Assessing Access: Obstacles and Opportunities for Minority Small Business Owners in Today's Capital Markets

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Good Morning Madam Chairwoman Landrieu, ranking minority member Snowe and distinguished members of the Committee, my name is Robert Johnson and I appreciate the opportunity to appear before the Committee to discuss the challenges and opportunities minority small business owners face in today's economic climate.

Many of you may know me as the entrepreneur who founded and built Black Entertainment Television (BET) on a $500,000 investment. When I created BET, I did so because I saw an opportunity to provide consumers with programming content that was not available on existing cable channels. Since selling BET in 2001 to Viacom for $3 billion, I have focused my attention on and invested in industries where minority ownership and the opportunity to create value in the urban market is warranted.

As an entrepreneur, I know first-hand the challenges minority entrepreneurs face. I also know the talent, dedication, determination and vision that minority entrepreneurs possess in their desire to become a part of and a contributor to the American Dream.

But the simple fact of economic reality in America *is* due to years of racial and economic discrimination minority Americans are significantly and disproportionately underrepresented in access to capital to start and fund entrepreneurial enterprises.

This Committee should know and make note of these compelling statistics: A recent study by the *Economic Policy Institute* found that the median net worth for African Americans was $11,800 compared with $118,000 for whites. When home equity was subtracted, African Americans had $300 in net assets while whites had $36,000. In metro Orlando, where my bank Urban Trust is headquartered, about 47 percent of African Americans are homeowners, compared to 74 percent of whites. This gap is likely to widen even more as the mortgage crisis costs black families their homes.

Without question the lack of access to capital and capital formation are the principal factors holding back opportunities for minority businesses and as a consequence wealth creation within the minority community.

Please note that I said “capital access” and not capital itself. As we all know, there is an abundance of investment capital in the U.S. economy and when minorities have access to capital on competitive terms and conditions they have proven to be quite successful.

Therefore, if we stipulate that access to capital is a core business necessity in the creation of value, wealth, and jobs, then the critical question is what is the political philosophy which underpins how and why we should direct capital to minority enterprises?

In my opinion, there are two crucial political and philosophical issues that first must be confronted and resolved before capital can be effectively directed to minority Americans in this society.

The first philosophical question is: Why do the Federal Government, state governments and major U.S. corporations define minority ownership as owning or holding 51% equity ownership in a company in order to be defined as a minority-owned enterprise?

The answer that is usually offered is this 51% structural requirement prevents so-called minority “front companies or shams” from gaining access to government subsidies or set-asides. But why do we assume minority companies are fronts? The answer is painfully obvious and it is partially why we are all here today. We *know* that minorities as a whole lack access to capital and therefore are unlikely to raise sufficient equity capital to control a company without outside financial assistance. But whose fault is that?

The 51% minority ownership provision is a true contradiction or a *catch-22*. In other words, the government and major corporations in an effort to ensure that minority companies are “true minority companies” place a barrier to their growth based on the fact that to be a minority company you must control and own 51% of the equity.

Think about this for a moment: As a minority business person your goal is to grow in scale and value. How do you accomplish this if your company cannot raise outside equity if it exceeds your 51% ownership requirement?

Raising equity capital, as we all know, requires that you give up commensurate equity to the outside investors based on the value of the company. If minorities are constrained in their equity raise they are therefore limited in their potential to obtain outside growth capital.

You might ask, why not raise capital in the debt market. If minority companies are forced by the 51% rule to raise debt to preserve their equity stake it is likely to be more expensive than equity capital and it further deprives the minority owner from seeking strategic partners who would be aligned in an equity raise.

Lenders have only one goal, a repayment of debt with interest as quickly as possible. On the other hand, strategic equity partners seek to combine investment and operational synergies with the minority company to maximize long-term growth and value.

More importantly, if minority companies can *only* grow through debt instruments, they run the risk of losing their company entirely if there are significant swings in interest rates or if debt covenants are so restrictive that they retard growth.

I suggest we let market relationships decide if a minority company is real or not and base the test of ownership not on equity control but other factors that determine true control in a business. Such factors could be: Is the minority the founder of the company? Is the minority the key revenue driver in the company based on his or her intellectual capital, *i.e.* Oprah Winfrey?

