged individuals," as defined by the Small Business Act.[3] Section 8(d) of the Small Business Act and relevant regulations, in turn, provided at that time that Black Americans, Hispanic Americans, Native Americans, Asian Pacific Americans, and other minorities were presumed to be "socially and economically disadvantaged individuals."[4]

Subsection (e) of Section 1207, titled "Competitive Procedures and Advanced Payments," provided:

> To the extent practicable and when necessary to facilitate achievement of the [five percent] goal…the secretary of defense may enter into contracts using less than full and open competitive procedures (including awards under section 8(a) of the Small Business Act), but shall pay a price not exceeding fair market cost by more than 10 percent.[5]

DOD implemented this directive by applying a price evaluation adjustment (PEA) to bids submitted by SDBs. In 1998, Congress amended the statute to require DOD to suspend the PEA mechanism for an entire year after any fiscal year in which the five percent goal had been met. DOD has met the goal every year since 1998, so the PEA was suspended through March 2009.[6] Congress reenacted the statute in 1989, 1999, 2002, and 2006, and it is the 2006 legislation that the court reviewed.

The 2006 statute differed significantly from the original enactments that gave rise to the case:

- The price adjustment need not be 10 percent and must be lower if non-SDBs are denied a reasonable chance to compete;
- The agency head is to ensure that no particular industry bears a disproportionate share of the contracts awarded to attain the five percent goal;
- A minority owner must now establish that his or her personal net worth is less than $750,000;
- Non-minorities may establish their eligibility under the lower standard of "preponderance of the evidence," rather than "clear and convincing evidence"; and
- A disappointed bidder may protest the SDB status of the successful bidder.

Opinion

The court reviewed the district court's holding[7] *de novo*, and applied the strict scrutiny standard because the statute incorporates explicit racial classifications. DOD bore the burden of production of evidence of its "compelling interest" in remedying discrimination and that the remedies adopted are "narrowly tailored" to that evidence.

The opinion discusses in detail the evidence that Congress considered in the 2006 reenactment. This consisted of:

- Six disparity studies of state or local contracting in the cities of Dallas,[8] Cincinnati,[9] and New York[10]; in Cuyahoga County, Ohio,[11] and Alameda County, California[12]; and in the Commonwealth of Virginia;[13]
- A September 2005 document issued by the United States Commission on Civil Rights (USCCR) titled "Federal Procurement After *Adarand*;"
- Letters from individual business owners describing incidents of perceived discrimination in state, local, and private contracting;
- Various anecdotes regarding discrimination recounted by members of Congress in floor statements or remarks;
- Testimony by small business owners before the House Small Business Committee in 2001 and 2004; and
- Three studies from the Small Business Administration regarding the ownership and success rates of small businesses.

The primary focus of the evidence was the strength of the six disparity studies. The court reaffirmed that such studies were relevant to the compelling interest analysis. It then turned to Rothe's first argument and rejected the position that data more than five years old must be discarded.

The court, however,

> ...decline[d] to adopt such a *per se* rule here. Indeed, as the district court noted, other circuit courts have relied on studies containing data more than five years old when conducting compelling interest analyses.... While we certainly agree with the [USCCR] that researchers should use current data when possible, we agree with the district court that Congress "should be able to rely on the most recently available data so long as that data is reasonably up-to-date" [citations omitted]. Because these disparity studies [relied upon by DOD] analyzed data pertaining to contracts awarded as recently as 2000 or even 2003, and because Rothe does not point to more recent, available data, we affirm the district court's conclusion that the data analyzed in these six disparity studies was [*sic*] not stale at the relevant time.[14]

While the studies were sufficiently current, the court held that they were not sufficiently before Congress to be relied upon to meet strict scrutiny. "The six studies were not discussed at any congressional hearings. And because Congress made no findings concerning these studies, we cannot even broach the question of whether to defer to Congress in any respect regarding them."[15]

