

# Board Governance

## Documenting Control – Corporation Board of Directors' Governance

### **Issue: Demonstrating control.**

Board of Directors governance rules, usually found in Corporate Bylaws, is the number one reason why corporations are found to be ineligible for the Veterans First Procurement Program under Public Law (P.L.) 109-461.

### **The Regulation – 38 CFR § 74.4**

38 CFR Part 74 is the regulation that implements P.L. 109-461 and establishes eligibility requirements.

38 CFR § 74.4(f) states that “One or more Veterans must control the board of directors of a corporate applicant or participant. “

38 CFR § 74.4(f)(1) states that “CVE will deem Veterans or service-disabled Veterans to control the Board where:

- (i) A single veteran owns 100 percent of all voting stock of an applicant or participant concern;
- (ii) A single veteran owns at least 51 percent of all voting stock of an applicant or participant, the individual is on the board of directors and no super majority voting requirements exist for shareholders to approve corporation actions. Where supermajority voting requirements are provided for in the concern's articles of incorporation, its by-laws, or by State law, the veteran must own at least the percent of the voting stock needed to overcome any such supermajority voting requirements; or
- (iii) No single veteran owns 51 percent of all voting stock but multiple veterans in combination do own at least 51 percent of all voting stock, each such veteran is on the board of directors, no supermajority voting requirements exist, and the veteran shareholders can demonstrate that they have made enforceable arrangements to permit one of them to vote the stock of all as a block without a shareholder meeting. Where the concern has supermajority voting requirements, the veteran shareholders must own at least that percentage of voting stock needed to overcome any such supermajority ownership requirements.”

38 CFR § 74.4(g) allows non-Veterans to be involved in the management of the applicant.

38 CFR § 74.4(g)(1). states that “no non-Veterans may “exercise actual control or have the power to control the applicant or participant.”

38 CFR § 74.4(i) provides a non-exhaustive list of circumstances in which non-Veterans or entities may be found to control or have the power to control the applicant.

“(i) Non-veterans or entities may be found to control or have the power to control in any of the following circumstances, which are illustrative only and not all inclusive:

- Non-veterans control the board of directors of the applicant or participant, either directly through majority voting membership, or indirectly, where the by-laws allow non-veterans effectively to prevent a quorum or block actions proposed by the veterans or service-disabled veterans.
- A non-veteran or entity, having an equity interest in the applicant or participant, provides critical financial or bonding support or a critical license to the applicant or participant which directly or indirectly allows the non-veteran significantly to influence business decisions of the participant, unless an exception is authorized by the Office of Small and Disadvantaged Business Utilization.
- A non-veteran or entity controls the applicant or participant or an individual veteran owner through loan arrangements. Providing a loan guaranty on commercially reasonable terms does not, by itself, give a non-veteran or entity the power to control a firm.

- Business relationships exist with non-veterans or entities which cause such dependence that the applicant or participant cannot exercise independent business judgment without great economic risk.

### **What This Means**

It is very important to understand that compliance with 38 CFR § 74.4(f) is necessary but not wholly sufficient to demonstrate control of an applicant. Firms must also demonstrate that non-Veterans do not have the ability to control the applicant. Firms must comply with 38 CFR § 74.4(g) to include, but not limited to the examples provided in 38 CFR § 74.4(i) that addresses how non-Veterans or entities may be found to have the power to control the company, thus making it ineligible for Vet First. Eligibility for the program is dependent on a board governance structure and process that meets both 38 CFR § 74.4(f) and 74.4(g), particularly as illustrated in 74.4(i).

- 38 CFR § 74.4(a) requires that the Veteran(s) must have control over the day-to-day operations and strategic direction of the company. It states that “[c]ontrol means both the day-to-day management and long-term decision-making authority for the VOSB.” 38 CFR § 74.4(a). However, having control of the Board of Directors does not necessarily mean that the Veteran wholly satisfies the control requirement. The Veteran must also be in control of the day-to-day management of the applicant (as well as the long-term strategic decision-making authority for the VOSB/SDVOSB). Furthermore, the applicant must demonstrate that non-Veterans do not control or have the power to control the applicant in accordance with 74.4(g) and (i).
- A non-Veteran owner(s), manager or board member must not have the ability to overrule any decision made by the Veteran owner(s) under any circumstances.
- The ability to hire and fire board members is not sufficient if the Bylaws give the board the ability to make legally binding decisions without approval of the Veteran owner(s).
- A firm is not verifiable if non-Veterans have the possibility to out vote the Veteran(s), can be deemed a quorum without the presence of the Veteran(s), can prevent the attainment of a quorum by their absence or in any way preclude the Veteran owner(s) from making any and all decisions on the firm.
- Veteran owners must always have the majority vote, either by representation on the board of directors or by weighted voting. A corporation with two directors (one a non-Veteran) may use weighted voting to show that the Veteran has the majority vote. Weighted voting is defined as a system in which the participants have varying numbers of votes, typically by the number of shares of stock held.

