

**ELEVENTH ANNUAL
SOUTHERN SURETY AND FIDELITY CLAIMS
CONFERENCE**

**THE CURRENT STATUS OF MINORITY AND
DISADVANTAGED ENTERPRISE SET-ASIDES;
HOW THEY MAY AFFECT THE SURETY.**

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I. Background

Most states have statutes allowing political subdivisions to promulgate regulations to encourage set asides on public contracts for business enterprises owned by minorities. See, e.g. La. Rev. Stat. 38:2233.2. Many such state statutes and local ordinances are fashioned after the Small Business Act's section 8(a) set-aside program, 15 U.S.C. 637 et seq. The SBA section 8(a) program was designed to encourage minority participation in government projects. Under 15 U.S.C. 637(a)(1)(A) the Small Business Administration is empowered to act as an intermediary between a federal agency and eligible contractors.

The Small Business Act does not classify businesses along racial lines. Instead, the Act identifies businesses that are "socially and economically disadvantaged." A socially and economically disadvantaged small business concern is defined as a small business which is at least 51 per cent owned by:

1. One or more socially and economically disadvantaged individuals,
2. An economically disadvantaged Indian tribe,(or a wholly owned business entity of such a tribe), or
3. An economically disadvantaged Native Hawaiian organization.

15 U.S.C. 637 (a)(4)(A). Socially disadvantaged individuals are defined as individuals "who have been subjected to racial or ethnic prejudice or cultural bias because of their identity as a member of a group without regard to their individual qualities." 15 U.S.C. 637(a)(5). Economically disadvantaged individuals are defined as "those socially disadvantaged individuals whose ability to compete in the free enterprise system has been impaired due to diminished capital and credit opportunities as compared to others in the same business area who are not socially disadvantaged...." 15 U.S.C. 637(a)(6)(A).

II. Landmark cases on minority set-asides

In 1980, the U.S. Supreme Court decided Fullilove v. Klutznick, 448 U.S. 448, 100 S.Ct. 2758 (1980). Fullilove held that with respect to federal funds for local public works projects, the federal statute's general requirement of a 10 percent set-aside for minority businesses did not, on its face, violate the equal protection component of the due process clause of the Fifth Amendment.

Nine years later, the U.S. Supreme Court decided City of Richmond v. J.A. Croson, Co., 488 U.S. 469; 109 S.Ct. 706 (1989). In April of 1983, the City of Richmond adopted a Minority Business Utilization Plan (the "Richmond Plan") which required prime contractors who were awarded city construction contracts to subcontract at least 30% of the dollar amount of each contract to one or more "Minority Business Enterprise(s)" ("MBE"). The Richmond Plan defined MBE's to include a business from anywhere in the country, at least 51% owned and controlled by black, Spanish-speaking, Oriental, Indian, Eskimo, or Aleut citizens. Although the Richmond Plan was declared to be "remedial," no evidence was presented by the city to show that the city had discriminated in the letting of prime construction contracts, or that prime

contractors had discriminated against minority sub-contractors. The U.S. Supreme Court struck down the Richmond Plan on the basis that such racial preferences could only be sustained if the preferences were narrowly tailored to remedy specifically identified past discrimination. In Croson, past discrimination was not established. The only evidence presented by the city in support of its contention that the plan was remedial was a study indicating that, although the city was 50% black, only 0.67% of its prime construction contracts had been awarded to minority business in recent years. The Croson court found that the 30% quota was not “narrowly tailored” to compensate black contractors for past discrimination. As such, the Richmond Plan was struck down.

The Court pointed out, however, that even absent evidence of past discrimination, the city had at its disposal an array of race-neutral devices to increase the accessibility of city contracting opportunities to small businesses, such as simplification of the bidding process, relaxation of bonding requirements, training and financial aid. Croson at 509.

The year after Croson was decided, the U.S. Supreme Court adopted intermediate scrutiny as the standard of review for congressionally mandated “benign” racial classifications, and held that some minority preference policies (with respect to federal broadcast licenses) did not violate the Fifth Amendment’s equal protection component. Metro Broadcasting v. FCC, 497 U.S. 547, 110 S.Ct. 2997 (1990).

Adarand Constructors, Inc. v. Pena, Secretary of Transportation, 515 U.S. 200; 115 S.Ct. 2097 (1995) focused on a federal agency practice of giving general contractors (on federal jobs) a financial incentive to hire subcontractors controlled by “socially and economically disadvantaged individuals.” Adarand claimed that the federal government’s practice of giving general contractors on government projects a financial incentive to hire subcontractors controlled by “socially and economically disadvantaged individuals” violated the equal protection component of the Fifth Amendment’s due process clause.

