

December 20, 2017

Reference No: 17-0116

Mr. Brad M. McFann, CPA
The Fyffe Jones Group, AC
REDACTED
Portsmouth, OH 45662

Re: DBE Certification Denial of SE Supply Company, Inc.

Dear Mr. McFann:

SE Supply Company, Inc. (SESC) appeals to the U.S. Department of Transportation, Departmental Office of Civil Rights (the Department), the certification denial as a Disadvantaged Business Enterprise (DBE) by the Ohio Department of Transportation (ODOT) pursuant to the DBE Program Regulation, 49 C.F.R. Part 26. ODOT denied SESC DBE certification on May 30, 2017, citing the firm's inability to meet the ownership requirements of §26.69. SESC appealed this decision to the Department on June 21, 2017, and we obtained ODOT's administrative record pursuant to §26.89(d). We conclude, based on a review of this record and the appeal, that substantial evidence supports ODOT's decision for the reasons stated.¹

Background

SESC was established in 2009 and is a food service equipment wholesaler. (Uniform Certification Application (UCA), p. 1). The firm's President, Ms. Nydia Alvarado and her non-disadvantaged husband, Mr. Robert Temple, Jr., (SESC's Vice President) are listed as each contributing \$1,568 for their respective 60 and 40% ownership interests. (Ibid., pp. 7,8). As part of the UCA, SESC provided a statement signed by Ms. Alvarado entitled "Documented proof of contributions used to acquire ownership for each owner." The document states:

The firm was being operated by Nydia Ileana Alvarado and Robert Temple, Jr. as a sole proprietorship until the firm incorporated in 2009. Funds were used from the

¹ When a firm appeals a certification denial determination, the Department does not make a de novo review or conduct a hearing; its decision is based solely on a review of the administrative record as supplemented by the appeal. §26.89(e). The Department affirms the initial decision unless it determines, based upon its review of the entire administrative record, that the decision was "unsupported by substantial evidence or inconsistent with the substantive or procedural provisions of this part concerning certification." §26.89(f)(1). The Department's decision is based on the status and circumstances of the firm as of the date of the decision being appealed; the Department does not consider new evidence that was not before the certifier when making a decision. §26.89(f)(6).

original business to continue the business as a corporation. We do not have proof of contributions. (ODOT record, p. 36)

The record contains a stock certificate listing Ms. Alvarado's 60% ownership interest; however, the firm's 2013, 2014, and 2015 tax returns (Schedule K-1) list Mr. Temple as SESC's 100% owner. On May 23, 2017, ODOT conducted an on-site interview with Ms. Alvarado and Mr. Temple as required by §26.83(c). The agency inquired whether SESC's structure or ownership underwent changes since the firm started. The response recorded states: "Company started as Nydia, President. Later [we] changed ownership and made Robert President. When [we] learned about DBE, [we] changed the titles of each owner, applied changes of ownership to apply to DBE." (On-Site Report, p. 2). When ODOT inquired as to the method of payment made by the owners to establish their ownership percentage, the response recorded is:

Robert had this company prior to Robert and Nydia getting married. [Robert] was a millionaire when he was 33 years old. After divorce and 9/11, most of that was lost. [He] only had assets from a company called RoTem Supply, Inc. When SESC was incor[porated], Robert gave Nydia a larger percentage of the company since he had nothing else to give her. (Ibid., p. 4)

ODOT also asked whether there were contributions other than cash to establish ownership. The response recorded is that Ms. Alvarado contributed her labor to the company. (Ibid.)

Discussion and Decision

1. As the applicant firm, SESC bears the burden of proving it meets all eligibility requirements, including those related to capital contributions by firm owners. ODOT determined that Ms. Alvarado's contribution of capital was not sufficient for the 60% ownership interest she claims. The relevant Regulation provisions in this regard is §26.69(c), which requires in part, that the disadvantaged owner demonstrate a contribution of capital or expertise for their ownership interest that is real, substantial, and continuing, that goes beyond pro forma ownership of the firm as reflected in ownership documents.²

² §26.69(c) states: "(1) The 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 REDACTED 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

The record indicates that Ms. Alvarado did not contribute any money when she acquired her initial ownership interests. Ms. Alvarado stated that funds from the original business were used to incorporate SESC in 2009, but she has no proof of those contributions. Her capital contribution is therefore zero, as reported to ODOT, which by definition is not real and substantial.

2. SESC reported to the Internal Revenue Service that Mr. Temple is the firm's sole owner. Again, the firm bears the burden of demonstrating that it meets the requirements for certification. One of these requirements is found in §26.69(b), which mandates that the disadvantaged owner(s) possess at least 51% of each class of voting stock.³ The record is unclear whether Ms. Alvarado is in fact the firm's majority owner.