### **Examples of Lack of Control**

#### **Quorum**

##### **Negative control by lack of quorum**

- “According to Bylaws, the Board of Directors manages the corporation. A quorum for Board meetings consists of the majority of Directors, and the act of a majority of Directors present at a meeting constitutes Board action. Non-Veterans have the ability to exert negative control, as defined in 38 CFR § 74.1, when their absence from a Board meeting prevents the attainment of a quorum. Therefore, it is unreasonable to conclude that you control the business as required by the regulations.”
- “According to Bylaws the majority of Directors constitutes a quorum for a Board of Directors meeting, and the act of a majority of Directors present constitutes a Board act. Both Veteran and

non-Veteran must be present for Board meetings, and you both must agree to make a Board act. Thus non-Veteran can exert negative control by preventing a quorum or blocking Board action, as prohibited by 38 CFR § 74.4(g) (1). Therefore, it is unreasonable to conclude that you control the business as required by the regulations.”

### **Negative control by lack of Veteran in a quorum**

- “According to Bylaws, the Board of Directors manages the corporation. A quorum for Board meetings consists of the majority of Directors, and the act of a majority of Directors present at a meeting constitutes Board action. According to corporate documentation, there are 3 Directors of the corporation: Veteran, non-Veteran, and non-Veteran. Since only a majority is needed for a quorum, the Veteran can be excluded entirely from Board meetings and Board action. Non-Veteran and non-Veteran have the ability to exert negative control, as defined in 38 CFR § 74.1. Therefore, it is unreasonable to conclude that you control the business as required by the regulations.”
- “CVE is unable to conclude that you satisfy the control requirements set forth in 38 CFR § 74.4. According to your Bylaws, the Board of Directors manages your corporation. A quorum for Board meetings consists of the majority of Directors, and the act of a majority of Directors present at a meeting constitutes Board action. According to your corporate documentation, there are 3 Directors of your corporation: you (Veteran), Jane Doe, and John Doe, both non-Veterans. Since only a majority is needed for a quorum, you can be excluded entirely from Board meetings and Board action. Ms. Doe and Mr. Doe have the ability to exert negative control, as defined in 38 CFR § 74.1. As such, it is unreasonable for CVE to conclude that you satisfy the control requirements of the regulations.”

### **Lack of Weighted Voting**

- Corporate Bylaws states that, business of a corporation shall be managed by its Board of Directors. In the case where there are only two directors of the company: Veteran and non-Veteran, and there is no provision for weighted voting, or other provision that in the event of a deadlock that the Veteran’s decision prevails, the firm fails to meet the requirements of 38 CFR § 74.4(i)(1) as the non-Veteran director can exercise negative control as defined by 38 CFR § 74.1 by blocking corporate action. Therefore, it is unreasonable to conclude that the Veteran controls the business as required by the regulations.
- “You supplied Corporate Bylaws for your company. Article II Section 1 states that, “...all corporate powers shall be exercised by or under the direction of, and the business and affairs of the corporation shall be managed under the direction of, the Board of Directors.” Article II, Sections 6 and 7, state that a quorum will be a majority of the directors and that the vote of a majority of the directors present when a quorum is established will be the act of the Board of Directors. The supplied Articles of Incorporation dated 08/27/2010 list you and Mr. John Doe, a non-Veteran, as directors of the company. There is no provision for weighted voting. Therefore, you fail to meet the requirements of 38 CFR § 74.4(f) as the non-Veteran director can exercise negative control as defined by 38 CFR § 74.1 by blocking corporate action. Therefore, it is unreasonable to conclude that you control the business as required by the regulations.”

### **Limitation on transfer of control**

- This applies when a non-Veteran either puts stipulations on control based on an equity interest in the company or when non-Veterans transfer a majority of the stock ownership or control to the Veteran within two years prior to applying for verification and remain involved in the firm. The stipulations on equity interest are stated in 38 CFR § 74.4(i)(2) “[a] non-veteran or entity, having an equity interest in the applicant or participant, provides critical financial or bonding support or a

critical license to the applicant or participant which directly or indirectly allows the non-veteran significantly to influence business decisions of the participant.” The transfer of control is spelled out in 38 CFR § 74.4(h), “[n]on-veterans who transfer majority stock ownership or control of the firm to an immediate family member within 2 years prior to the application and remain involved in the firm as a stockholder, officer, director, or key employee of the firm are presumed to control the firm,” but can be overcome by providing proper documentation that the Veteran has the requisite independent management experience and is actively participating in the firm.

- “A corporation is typically owned by its stockholders. The Articles of Incorporation state “the number of shares which the corporation is authorized to have outstanding is 950 shares”. The Stock Ledger showed on 5/05/07, John Doe and Jane Doe were each issued shares; however, the number of shares are not available. A cancelled Stock Certificate, dated 5/14/07 showed Jane Doe was issued 575 of 950 shares and held 50% ownership of the applicant. The 2010 Schedule K-1 showed Catherine Doe held 50% ownership and John Doe held 50% ownership. The Stock Power, dated 2/1/11 showed Jane Doe transferred 8 shares to John Doe. The Stock Ledger showed that on 2/1/11, John Doe was issued 583 shares represented by Stock Certificate 3 and Jane Doe was issued 567 shares represented by Stock Certificate 4. Since Jane Doe, non-Veteran, recently transferred some stock to John Doe, confirmed service-disabled Veteran, in order to make him 51% owner of Doe Consulting, Inc.; your company does not meet the minimum 51% service-disabled Veteran ownership requirement set forth by the Code of Federal Regulations.”

**Center for Veterans Enterprise Verification Education Brief - *Providing Clarification to Promote Verification***