In Adarand, the U.S. highway division awarded the prime contract for a highway construction project in Colorado to Mountain Gravel and Construction Co. (“Mountain Gravel”). Mountain Gravel solicited bids from subcontractors for the guardrail work. Adarand was a Colorado based highway construction company that specialized in guardrail work. Adarand submitted the lowest bid, but was not awarded the job. The job went to Gonzalez Construction Company, which was certified as a small business controlled by “socially and economically disadvantaged individuals.” The prime contract provided that Mountain Gravel would receive additional compensation if it hired subcontractors certified as disadvantaged.

The Court of Appeal applied an intermediate scrutiny standard, and found that the contractor compensation clause at issue was constitutional. However, on certiorari, the U.S. Supreme Court vacated and remanded for further proceedings, holding that the lower court should have used the strict scrutiny standard. In Adarand, the U.S. Supreme court announced that all federal, state and local MBE programs should be subjected to strict scrutiny. The strict scrutiny standard provides that racial classifications are only constitutional if they are narrowly tailored measures that further compelling governmental interests.

III. Current Proceedings

In W.H. Scott Construction Company, Inc. v. City of Jackson, Mississippi, 199 F.3d 206 (5th Cir. 2000), at issue was the City of Jackson's Minority Business Enterprise program which was allegedly designed to remedy the effects of past discrimination. The program was managed by the city's Office of Business Development, which established a minority participation goal of 15% in all areas of procurement. In the summer of 1997, the city advertised for the construction of the Thalia Mara Hall toilet expansion project through its Department of Public Works. W.H. Scott Construction Company, Inc. ("Scott") was the low bidder on the job. The day after bids were opened, Scott informed the Department of Public works that its disadvantaged business enterprise participation would only be 1%.

Even though Scott was the low bidder on the job, it was not awarded the contract. Scott maintained that the rejection of its bid was racially motivated. The city claimed that it rejected Scott's bid because it exceeded the established budget for the 1996-1997 fiscal year.

The court found that the city policy was unconstitutional because it lacked the requisite findings to justify a 15% minority participation goal. The city argued that the Croson strict scrutiny test was inappropriate, because the program established a preference based on "disadvantage" and not on race. However, the city policy stated that Black Americans, Hispanic Americans, Native Americans, Asian Pacific Americans and other minorities were presumed to be socially and economically disadvantaged. Therefore, the court found that by its own terms, the program created race based presumptions that warranted strict scrutiny.

In Louisiana Associated General Contractors, Inc. v. New Orleans Aviation Board, ___ So.2d ___ (1999); 1999 La. Lexis 1715, the Louisiana Supreme Court permanently enjoined the New Orleans Aviation Board ("NOAB") from implementing La. R.S. 38:2233.2 which provides for set-asides in public works contracts for minority contractors. The Louisiana Supreme Court also permanently enjoined the city from utilizing its own "Disadvantaged Business Enterprise Plan For the New Orleans International Airport" in all non-federal public works projects.

The Court found that the NOAB program violated the New Orleans Interim Disadvantaged Small Business Development Ordinance. The city's interim ordinance, adopted in 1989, **after Croson was decided**, prevents the City of New Orleans from issuing or carrying out any policy dealing with city contracts that provides preferential treatment on the basis of race or gender. Like the Small Business Act, the New Orleans city ordinance focuses on awarding city contracts to firms owned by "socially and economically disadvantaged" persons. In order to qualify as socially or economically disadvantaged under the city ordinance, the person must prove by clear and convincing evidence that he has actually suffered a disadvantage. Conversely, under the NOAB program, certain individuals were presumed to be socially and economically disadvantaged. Those presumed to be socially and economically disadvantaged under the NOAB program were: women, African American, Hispanic Americans, Native Americans, Asian-Pacific Americans, and Asian-Indian Americans.

The court found that the NOAB program's presumption of disadvantage, on its face, violated the clear and convincing standard required by the city ordinance. The Louisiana Supreme Court enjoined the NOAB from using the Louisiana public works set-aside statute, and its own set-aside program in non-federal public works projects.

IV. Outlook

The New Orleans Aviation Board litigation and the City of Jackson litigation are illustrative of country wide attacks on minority set-asides, particularly in state and local government contracting. Recently, Florida affirmative action opponents asked the Florida Supreme Court to approve ballot language on proposed amendments to the state constitution to end racial preferences in education, hiring and contracts. (The proposals are known as the Florida Civil Rights Initiative). In Atlanta last summer, the U.S. District Court for the Northern District of Georgia struck down Fulton County's Minority and Female Enterprise Program which set aside 34% of public contracts for minorities and females. See, Webster v. Fulton County, 51 F.Supp.2d 1354; 1999 WL 409462 (N.D. Ga. 1999).

In light of Croson and Adarand, how will local, federal and state governments continue to encourage minority participation in contracting? In cases where past discrimination is demonstrated, a government entity may still rectify the effects of discrimination by implementing a narrowly tailored scheme of racial preferences. Additionally, a government entity may penalize racially motivated refusals to employ minority contractors. However, as pointed out by the U.S. Supreme Court in Croson, race neutral devices may be implemented to increase the accessibility of government contracting opportunities to small businesses, such as simplification of the bid process, or relaxed bond requirements.