Despite finding that Congress did not rely upon the studies, the court chose to review them anyway, and held that "we need not decide whether these six studies were put before Congress, because we will hold in any event that the studies do not provide a substantially probative and broad-based statistical foundation necessary for the 'strong basis in evidence' that must be the predicate for nationwide, race-conscious action."[16]

The district court held that Rothe's failure to offer any expert reports to rebut the studies did not meet its burden of persuasion to demonstrate that Congress lacked compelling evidence because the studies were irrelevant or flawed.[17] The appellate court disagreed, saying the studies should have been examined *de novo* despite the lack of a trial record because the type of general objections raised by Rothe was of the "same general character" as that voiced by Justice O'Connor in *Croson*. Without addressing later cases that have given substance to *Croson's* broad comments in the context of actual studies by establishing that generalized objections are not sufficient, and despite the lack of expert reports or the testimony of the studies' authors to guide its consideration of complex statistical issues, the Federal Circuit stated that "the potential pitfalls of race-conscious legislation are far too great for a court to dismiss such objections as incompetently offered, rather than to address them on their merits."[18] Rather than remand the case, the appeals court chose to consider the merits of the studies for the first time.

In the absence of expert testimony about accepted econometric models of discrimination, the court was troubled by the failure of five of the studies to account for size differences and "qualifications" of the minority firms in the denominator of the disparity analysis,[19] or as the court terms it, "relative capacity."[20] The court was concerned about the studies' inclusion of possibly "unqualified" minority firms and the failure to account for whether a firm can perform more than one project at a time in two of the studies.[21] In the court's view, the combination of these perceived deficits rendered the studies insufficiently probative to meet Congress' burden.

The appellate court ignored the cases upholding the U.S. Department of Transportation Disadvantaged Business Enterprise (USDOT DBE) Program and the City of Denver's local affirmative action contracting program where the fallacy of "capacity" was debunked, all of which were cited extensively by the district court.[22] It relied instead on a report from the USCCR, which adopted the views of anti-affirmative action writers, including those of the plaintiff's consultant.[23]

However, the court was careful to limit the reach of its review to the facts of the case:

> To be clear, we do *not* hold that the defects in the availability and capacity analyses in these six disparity studies render the studies wholly unreliable for any purpose. Where the calculated disparity ratios are low enough, we do not foreclose the possibility that an inference of discrimination might still be permissible for *some* of the minority groups in *some* of the studied industries in *some* of the jurisdictions. And we recognize that a minority owned firm's capacity and qualifications may themselves be affected

> by discrimination. But we hold that the defects we have noted detract dramatically from the probative value of these six studies, and, in conjunction with their limited geographic coverage, render the studies insufficient to form the statistical core of the "strong basis in evidence" required to uphold the statute.[24]

Finally, the additional statistical evidence relied upon by the district court was held to be insufficiently current, or was not "before" Congress, or failed to account for "capacity":

> We conclude that the remaining statistics cited by members of Congress in the floor speeches quoted by the district court cannot serve as the foundation of a "strong basis in evidence," because they are not sufficiently probative of nationwide discrimination against the range of minority groups afforded a presumption under Section 1207. Nor are the statistics quoted by the district court from the three SBA reports sufficient, because they do not account for firm size or qualifications.[25]

The Federal Circuit concluded its analysis of compelling interest by "stress[ing] that our holding is grounded in the particular terms of evidence offered by DOD and relied on by the district court in this case, and should not be construed as stating blanket rules, for example, about the reliability of disparity studies."[26]

Given the holding that Congress lacked a strong basis in evidence for Section 1207, the court did not rule on whether its provisions were narrowly tailored. The lack of "strongly probative statistical evidence makes it impossible" to determine whether the five percent goal reflects "the share of contracts minorities would receive in the absence of discrimination."[27] It did note, however, its prior rulings that the program was flexible, limited in duration, and not unduly burdensome to third parties, and that the program has tended to narrow the reach of its remedies over time.

