Minority Rules

Lending to Minority- and Woman-Owned Businesses

by Michael J. Lubben

The majority usually rules. However, when lending to minority- and woman-owned businesses it is important for the lender to know the minority rules. Minority- and woman-owned business enterprises (MWBEs) are a rapidly growing presence in our economy, with minorities owning approximately 18 percent of our nation's businesses in 2002.[1] New minority-owned firms have been growing at more than four times the rate of all firms in the U.S., and at nearly twice the rate of all firms in annual sales, according to U.S. census data. Nationwide, minorities account for approximately 33 percent of the population, and women make up more than 50 percent of the population.[2]

Couple these facts with massive governmental spending on infrastructure and other projects through the American Recovery and Reinvestment Act of 2009, and government policies to increase minority participation in government contracts, and what do you get? Opportunities, and not just for MWBEs, but for banks and other lenders doing business with these firms.

So why exactly is any of this relevant or helpful to a lender? First, knowing your borrower (or potential borrower), the industry in which it operates, and the macro-socio and economic factors that influence its success (or lack thereof), is a necessity in today's lending environment. Second, a good lender, like a good lawyer or accountant, will want to add value to its relationship with its borrowers. The more successful and efficient your borrower, the better for the lender (and its loan portfolio) as well. Third, and perhaps most critical when lending to a MWBE, is the need to understand why the MWBE designation is important to your borrower, and what would happen if that designation were eliminated.

A prudent lender would not lend to a highly regulated entity without understanding the regulatory framework within which the company must operate. Similarly, if a company is minority- or woman-owned, and is using that status to gain a competitive advantage over non-MWBEs, it is critical for the lender to understand the foundation for MWBE certifications, its basis, and the implications to the business of a failure to maintain its MWBE status.

This article is intended to give lenders an overview of some of the programs in place to benefit a business organized as a MWBE, and the specific due diligence items that are important for a lender lending to a MWBE.

New Jersey State and Federal Initiatives

There are few governmental lending programs that are specific to MWBEs. Although many MWBEs (and lenders) participate in loan programs issued under the U.S. Small Business Administration and the New Jersey Economic Development Authority, these and similar programs generally are open to all businesses that meet certain criteria (such as revenue size, for example), irrespective of whether the business is a MWBE.

Instead of providing lending benefits, most of the government programs designed for MWBEs relate to set-aside and procurement programs. Set-aside programs require state and government agencies to award minimum amounts of their overall purchasing and contracting needs to MWBEs.

Governmental programs to incentivize the use of MWBE contractors and subcontractors exist at the state and federal level. In New Jersey, for example, Governor Jon Corzine signed Executive Order 151 (EO 151) in 2009. EO 151 reaffirmed the state's commitment to increase the participation of minority- and woman-owned businesses in the state's purchasing and procurement process as set forth in Executive Order 34 (signed in 2006). More importantly, EO 151 requires all construction contracts entered into and funded by the state, in whole or in part, to include mandatory language requiring contractors to make a "good faith effort" to recruit and employ minorities and women. EO 151 also directed the Division of Minority and Women Business Development (established by EO 34) to work with various state departments and agencies to ensure alloca-

tion of a specific percentage of each department's contracts to minority- and woman-owned businesses.

With billions of government stimulus dollars being deployed throughout the country and in New Jersey, and governmental programs and incentives in place specifically geared toward steering these dollars to MWBEs, businesses that are able to take advantage of these opportunities could be strong borrower candidates for lenders.

Due Diligence

Once a lender decides to dive into the MWBE pool and lend to one of these entities, it needs to understand the due diligence issues peculiar to MWBEs. Generally speaking, the due diligence a lender will perform on a MWBE borrower will be the same as the lender would conduct on a non-MWBE borrower. The key question to be asked at the outset of the underwriting process is whether the borrower relies on, or uses in any way, its status as a MWBE in order to conduct its business. Stated differently, what would happen to this company's business if it ceased to be a MWBE? Does it lose key contracts? If its status as a MWBE is critical to its operations, the lender will need to understand why that is, and what is necessary for it to maintain its status as a MWBE.

