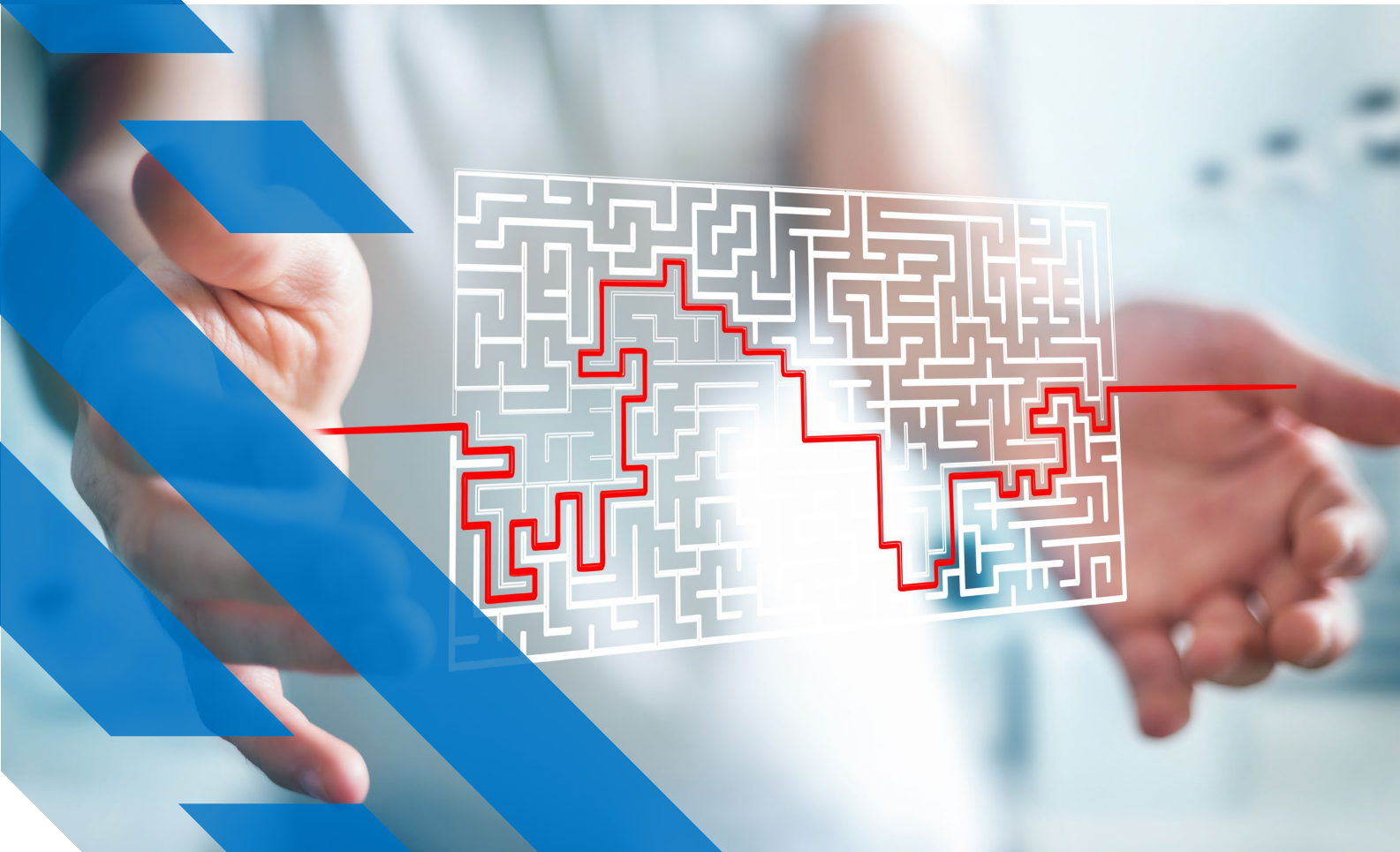


PASS-THROUGH BUSINESSES: WHAT ARE THEY AND ARE THEY LEGITIMATE?

BY Kelly Jeffcote AND Fred McKinney, PH.D.

Beginning in the late 1960s, public and private programs were created to increase utilization of diverse businesses and help level the competitive playing field. Since then, however, there have been “entrepreneurs” that have taken advantage of these programs by creating businesses that appear to be eligible for these benefits but actually are not.



Many established businesses have articulated goals for procurement of goods and services from disadvantaged or diverse businesses. This practice is recognized as a viable means to support and encourage development of minority-owned and women-owned businesses, as well as other businesses like disabled-veteran-owned companies. The practice has benefited these disadvantaged enterprises, while also providing economic benefits more broadly to underserved communities. However, these goals are sometimes circumvented when seemingly eligible companies pass through much of the money they have received under these programs to purchase goods and/or services from firms that would otherwise be ineligible.

Under common practice, companies that intend to circumvent the requirements of these programs put eligible persons nominally in charge of the business, though they are actually fronts that are owned, managed and controlled by noneligible persons.