3. According to statements made during ODOT's on-site interview, Mr. Temple gifted shares to Ms. Alvarado in exchange for her labor to the company. There are two issues here.

a. Gifts may be an acceptable form of contribution, but if the person who provided the gift is a non-disadvantaged individual, this creates a presumption that the interests in the business are not held by the disadvantaged owner. The operable provisions describing situations wherein gifts or transfers without adequate consideration are presumed to not be counted for purposes of DBE certification are contained in §26.69(h), a provision ODOT cites.⁴ In this case, Mr. Temple, a non-disadvantaged individual who remains involved in the firm, gifted his shares to Ms. Alvarado. She stated to ODOT this occurred when the firm learned about the DBE program. The rule permits these assets to be counted only if SESC proves by "clear and convincing evidence" that (i) the gift or transfer to Ms. Alvarado was made for reasons other than obtaining certification as a DBE; and (ii) that she actually controls the management, policy, and operations

owner and a non-disadvantaged 49% owner contribute REDACTED, 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 REDACTED loan, but makes only nominal or sporadic payments to repay the loan. This type of contribution is not of a continuing nature." (Emphasis Added)

³ §26.69(b) states: "To be an eligible DBE, a firm must be at least 51 percent owned by socially and economically disadvantaged individuals. (1) In the case of a corporation, such individuals must own at least 51 percent of the each class of voting stock outstanding and 51 percent of the aggregate of all stock outstanding. (2) In the case of a partnership, 51 percent of each class of partnership interest must be owned by socially and economically disadvantaged individuals. Such ownership must be reflected in the firm's partnership agreement. (3) In the case of a limited liability company, at least 51 percent of each class of member interest must be owned by socially and economically disadvantaged individuals.

⁴ §26.69(h)(1) states: "You must presume as not being held by a socially and economically disadvantaged individual, for purposes of determining ownership, all interests in a business or other assets obtained by the individual as the result of a gift, or transfer without adequate consideration, from any non-disadvantaged individual or non-DBE firm who is—(i) Involved in the same firm for which the individual is seeking certification, or an affiliate of that firm; (ii) Involved in the same or a similar line of business; or (iii) Engaged in an ongoing business relationship with the firm, or an affiliate of the firm, for which the individual is seeking certification. (2) To overcome this presumption and permit the interests or assets to be counted, the disadvantaged individual must demonstrate to you, by clear and convincing evidence, that—(i) The gift or transfer to the disadvantaged individual was made for reasons other than obtaining certification as a DBE; and (ii) The disadvantaged individual actually controls the management, policy, and operations of the firm, notwithstanding the continuing participation of a non-disadvantaged individual who provided the gift or transfer.

of the firm, notwithstanding the continuing participation of a non-disadvantaged individual who provided the gift or transfer. There is no offer of proof in this regard in the record.

b. The Regulation does not recognize contributions based on sweat equity. The mere management and participation in a firm's activities does not establish a contribution of capital under the Regulation. There is a limited exception described in §26.69(f), which involves contributions based on expertise, but there is reference at all in the record that this is alleged. There is no proffer of information claiming that her skills/qualifications satisfy the other requirements of §26.69(f)—(i) expertise in a specialized field, (ii) of outstanding quality, (iii) in areas critical to the firm's operations, (iv) indispensable to the firm's potential success, and (v) specific to the type of work the firm performs; these were not documented in the firm records nor presented to ODOT.⁵ Also, §26.69(f) makes clear that the person upon whose skills or expertise the firm relies "must have a significant financial investment in the firm." We find that Ms. Alvarado has not demonstrated any such investment for the reasons stated above.

You stated in your appeal that because Ms. Alvarado did not have a social security number, SESC's 2009 tax returns listed Mr. Temple as the firm's sole owner; an entry that was inadvertently repeated each year thereafter through 2015. You offer to amend the corporate tax returns if necessary and enclose draft K-1 statements for the years in question. You stated that the 2016 tax returns will show SESC's correct ownership percentages (i.e., Ms. Alvarado as the 60% owner).

While we acknowledge SESC's intention to remedy the eligibility deficiencies that ODOT identified, it may not effectively do so on appeal in this case. The Department's role on appeal is not to consider new evidence that was not before the certifier. *See* §26.89(e). The Department does not perform a *de novo* review. Rather, it is to determine whether, based on the record at the time of the initial decision, substantial evidence supported ODOT's decision. *See* §26.89(e) and (f)(6) (Department bases its appeal decision on status and circumstances of firm as of date of certifier's decision).

Conclusion

We affirm the certification denial of SESC as a DBE under §26.89(f)(1) based on the ownership grounds specified above. There exists substantial record evidence to support the denial, and the denial is consistent with applicable substantive and procedural provisions of the Regulation.⁶ **SESC may reapply to the DBE program after the appropriate waiting period, here May 30, 2018.** This decision is administratively final and not subject to further review.

⁵ §26.89(f) states: "The following requirements apply to situations in which expertise is relied upon as part of a disadvantaged owner's contribution to acquire ownership: (1) The owner's expertise must be—(i) In a specialized field; (ii) Of outstanding quality; (iii) In areas critical to the firm's operations; (iv) Indispensable to the firm's potential success; (v) Specific to the type of work the firm performs; and (vi) Documented in the records of the firm. These records must clearly show the contribution of expertise and its value to the firm. (2) The individual whose expertise is relied upon must have a significant financial investment in the firm."

⁶ The Department's decision that a recipient's certification decision was supported by substantial evidence is not a decision that the firm is ineligible. Rather, it is a finding that the recipient had enough evidence to reach that decision. *See* 64 Fed. Reg. 5096, at p. 5124 (Feb. 2, 1999).

Sincerely,

Marc D. Pentino
Lead Equal Opportunity Specialist
Disadvantaged Business Enterprise Program Division

cc: ODOT