March 20, 2019

Reference Number 18-0042

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Dear Mr. Sanner:

Dunker Electric Supply, Inc. (DES) appeals the Illinois Department of Transportation's (IDOT) October 24, 2017 determination that DES is ineligible for certification as a Disadvantaged Business Enterprise (DBE) under the criteria set out at 49 C.F.R. part 26 (the Regulation). IDOT determined that DES did not demonstrate eligibility under Regulation §§26.69(c) and 26.71(c) provisions relating to ownership and control. We affirm on the basis of ownership because DES failed to prove that it satisfies the requirements of Regulation §26.69(c)(3).[1]

I. Background

The pertinent facts are uncontroverted. On December 15, 2015, Lori Huddleston entered into entirely seller-financed agreements to acquire 51% ownership of DES from her parents; she used the purchased shares in the business as collateral for the transaction. *See generally* Stock Pledge and Control Agreement (Pledge Agreement) (December 17, 2015); Security Promise Note (Note) (December 17, 2015).[2] Ms. Huddleston agreed to pay for the firm through recurring monthly installment payments (from February 1, 2016 until January 1, 2031).

The pledge agreement contains a restrictive covenant that, in effect, requires Ms. Huddleston to obtain written consent from her nondisadvantaged father, David Dunker, before she can take several actions on behalf of DES, including transferring any of her shares, selling assets of the corporation, redeeming stock, paying dividends or making distributions to shareholders (except to pay taxes and to make installment payments per the purchase agreement), making loans or guarantees on behalf of the corporation, and increasing salary or compensation paid to shareholders. *See* Pledge Agreement at 3-5.

[1] We decline to opine on IDOT's control ground based on Regulation at §26.71(c) because our disposition on ownership is sufficient to affirm the decision. *See* §§26.61(b), 26.89(f)(1).

[2] Ms. Huddleston's brothers entered into similar agreements to each acquire 24.5% ownership interest.

II. Authority

Section 26.61(b) provides: "[t]he firm seeking certification has the burden of demonstrating to you, by a preponderance of the evidence, that it meets the requirements of this subpart concerning group membership or individual disadvantage, business size, ownership, and control."

Section 26.69(c) provides:

(1) [t]he firm's ownership by socially and economically disadvantaged individuals, including their contribution of capital or expertise to acquire their ownership interests, must be real, substantial, and continuing, going beyond pro forma ownership of the firm as reflected in ownership documents. Proof of contribution of capital should be submitted at the time of the application. When the contribution of capital is through a loan, there must be documentation of the value of assets used as collateral for the loan.

(2) Insufficient contributions include a promise to contribute capital, an unsecured note payable to the firm or an owner who is not a disadvantaged individual, mere participation in a firm's activities as an employee, or capitalization not commensurate with the value for the firm.

(3) The disadvantaged owners must enjoy the customary incidents of ownership, and share in the risks and be entitled to the profits and loss commensurate with their ownership interests, as demonstrated by the substance, not merely the form, of arrangements. Any terms or practices that give a non-disadvantaged individual or firm a priority or superior right to a firm's profits, compared to the disadvantaged owner(s), are grounds for denial.

(4) Debt instruments from financial institutions or other organizations that lend funds in the normal course of their business do not render a firm ineligible, even if the debtor's ownership interest is security for the loan.

Examples to paragraph (c): (i) An individual pays $100 to acquire a majority interest in a firm worth $1 million. The individual's contribution to capital would not be viewed as substantial.

(ii) A 51% disadvantaged owner and a non-disadvantaged 49% owner contribute $100 and $10,000, respectively, to acquire a firm grossing $1 million. This may be indicative of a pro forma arrangement that does not meet the requirements of (c)(1).

(iii) The disadvantaged owner of a DBE applicant firm spends $250 to file articles of incorporation and obtains a $100,000 loan, but makes only nominal or sporadic payments to repay the loan. This type of contribution is not of a continuing nature.

Section 26.89(f)(1) provides: "[t]he Department affirms your decision unless it determines, based on the entire administrative record, that your decision is unsupported by substantial evidence or inconsistent with the substantive or procedural provisions of this part concerning certification."

III. Decision

Regulation at §26.69(c)(3) states:

> The disadvantaged owners must enjoy the customary incidents of ownership, and share in the risks and be entitled to the profits and loss commensurate with their ownership interests, as demonstrated by the substance, not merely the form, of arrangements. Any terms or practices that give a non-disadvantaged individual or firm a priority or superior right to a firm's profits, compared to the disadvantaged owner(s), are grounds for denial.

The facts presented in this case show that Ms. Huddleston is not entitled to the profits commensurate with her ownership interest because the restrictive covenant precludes her from receiving any distribution or dividend—for purposes other than to pay taxes and to make installment payments under the purchase agreement—without written consent from Mr. Dunker. *See* Pledge Agreement at 4-5.

Further, the pledge agreement gives Mr. Dunker a prohibited superior right to the firm's profits. He gets paid before any shareholder has a right to the firm's profits. It does not matter that the parties nominally cast these transfers as distributions with simultaneous installment payments on Ms. Huddleston's debt to Mr. Dunker. *See* Appeal at 6. The payments remain forced transfers to ensure that an outside creditor gets paid before Ms. Huddleston, the majority shareholder, has *any* right to profits, diminished, subordinate, or otherwise.[3] Ms. Huddleston's rights to firm profits are neither commensurate with her ownership interest nor superior to those of Mr. Dunker. DES, accordingly, is ineligible for certification because the ownership transactions do not satisfy the requirements of §26.69(c)(3).

IV. Conclusion

Substantial evidence supports IDOT's conclusion that DES is ineligible. We therefore affirm under §26.89(f)(1).

This decision is administratively final and not subject to petitions for reconsideration. DES may reapply for certification as the applicable waiting period has elapsed.

[3] It also shows that Ms. Huddleston has not put her own capital at risk. To the extent the firm has insufficient profits, Ms. Huddleston appears to have no obligation to make a payment. It makes no difference that Mr. Dunker, in the event of nonpayment, can foreclose on her shares. Ms. Huddleston makes no showing that she bought any of the shares with her own money. We have consistently opined that the capital contribution rules render a firm ineligible for certification when its disadvantaged owner fully finances her share purchase with debt to be repaid exclusively from the firm's resources.

Sincerely,

Samuel F. Brooks
DBE Appeal Team Lead
Disadvantaged Business Enterprise Division

cc: IDOT