The problem is being increasingly addressed through third-party certifications that can effectively root out ethnic or racial minority front companies. However, there are still questions about legitimacy and certification of women-owned businesses, where a woman serves as owner and principal officer but the husband is actively involved. In these instances, it is nearly impossible to ascertain if these firms are legitimate or are fronts.

BROKERS VERSUS PASS-THROUGHS

Though certification has addressed part of the problem, there are still issues with respect to minority business enterprise or women-owned business enterprise (MBE/WBE) companies that claim to function as brokers, but actually provide significantly less value than advertised. These companies buy products from noneligible firms then resell to the buying organization. The basic problem is that the broker is not adding any value to the overall transaction. The buying organization is able to claim the entire amount as spending that counts toward supplier diversity goals while its MBE/WBE “supplier” is actually distributing much of the proceeds to noneligible companies.



There is a fine line that separates legitimate brokering businesses from questionable pass-through businesses. Brokers provide legitimate value to customers in markets while pass-through businesses do not. The key distinction between brokers and pass-throughs is control. Brokers provide real value to their clients because they are independent and not captive to any downstream business relationships. They search out competitively priced products and services on behalf of their clients that meet real needs.

Pass-throughs, on the other hand, are captured by a primary supplier, meaning they are restricted to selling goods and services only from that single entity. This distinction is a telltale sign of whether the purchasing company is buying from a legitimate MBE/WBE broker or from a pass-through that lacks control over its product offerings and the companies it represents. In fact, these types of businesses are little more than glorified sales organizations, with some even physically located within their suppliers' facilities. While this may be an efficient way for the MBE/WBE business to organize its activities, the business is uncertifiable in these cases. Even if the pass-through has its own location, but is only selling products from a single company, it still fails to meet the test of offering independent advice and direction, which is the essence of value provided by brokers.

IDENTIFYING PASS-THROUGHS

Pass-through companies posing as MBE/WBEs are more likely to be found in certain industries where low-margin products are common. The technology sector, where there is high industry concentration, is one example.

These industries often have high barriers to entry, and the only way for an MBE or WBE company to participate is through partnerships. Not all diverse businesses in these types of markets are pass-throughs, and there are many examples of MBE/WBE businesses in these spaces that have strong downstream relationships with multiple companies, in addition to strong relationships with customers based on industry and product knowledge.

Buying organizations can test whether they are dealing with an MBE/WBE pass-through by asking for products from multiple competing suppliers they wish to consider. If the potential seller can only offer products from one company, or that company's product is always less expensive than competitor companies, then there is a good chance you are dealing with a pass-through.

WHERE IS THE HARM?

If nobody were harmed by pass-throughs, there would be no reason for concern. Indeed, most diverse businesses are legitimate enterprises, employing minorities and women and generating income for themselves, their families and communities.



The crux of the problem is that there is harm if the pass-through and its majority-owned, noneligible supplier are blocking the growth, development and overall success of MBE/WBE firms that are attempting to compete in the same or similar lines of business. In these situations — even when there are not significant MBE/WBE companies competing in the space — the pass-through and supplier are discouraging legitimate MBE/WBE business development. Buying firms that already have a minority incumbent that is helping them meet diverse spend goals have little incentive to make changes.

WHAT IS THE SOLUTION?

What should buying organizations do when they realize they are dealing with a pass-through?

The best solution is for the buying organization to identify a legitimate MBE/WBE supplier and discontinue the relationship with the pass-through and its noneligible supplier.

What should MBE/WBEs and others who are operating as pass-throughs do? They should start operating as legitimate brokers, realizing they are hindering the growth and development of other diverse businesses that want to operate legitimately. They should also evaluate the harm this causes to broader economic development within disadvantaged or underserved communities by helping perpetuate the myth that working with diverse, minority-owned or women-owned businesses costs more.

Buying organizations have some ethical responsibilities in correcting this as well. They must remember that when using a pass-through, they are paying for a certification without any business value added. While they may be able to say they have met a diverse spending goal, the truth is that the intent and purpose has been effectively undermined.

There is no question that MBE/WBE and other types of diverse businesses often face difficult choices. Choosing the path of legitimacy and staying within the intent of the supplier diversity programs might mean working creatively to find alternative solutions such as saying: "I won't choose to be a pass-through, but will accept mentorship

and training in order to find a way to add value to these transactions.” Aiming for long-term, win-win relationships will be the best path forward for diverse businesses.

Buying organizations have a role as well. They should make sure policies and expectations are clear, and they should make an honest effort to work with and develop the capabilities of diverse-owned businesses that are in the market. Just as important, diverse spend goals should be realistic and achievable.

What is the value of purchasing from a diverse business, rather than purchasing directly from a manufacturer? Answering that question will require getting past myths and misperceptions that pricing, delivery or overall service will be less competitive when buying from diverse businesses.

BIOGRAPHIES

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