Analysis

The question of broad application in *Rothe VII* is whether disparity studies must somehow control for "capacity." Some anti-affirmative action advocates have tried to argue that this decision about the DOD program renders all state and local programs based upon disparity studies *per se* "constitutionally [un]sound."[28] Of course, the court states clearly that it is not "stating blanket rules... about the reliability of disparity studies," but that has not stopped the attempts to intimidate agencies into abandoning affirmative actions programs. Such efforts should be ignored as contrary to existing law and scientifically unsound.

First, we note that the absence of expert testimony may have influenced the court's analysis. Where reports have been proffered by highly qualified experts, judges have understood that variables such as firms' size and experience are adversely affected by discrimination.[29] In fact, the Federal Circuit alludes to this fact, noting "that a minority owned firm's capacity and qualifications may themselves be affected by discrimination," without seeming to understand the implications for econometric modeling of discrimination.[30] Had DOD presented expert testimony, Section 1207 might have been upheld as has the USDOT DBE program.

Claims that the availability measure in the disparity statistic does not factor in "capacity" or, stated another way, that availability statistics may include firms

that are not "qualified, willing, and able" to perform the work are unwarranted and unscientific. Statistical evidence in disparity studies should not be adjusted for so-called "capacity" measures because doing so would prevent accurate measurement of the existence of the "market failure" of discrimination.[31] Many, if not all, "capacity" indicators are themselves impacted by discrimination. Therefore, it is not good social science to limit availability measures by factors such as firm age, revenues, or numbers of employees.

The reality is that large, adverse statistical disparities between minority owned or women-owned businesses and non-minority male-owned businesses have been documented in numerous research studies and reports since *Croson*.[32] Business outcomes, however, can be influenced by multiple factors, and it is important that disparity studies examine the likelihood of whether discrimination is an important contributing factor to observed disparities.

Second, terms such as "capacity," "qualifications," and "ability" are not well defined in any statistical sense. Does "capacity" mean revenue level, employment size, bonding limits, or number of contracts bid or awarded? Does "qualified" or "able" mean possession of a business license, certain amounts of training, types of work experience, or the number of contracts a firm can perform at a given moment? What mix of business attributes properly reflects "capacity"? Does the meaning of such terms differ from industry to industry, locality to locality, or through time? Where might such data be reliably gathered?

Even if capacity is well-defined and adequate data gathered, when measuring the existence of discrimination, the statistical method used should not improperly limit the availability measure by incorporating factors that are themselves impacted by discrimination, such as firm age, revenues, bonding limits, or numbers of employees.

Consider an extreme example where discrimination has prevented the emergence of any minority owned firms. Suppose that racial discrimination was ingrained in a state's highway construction market. As a result, few minority construction employees are given the opportunity to gain managerial experience in the business; minorities who do end up starting construction firms are denied the opportunity to work as subcontractors for non-minority prime contractors; and non-minority prime contractors place pressure on unions not to work with minority firms and on bonding companies and banks to prevent minority owned construction firms from securing bonding and capital. In this example, discrimination has prevented the emergence of a minority highway construction industry with "capacity." Those minority firms that exist at all will be smaller and less experienced and have lower revenues, bonding limits, and employees because of discrimination than firms that have benefited from the exclusionary system.

Using revenue as the measure of qualifications illustrates the point. If minority owned and women-owned businesses are subject to marketplace discrimination, their revenues would be smaller than non-minority, male-owned businesses because they would be less successful at obtaining work. Using revenues as a measure of DBE availability in contracting is like using pay as a measure of qualifications in an equal-pay case. Revenue, like pay, measures the extent to which a firm has succeeded in the marketplace, perhaps in spite of discrimination—it does not measure the ability to succeed in the absence of discrimination and should not be used to evaluate the effects of discrimination.