Identifying Applicable Certifications

If a company holds itself out as a MWBE, chances are good it is using that status to enhance its business opportunities, for example to bid on and obtain government contracts or contracts from large companies looking to satisfy requirements of a supplier diversity program. If the company is, in fact, receiving favorable treatment as a MWBE (*e.g.*, being awarded a contract), it likely is (or should be) certified as a minority- or woman-owned business under either a federal, state or private certification program.

Certification programs can confirm to third parties that the MWBE is certified to have satisfied specified criteria regarding its ownership and operations, which may be important to the third party. Failure to maintain an applicable certification could be disastrous for the MWBE (and the lender) if the certification is required as a condition of a third-party contract.

Each certification program (and certifying entity) is in place for specific purposes. For example, to take advantage of certain federal government procurement programs, the MWBE would need a federal certification. Federal certifications are required for procurement of a federal contract. In addition, some states, and also some corporate programs, accept the federal certifications.

This article is not intended to describe all of the certification programs that may be available. Following, however, is a description of some of the more popular certification programs in existence. The key for the lender is identifying when a certification is necessary or being utilized by its borrower, and then understanding and confirming that the borrower is meeting the applicable criteria for continued eligibility under any applicable certification program.

Federal Certification

The U.S. Small Business Administration (SBA) is a primary certifying agent for companies seeking eligibility for certain federal contracts. Under the SBA 8(a) BD Program,[3] the SBA certifies businesses that meet certain size and ownership criteria, enabling them to be eligible to do business with the federal government with respect to particular contracts. The SBA 8(a) BD Program is a business development program created to help small disadvantaged businesses compete in the American economy and access the federal procurement market.

Small is a relative term; depending on the industry, the annual sales of a certified entity could be as much as $21.5 million, with employees of up to 1,500, before exceeding the size limitations. A "disadvantaged" business is a business with at least 51 percent ownership by individuals who are socially or economically disadvantaged. Individuals who are members of the following groups are presumed to be socially disadvantaged: African and Hispanic Americans, Native Americans (American Indians, Eskimos, Aleuts, and Native Hawaiians), Asian Pacific Americans and Subcontinent Asian Americans. Women, veterans and individuals with disabilities are also eligible owners, provided they meet certain additional criteria.

State Certification

The state of New Jersey and its municipalities will require the state-issued minority and women business enterprise certification in order for a MWBE to take advantage of certain contracting opportunities in New Jersey.[4] To be eligible for certification under this program, a business must be managed by, and the daily business operations must be controlled by, one or more minorities or women owner(s). Additionally, the business must be at least 51 percent owned by one or more minorities or women. In order to satisfy the requirement for operational control, the women or minority owners shall demonstrate technical competence in the affairs of the business.

Private Certification Programs

Many private corporations have supplier diversity and similar programs in place that are intended to grow the corporation's use of MWBEs as suppliers and contractors, and to help the corporation in connection with its own governmental contracting needs and requirements. These corporations may accept federal or state certifications, like an SBA 8(a) or New Jersey MWBE certification mentioned above. In addition, they may require or accept a certifica-

tion from a private certification agency.

Both the National Minority Supplier Development Council[5] (NMSDC) and the Women's Business Enterprise National Council[6] (WBENC) are two popular private certification programs. In addition to eligibility criteria similar to state and federal programs, private organizations such as these often have a much more rigorous and intensive application and continued eligibility process, which includes site visits. These organizations will typically confirm (and require for certification), in addition to being minority- or woman-owned, that the owners of a MWBE are actively managing and overseeing the day-to-day operations of the business. Lenders should be aware of this key component. Less scrupulous borrowers may establish MWBEs with figurehead management and ownership, purely to take advantage of government contract opportunities.

Certification programs that require the woman or minority owner to demonstrate technical competence in the affairs of the business are in place to ferret-out figurehead businesses set up simply to take advantage of the procurement process. A lender will want to do its own due diligence to assure itself that the required individuals are, in fact, knowledgeable of the business and managing the day-to-day operations. Such due diligence may include interviews with management and employees, and possibly with customers and suppliers of the MWBE.

