

Keys Facets Of Retooled Minority Biz Investment Program

By Zachary Turke and Peter Park (March 9, 2022, 6:13 PM EST)

The minority business enterprise, or MBE, certification program, which was initially developed by the federal agencies during the inception of the federal affirmative action program, has since been adopted by numerous state and local governments as well as private corporations.

By granting minority-owned businesses preferential access to lucrative contracting opportunities, these MBE programs serve an important social equity purpose. However, due to the structuring limitations inherent in MBE programs, it can be difficult for minority entrepreneurs to raise growth capital or recognize meaningful exits from the businesses they worked so hard to grow.

The National Minority Supplier Development Council is one of the largest MBE certification programs in the country. Recognizing the potentially limiting effect that the traditional MBE certification requirements have on minority-owned businesses, over the last 10 years the NMSDC has allowed MBEs to raise equity capital from qualifying nonminority professional investors without losing their certification through its Growth Initiative program.

In 2021, the NMSDC revamped the program by significantly expanding the definition of qualifying professional investors and imposing additional governance requirements.

This article explains how NMSDC-certified MBEs can take advantage of the revamped Growth Initiative program to improve liquidity and bring on new partners to help their businesses achieve new levels of success.

NMSDC's Growth Initiative

To make sure the benefits of their program accrue to the minority community, the NMSDC's traditional MBE certification process requires, among other things, that at least 51% of certified businesses (and/or the equity interest of these businesses) are owned by U.S. citizens who are members of an ethnic minority group, with such minority owners controlling the management and daily operations.

Prior to the introduction of the Growth Initiative, this meant that minority entrepreneurs' ability to partner with nonminority investors was capped at 49%. Limiting nonminority investors' investment in



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this manner, however, significantly reduced the amount of available investment capital, as most private equity firms and other professional investors generally prefer taking majority stakes in businesses.

The Growth Initiative directly addresses this issue by differentiating between voting equity, which refers to equity interest that gives its holder the right to vote on the election of board of directors, and economic equity, which refers to equity interest that gives its holder a residual claim on the entity's economic assets. Under the Growth Initiative, an MBE may take in outside investment in excess of 49% and keep its certification if the following conditions are met:

- The investment is made by a professional institutional investor;
- The minority owner or owners(s) retain at least 51% of the voting equity;
- The minority owner(s) retain at least 25% of the economic equity;
- The minority owner(s) retain day-to-day management control of the business;
- The minority owner(s) have voting power to elect or appoint a majority of the board of directors; and
- The board meets the following requirements: (1) the board has a chairman who is an ethnic minority, (2) at least 25% of the board members are ethnic minorities unaffiliated with the outside investor(s) and (3) a majority of the board members are either ethnic minorities unaffiliated with the outside investor(s) or independent directors.

For purposes of determining the foregoing equity calculations, special rules apply to certified investment funds that should be reviewed carefully.

Transaction Strategies

Given these exacting requirements, it is important that both the MBE and the proposed investor spend sufficient time understanding how they will effectuate the proposed transaction.

Selecting a Partner

The first question that needs to be answered as part of this process is whether the proposed investor is suitable for the program. The NMSDC recently issued a guideline that significantly expanded the categories of outside investor who can qualify for the Growth Initiative to include:

- Angel investment groups — entities that invest in early stage companies that are composed entirely of accredited investors, have a track record of investing in private companies, and manage at least \$10 million of capital;
- Independent sponsors — entities without committed funds that invest in private companies, have a track record of investing in and existing private companies, and manage at least \$25 million of capital;
- Investment funds — entities that are in the business of making equity investments (not managing businesses), manage more than \$25 million of capital, have at least 30% of its capital

owned and controlled by at least three persons unaffiliated with the fund's management and unaffiliated with each other, and have a general partner that consists of two individuals or entities;

- Family offices — entities that provide wealth management and concierge services directly to a family, have a limited number of families for which they provide services, do not hold themselves out to the public as investment advisers, have a track record of investing in and existing private companies, and manage more than \$50 million of capital for each family;
- Foreign operating companies — entities organized and headquartered outside the U.S., with at least 75% of their revenue generated and 75% of their assets located outside the U.S., have revenue of at least \$250 million, and are either in a different industry than the MBE or, if in the same industry as MBE, have a different product mix, customer mix and geography; and
- Public market companies — public companies that hold equity interests in the MBE as a result of a public offering.