Therefore, focusing on the "capacity" of businesses in terms of employment, revenue, bonding limits, number of trucks, and so forth is simply wrong as a matter of economics because it can obscure the existence of discrimination. A truly "effective" discriminatory system would lead to a finding of "no capacity," and under the "capacity" approach, a finding of "no discrimination." Excluding firms from an availability measure based on their "capacity" in a discriminatory market merely affirms the results of discrimination; it does not remedy them. A capacity requirement would preclude a government agency from doing anything to rectify its passive participation through public dollars in a clearly discriminatory system. The capacity argument fails to acknowledge that discrimination has prevented the emergence of "qualified, willing, and able" minority firms. Without such firms, there can be no statistical disparity.

Further, in dynamic business environments, and especially in the construction sector, such "qualifications" or "capacity" can be obtained relatively easily. It is well known that small construction companies can expand rapidly as needs arise by hiring workers and renting equipment, and many general contractors subcontract the majority of a project. Firms grow quickly when demand increases and shrink quickly when demand decreases. Subcontracting is one important source of this elasticity, as has been noted by several academic studies. Bourdon and Levitt, for example, in their study of construction labor markets, observed that:

> Construction projects are undertaken by a multitude of firms assembled for brief periods of time on a site then disbanded. General contractors can undertake projects of considerable scale without large amounts of direct labor or fixed capital; subcontractors can start with one or two employees and bid only on particularly highly specialized contracts.[33]

Other industry sectors, especially in this era of Internet commerce and independent contractors, can also quickly grow or shrink in response to demand.

Finally, even where "capacity"-type factors have been controlled for in statistical analyses, results consistent with business discrimination are still typically observed. For example, large and statistically significant differences in commercial loan denial rates between minority and non-minority firms are evident throughout the country, even when detailed balance sheet and creditworthiness measures are held constant.[34] Similarly, economists using decennial census data have demonstrated that statistically significant disparities in business formation and business owner earnings between

minorities and non-minorities remain even after controlling for a host of additional relevant factors, including educational achievement, labor market experience, marital status, disability status, veteran status, interest and dividend income, labor market attachment, industry, geographic location, and local labor market variables such as the unemployment rate, population growth rate, government employment rate, or per capita income.[35]

To summarize, the statistical analysis of the availability of minority firms compared to non-minority firms to examine the existence and effects of discrimination in disparity studies should not adjust for "capacity" because:

- "Capacity" has been ill-defined;
- Small firms, particularly in the construction industry, are highly elastic with regard to ability to perform;
- Many disparity studies have shown that even when "capacity" and "qualifications"-type factors are held constant in statistical analyses, evidence of disparate impact against DBE and MWBE firms tends to persist; and
- Most important, identifiable indicators of "capacity" are themselves impacted by discrimination.

In any event, *Rothe VII* does not suggest, let alone require, that state and local governments unilaterally dismantle their M/W/DBE programs. It does counsel that agencies seeking to meet strict constitutional scrutiny should commission studies based on sound science and conducted by qualified experts, and then make their case to the court if challenged. **CM**

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The opinions expressed in this article do not necessarily represent the views of NERA Economic Consulting or any other NERA consultant.

ENDOTES

1. 545 F.3d 1023 (*Fed. Cir*. 2008) ("*Rothe VII*").
2. 10 U.S.C. § 2323.
3. 15 U.S.C. 673.
4. 15 U.S.C. ß 637(d)(3)(C)(ii) (1990).
5. *Public Law* 99-661, ß 1207(e)(3).
6. Other measures have continued to be applied by DOD, such as 8(a) set-aside contracts, SDB subcontracting plans, etc.
7. The court discusses an interesting jurisdictional question that is not relevant to the strict scrutiny analysis, i.e., whether the Federal Circuit, whose jurisdiction rests upon an appeal of a judgment based in whole or in part on the Tucker Act (28 U.S.C. ß 1295[a][2]) has jurisdiction over the appeal where the Tucker Act claim had been satisfied. Moreover, the very limited jurisdiction of the Federal Circuit to federal contract claims casts into question the precedential value of its reasoning on a constitutional matter far afield from its statutorily defined docket.
8. "City of Dallas Availability and Disparity Study," Mason Tillman Associates, Ltd. (2002).
9. "City of Cincinnati Disparity Study," Griffin & Strong, PC (2002).