In keeping with the concept of race neutral devices to increase small business participation in contracting is a provision in the Louisiana Small and Emerging Business Act which provides for a Small Business Surety Bonding Fund. La. R.S. 51:1766.¹ The fund is intended to be used to provide financial assistance to small businesses who may otherwise have difficulty obtaining a surety bond. An “Economically Disadvantaged Business” (“EDB”) is a small business organized for profit and performing a commercially useful function which is at least 60% owned and controlled by one or more economically disadvantaged persons. La. Admin. Code, Title 19, § 105.² An “Economically Disadvantaged Person” must be a United States Citizen and a resident of Louisiana for at least one year with a net worth that does not exceed \$150,000.00. La. Admin. Code, Title 19, § 105.

An EDB’s net worth at the time of application may not exceed \$750,00.00. The EDB must have a minimum of two employees, and managing owners who claim economically disadvantaged status must be full time employees of the EDB. La. Admin. Code tit. 19, § 105.

In order to be eligible for an EDB bond, the contractor must be certified by the Louisiana Department of Economic Development, and accredited by the Louisiana Contractors Accreditation Institute. La. Admin. Code tit. 19, § 901.

Once the EDB obtains certification and accreditation, it is eligible to receive bond guarantee assistance to be used as collateral when seeking bonds. Application for surety bond guarantee assistance must be submitted to the manager of the Bonding Assistance Program (“BAP”). Qualified EDB’s may be eligible for surety bond guarantee assistance in the form of a letter of credit to the surety for an amount up to 25% of the base contract amount, or \$200,000.00, whichever is less. La. Admin. Code, Title 19, § 903.

In order for a surety to participate in the Bonding Assistance Program (“BAP”), the surety must have a certificate of authority from and its rates approved by the Louisiana Department of Insurance. La. Admin. Code, Title 19, § 903. If there are multiple sureties on the same project for the same contractor, a primary surety must be designated. La. Admin. Code, Title 19, § 903. In a default situation, the BAP will recommend indemnification to the primary surety only. The primary surety may seek indemnification from co-sureties. La. Admin. Code, Title 19, § 903. The regulations appear to treat the situation as one of reinsurance as opposed to co-suretyship.

A portion of the bond fee, not to exceed two percent, is paid by the surety to the BAP. La. Admin. Code, Title 19, § 905. A surety may require the contractor to engage in risk management and/or engage a management construction company to provide certain services, such as: job cost breakdown and bid preparation assistance; project monitoring; receipt and disbursement of funds; project completion. La. Admin. Code, Title 19, § 907.

The surety bond agreement must contain provisions outlined by the BAP. For example, the surety must affirm that without the BAP guarantee, it would not issue the bond(s) to the

¹ See Exhibit “A.”

² See Exhibit “B.”

principal. In addition, the surety must represent that the terms and conditions of the bond(s) are in accordance with those generally used by the surety for the type of bond involved. La. Admin. Code, Title 19, § 911.

In a default situation, where the liability of the BAP is \$500.00 or less, the surety must notify the contractor in writing of its outstanding debt, but may not further pursue the contractor for indemnification. La. Admin. Code, Title 19, § 911(b)(ii). In case of a default ranging between \$500.00 and \$2,500.00, the surety must develop financial background information on the debtor contractor, after receipt of which the BAP will determine whether to seek indemnity from the contractor. La. Admin. Code, Title 19, § 911(b)(iii).

Where the default exceeds \$2,500.00, the surety must pursue recovery through its normal methods. La. Admin. Code, Title 19, § 911(b)(iv). After all recovery efforts have been exhausted, the surety and BAP make a final reconciliation, with the surety charged with conducting a recapitulation to insure that the BAP is properly credited with all funds recovered. La. Admin. Code, Title 19, § 911(b)(vi). Settlements on defaulted bonds must be approved by the BAP. La. Admin. Code, Title 19, § 911(b)(vii).

Other race neutral incentives for small businesses established by the Louisiana legislature include loan assistance programs, investment programs, and a Mentor-Protégé program aimed at fostering economic self sufficiency for small businesses.

Aside from the formal programs which exist on both a state and federal level, the sheer volume of work being designated by the Corps of Engineers on section 8(a) work has made it worth the while of the major contractors to develop mentoring programs which have lead to meaningful minority participation and, hopefully, will lead to the development of a stable minority contractor base.

V. Conclusion

Minority and women business enterprise set aside programs are coming under attack nation wide. The holding in Croson, reinforced by Adarand will make it difficult for set-asides to survive unless the proponent of the set-aside can show actual past discrimination. As set-aside programs are dismantled, through litigation or legislation, there is sure to be pressure on the construction and surety industries, and the business community as a whole to find other ways to increase minority participation in the process, such as relaxed bonding requirements or the creation of bond funds similar to the one established in Louisiana.

EXHIBIT "A"

EXHIBIT “B”