In evaluating a partnership, both the MBE and the proposed investor should review these requirements carefully to confirm that the proposed investor will qualify.

Application Timing

Timing is another factor that MBEs should be aware of when going to market, as the Growth Initiative process is likely to be more time-consuming than standard investment processes.

All Growth Initiative applications are processed by the national office of the NMSDC and require the MBE to submit, among other things, copies of all transaction documents, financial statements, tax returns and corporate records — including evidence of equity interests. Biographies of executive officers and proposed board members are also required, along with various other information about ownership and control.

Once the voluminous application has been submitted, the NMSDC may make any number of subsequent information and document requests, and even propose changes to the transaction documents as a condition to granting approval. The NMSDC does not promise any specific approval timeline and the transaction parties should allocate at least 60 days for the process to play out.

Recapitalization

Unless the MBE's capital structure already includes voting and nonvoting equity, it will likely have to amend its organizational documents to create such securities to satisfy the program's requirements. In general, this process can be accomplished by amending and restating the target's articles of incorporation, or equivalent organizational document, and effectuating a stock split — e.g., one share of common stock splits into one share of voting common stock and one share of nonvoting common stock.

Once the MBE's capital structure includes both voting and nonvoting equity, the MBE can issue voting and nonvoting equity to the professional institutional investor or the existing equity holders can sell portions of their voting and nonvoting equity to them — or the parties can execute a combination of both — such that the post-closing ownership percentage requirement of the Growth Initiative is satisfied.

Governance

Governance of the MBE is another factor that will need to be addressed as part of the transaction. The key requirement of the initiative is that the minority owner or owners retain the right to appoint a majority of the board of directors and control the day-to-day operation of the business.

The MBE's governing documents must be drafted in a way that does not contradict this fundamental requirement, whether explicitly — e.g., giving the outside investor the right to appoint a majority of the board — or implicitly — e.g., including an inflexible quorum provision that requires the presence of investor directors, or nonordinary-course delegation of the board's authority to an executive officer who is not a minority.

Of particular concern in this area are investor-protective blocking rights — rights granted to the institutional investor that require its consent for the target to take certain actions. Although the NMSDC has shown willingness in the past to approve certain blocking rights, the scope of such rights must generally be limited to fundamental corporate actions, such as recapitalization, mergers and acquisitions, bankruptcy and dissolution, rather than operational matters like hiring or firing employees.

The NMSDC has also taken the position that "controlling the day-to-day operation of the business" means that the chief executive of the MBE has to be a minority. To the extent that the MBE has multiple offices that could be construed as the chief executive — for example, a minority chief executive officer and a nonminority president — the NMSDC will require the organizational documents to specify that the nonminority officer reports to the minority officer.

Maintenance of MBE Certification

Since MBE certification is renewed on an annual basis, these structuring concerns do not end with the closing of the investment, and investors will likely demand assurances from the existing owners that they will maintain the certification for a period of time after the closing.

In addition to an express covenant to use efforts to maintain MBE certification, investors may also ask to put economic incentives in place, such as requiring a portion of the investment proceeds to be placed in escrow, to be released to the investor upon loss of certification or released to the existing owners upon renewal of certification, tying the minority owner's compensation to the certification status, utilizing put/call arrangements for the remaining minority-owner equity that are tied to the certification status and/or flipping in new governance provisions that provide greater rights to the investor upon the loss of certification.

Conclusion

The Growth Initiative is an innovative program that has the potential to provide much-needed growth capital to MBEs, allowing minority entrepreneurs to monetize a part of their ownership and fuel future success. For professional investors, the Growth Initiative also provides a unique opportunity to invest in this underserved community of business owners without sacrificing the economic benefits that make these businesses attractive from a financial perspective.

However, to prevent abuse, the Growth Initiative has many complex legal and procedural requirements

that must be complied with exactly for approval to be granted. Both entrepreneurs and investors need to be aware of these nuances to maximize their chances for approval.

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