What about considering such factors as voting control in different classes of stock that give more votes to the minority? Board control where the minority has the right to appoint the majority of the board members is another example. Or we could simply drop the equity requirement from 51% to say 10%.

This would recognize something we all agree is the *true* problem which is the disparity in capital access that minorities face when launching a business. We could also use a combination of the aforementioned factors to define minority ownership if we insist on having minority-ownership criteria.

Placing a 51% equity hurdle rate on minority companies retards their ability to grow and could restrict their value at sale or exit. For example, if we imply that 51% minority ownership adds value, could a non-minority argue that they should pay less for the company because upon acquisition it loses its status as a minority company? Or conversely, could a white-owned company argue that a minority acquirer should pay more because the minority will get the benefit of changing the company's status to a minority-owned company?

As you can see, the arbitrary 51% equity requirement for minority companies is *politically* based, not market-place based and needs to be thoroughly reexamined and/or eliminated.

This leads me to my second and final point. **Is there a compelling national interest for helping minority businesses and what are its limitations?**

If the goal is to foster minority businesses as opposed to small businesses, irrespective of race or net worth, how do we address the Supreme Court's compelling national interest test? The Court has ruled that any government-sponsored economic preference to minority businesses should be "narrowly tailored" so as not to cause reverse discrimination. This ideology was embedded in law in the 1995 Supreme Court decision in the so-called *Adarand*[1] case.

[1] *[Adarand Constructors, Inc. v. Peña, 63 U.S.L.W. 4523 (U.S. June 12, 1995)] - under strict scrutiny, a racial or ethnic classification must serve a "compelling interest" and must be "narrowly tailored" to serve that interest.*

Justice O'Conner, writing for the majority, stated that there was no compelling national interest in favoring a minority contractor for a highway construction job over a majority company. If that Court precedent dictates our approach to minority business development it will forever, in my opinion, restrict minority access to government-sponsored business opportunities.

We agree that due to past discrimination minorities can't compete on capital formation, can't compete on experience or scale without capital, and are therefore unlikely to win most competitive bids when there is no advantage or preference given to being a minority enterprise.

If we *truly* want to create more minority companies of size and scale then we must confront this compelling national interest test.

You may not agree, but I can make a *number* of cases where there are compelling reasons why minority companies should be granted government advantages. For example, there are *no* large minority banks of national reach, yet minorities represent the largest group of the unbanked and underbanked and those most in need of transparent financial products and services at reasonable costs and financial literacy.

There is no national mortgage loan servicer that is minority-owned. Think what this could mean today if there was an experienced minority loan servicer company. It is possible this company would likely understand the challenges of minority homeownership and could engage these consumers in positive mortgage modification efforts and foreclosure prevention. Without question, sustaining and increasing minority homeownership is, in my opinion, a compelling national interest.

The film production industry is one of the few areas where we have a positive trade balance with the rest of the world; yet, there are no major minority film companies exporting film content. Why not use the tax preferences to favor minority film companies to aid the exportation of American culture from a minority point of view to the rest of the world. I find that a compelling national interest since African Americans have a *huge* influence on overall U.S. culture, and I believe the world would benefit from exposure to that culture.

I could provide other examples, but the fundamental question is **how will we define whether or not it is in our country's best interest to make minority businesses a *true* participant in the U.S. economy?**

In conclusion, let me state that I don't have a ready politically acceptable answer to these philosophical quandaries, but I am enough of a business person to know that the market place will not resolve them without defining the role of government in fostering minority ownership. The free marketplace left to its own devices simply will not solve this problem.

I don't believe the government can say we want minority companies to grow as large as possible and then place restrictions on their growth potential by requiring an "unconditional 51% ownership." I don't believe the government can say it's critically important to have minority businesses succeed in this society and on the other hand declare there is no compelling national interest to favor these businesses.

I hope that I have provided some framework for a debate and I *know* I am committed to work with this Committee to achieve a viable consensus on how to grow and expand minority business ownership and opportunities in America.

Thank you.

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