10. "City of New York Disparity Study," Mason Tillman Associates, Ltd. (2005).
11. "Ohio Multi-Jurisdictional Disparity Studies," Mason Tillman Associates, Ltd. (2003).
12. "Alameda County Availability Study," Mason Tillman Associates, Ltd. (2004).
13. "Procurement Disparity Study of the Commonwealth of Virginia," MGT of America, Inc. (2004).
14. 545 F.3d at 1038–1039.
15. *Ibid*.
16. *Ibid*. at 1040.
17. *Rothe Development Corp. v. U.S. Department of Defense et al*, 499 F.Supp.2d 775, 847 (W.D. Tex. 2007) ("*Rothe VI*"): "Rothe did not submit an expert report attacking the data, methodology, or conclusions of the New York Study.... The Court rejects Rothe's objections to the data or reliability of the six disparity studies, including the New York Study, because those objections are not supported by an expert report or other competent summary judgment evidence.... General criticism of disparity studies, as opposed to particular evidence undermining the reliability of the particular study, is of little persuasive value."
18. 545 F.3d at 1040.
19. There is no explanation why similar concerns should not be raised about non-minority owned firms included in the denominator.
20. 545 F.3d at 1042.
21. *Ibid*.
22. *Northern Contracting, Inc. v. Illinois Department of Transportation*, 2005 U.S. Dist. LEXIS 19868 (September 8, 2005) ("*Northern Contracting II*"), aff'd.; *Northern Contracting, Inc. v. Illinois Department of Transportation*, 473 F.3d 715 (7th Cir. 2007) ("*Northern Contracting III*"); *Sherbrooke Turf, Inc. v. Minnesota Department of Transportation*, 345 F.3d 964 (8th Cir. 2003), *cert. denied*, 541 U.S. 1041 (2004); *Concrete Works of Colorado, Inc. v. City and County of Denver*, 321 F.3d 950 (10th Cir. 2003), *cert. denied*, 540 U.S. 1027 (2003).
23. USCCR, *Disparity Studies as Evidence of Discrimination in Federal Contracting* (May 2006): 79.
24. 545 F.3d at 1045 (quoting from Justice Scalia's dissent in *Concrete Works V*, 540 U.S. 1027, 1032 [2003]).
25. *Ibid*. at 1047–1048.
26. *Ibid*. at 1049.
27. *Ibid*. at 1049–1050.
28. *See*, *e.g.*, form letter to the City of Austin from the Pacific Legal Foundation, April 13, 2009.
29. See note 22.
30. 545 F.3d at 1045.
31. *Builders Association of Greater Chicago v. City of Chicago*, 298 F.Supp.2d 725, 737 (N.D. Ill, 2003).
32. Enchautegui, *et al*, 1996.
33. Clinton C. Bourdon and Raymond E. Levitt, *Union and Open-Shop Construction, Compensation, Work Practices, and Labor Markets* (Lexington, MA: Lexington Books, 1980); *see also* Robert G. Eccles, "Bureaucratic versus Craft Administration: The Relationship of Market Structure to the Construction Firm," *Administrative Science Quarterly*, v.26, 1981; *and* Frederick Elliot Gould, "Investigation in Construction Entrepreneurship," Masters Thesis, MIT, May 1980.
34. *See* "Discrimination Facing Small Minority Owned and Women-Owned Businesses in Commercial Credit Markets," Testimony of Jon S. Wainwright before the Committee on Small Business and Entrepreneurship, U.S. Senate, September 11, 2008.
35. Jon S. Wainwright, "Racial Discrimination and Minority Business Enterprise, Evidence from the 1990 Census," *Studies in Entrepreneurship Series*, Edited by S. Bruchey (New York, NY: Garland Publishing, 2000.)