Key Contracts

Once you have identified that the borrower is a MWBE and is approved by one or more of the certifying bodies, the lender should identify the key contracts of the borrower and whether there are any other eligibility requirements. Again, this is similar to typical underwriting the lender would do for all borrowers. Particularly when making a cash-flow loan, the lender will want to know where the company's revenue comes from and the risk factors that could affect that revenue.

With a MWBE, the eligibility issues create an extra layer of due diligence. In addition to any eligibility concerns, the lender may want to find out whether the revenues generated by the contract are subject to annual appropriations. For example, is the government agency that is the borrower's customer reliant on an annual inclusion in a state or federal budget?

Governance Documents

Most certification and government programs require that the MWBE maintains a certain percent (usually at least 51 percent) of minority or woman ownership, and that these owners actually control the company. Another significant aspect of a lender's due diligence when lending to a MWBE relates to this ownership and control criteria. The organization documents of the MWBE (articles of incorporation, bylaws, operating agreement, etc.) must be reviewed to confirm who owns and controls the entity. The lender needs to ask whether there are shareholder agreements, voting trusts, option agreements or similar documents that effectively take away control, or that could take away control or ownership in the future (for example, by the exercise of a warrant).

Along these lines, it is more important than in a typical situation to learn about the succession plans for ownership and management of the business. What happens if the minority or woman owner were to exit the company (through death or otherwise)? While there may be strong middle management that can carry the company operationally, how will the company satisfy its eligibility requirements?

It is simply not enough to check the box on the eligibility requirements. To be adequately protected the lender should be looking down the road and making sure the MWBE has done what it can to protect its status as a MWBE. A problem for the MWBE will often spell a problem for the lender.

Supplier Diversity Initiatives

One way for the lender to add value to its MWBE customers is to educate them on supplier diversity initiatives. In addition to government contracts, an MWBE may also take advantage of its MWBE status by being a subcontractor to a private corporation. Since the late 1970s, Public Law 95-507 (a part of the Small Business Act) has required corporations doing business with the federal government develop programs to increase spending with MWBEs and small business enterprises. Boards of public utilities (BPUs) require the same of utility companies.

To comply with these requirements, large corporations like Wal-Mart, IBM and Dell have established supplier diversity programs. These programs are also used by the large corporations to track the dollar values of contracts given by them to qualifying entities. Dollars are tracked by tier, with dollars paid by a Fortune 500 company to a MWBE prime supplier considered as first-tier dollars. Second-tier dollars are those paid by a majority prime supplier of a Fortune 500 to a MWBE provider.

With the massive increases in government spending, we are seeing more and more businesses implement supplier diversity programs in order to compete for lucrative government contracts. While borrowers who are MWBEs can bid directly for government contracts, they can also benefit by acting as suppliers to other prime government contractors. They can also form joint ventures with larger entities to win contract work.

Banks and other non-MWBE businesses can also benefit by establishing

their own programs. For example, a bank that utilizes a MWBE as a supplier or vendor puts itself in a better position to win banking business from a larger business that has an interest in seeing dollars flow to MWBEs.

Conclusion

Although the majority rules, lenders must follow the minority rules when conducting due diligence on MWBE borrowers. Knowing the basis for a borrower's organization as a MWBE, its revenue sources that are derived or dependent on this status, and the eligibility criteria it must maintain in order to retain its MWBE status, is critical to the prudent underwriting of a loan to a MWBE borrower. ⚖

Endnotes

1. SBA Office of Advocacy, *Small Business Research Summary*, April 2007, No. 298.
2. U.S. Census Bureau.
3. 13 C.F.R. §§ 121, 124.
4. A helpful web-link for anyone seeking more information on the New Jersey certification program is www.state.nj.us/njbusiness/contracting/minority/certification.shtml.
5. www.nmsdc.org/nmsdc/.
6. www.wbenc.org/.

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This article was originally published in the October 2010 issue of New Jersey Lawyer Magazine, a publication of the New Jersey State Bar Association, and is reprinted here with permission.