February 21, 2019

Reference Number 18-0114

Gregory J. Hout
Law Offices of Gregory J. Hout
12396 World Trade Drive, Suite 206
San Diego, CA 92128

Dear Mr. Hout:

This is in response to your appeal of the decision of the Los Angeles County Metropolitan Transportation Authority (Metro) to deny certification to your client, Cutting Edge Concrete Services. The U.S. Department of Transportation (DOT) affirms Metro's decision.

I. Procedural History

The firm applied for certification on December 8, 2017. An on-site interview was conducted on January 19, 2018. Metro denied the firm's application through a letter dated April 17, 2018. The firm timely appealed to the Department.

II. Burdens of Proof and Standard of Review

(a) Burdens of Proof

As provided in 49 CFR 26.61(b) of the Department's DBE rule, an applicant firm must generally demonstrate to the certifier, by a preponderance of the evidence, that it meets Part 26 requirements concerning business size, social and economic disadvantage, ownership, and control. This means that the applicant must show that it more likely than not meets these requirements. A certifier is not required to prove that a firm is ineligible. A certifier can properly deny certification on the basis that an applicant did not submit evidence meeting the preponderance standard that it meets eligibility criteria.

However, a different burden of proof applies in situations addressed by section 26.69(h) of the rule. This provision concerns ownership interests in a business that a non-disadvantaged individual has transferred to a disadvantaged individual without adequate consideration, while the non-disadvantaged individual remains involved in the firm. A related provision concerning control, section 26.71(l), applies to a situation in which a firm was formerly owned and/or controlled by a non-disadvantaged individual who remains involved with the firm, and ownership and/or control was transferred to a disadvantaged individual.

In either case, the firm must show by the more stringent "clear and convincing evidence" standard both that the transfer was made for purposes other than obtaining DBE certification and that the disadvantaged individual actually controls the company, notwithstanding the continued participation of the non-disadvantaged individual who made the gift or transfer.

(b) Standard of review for certification appeals

On receipt of an applicant's appeal from a denial of certification, the Department makes its decision "based on the entire administrative record as supplemented by the appeal…[1]

The Department does not make a *de novo* review of the matter…."[2] The Department affirms (a certifier's) decision unless it determines, based on the entire administrative record, that (the certifier's) decision is unsupported by substantial evidence or inconsistent with the substantive or procedural provisions of this part concerning certification."[3]

This language means that the Department does not act as though it were the original decision maker in the case or substitute its judgment for that of the certifier. If the certifier's decision – including a finding that an applicant failed to meet its burden of proof – is supported by substantial evidence, then the Department will affirm the certifier's decision.

III. Discussion

(a) The Metro Denial

Metro denied the firm's application on intertwined grounds of ownership and control. With respect to ownership, the denial said that the firm had originally been a sole proprietorship owned by Mr. Kurt Schulthess. In 2003, 51 percent of the firm's stock was transferred to Ms. Leticia Schulthess without monetary consideration, with her husband retaining 49 percent of the stock and continuing to work in the company. This triggered the application of the "clear and convincing evidence" standard of proof of sections 26.69(h) and 26.71(l) with respect to the control of the firm by its socially and disadvantaged owner (i.e., Ms. Schulthess)

In concluding that the firm did not meet this standard, Metro cited a provision of the firm's bylaws, the vote of a majority of the directors of the firm (not a vote representing the majority of the stock) is necessary to take certain actions. Since Mr. and Ms. Schulthess are the only directors, this means that both most concur in such actions, giving Mr. Schulthess negative control over actions by the board of directors. This is contrary to section 26.71(c) and (d) of the role, Metro said.

[1] 49 CFR 26.89(e)
[2] Id.
[3] 49 CFR 26.89(f)(1)

Moreover, the Metro letter said, Mr. Schulthess supervises field operations and is responsible for bidding and estimating. He has extensive and lengthy experience related to the main work of the firm, in such areas as general engineering and construction, including demolition, asphalt, flatwork, etc. On the other hand, Metro said, Ms. Shulthess has experience in office management, administration, finance, human resources, and marketing, functions she performs for Cutting Edge. Citing the last sentence of 26.71(g), the denial letter said that her expertise of this kind, not related to the principal activities of the firm, is insufficient to demonstrate that she controls the firm.

(b) The Appeal

The appeal states that Cutting Edge is a qualified HUBZone firm and a former participant in the Small Business Administration (SBA) section 8(a) program, suggesting that these other programs have recognized Ms. Schulthess' qualifications.[4]

The appeal contends, in apparent reference to the language of the first sentence of section 26.69(e) of the regulation, that Ms. Schulthess contributed both expertise and capital to the company, thereby meeting ownership requirements. The contribution of expertise concerns her business degree and long experience as a market analyst, which she has contributed to the firm in her capacity as a full-time executive. Her capital contribution is that she assumes all risks associated with Cutting Edge by executing personal General Indemnity Agreements concerning the company's bonds, guaranteeing bank loans, and pledging her personal assets as collateral for the company's obligations.[5]

With respect to control, the appeal points out that Ms. Schulthess is the holder of California States Contractors' licenses (for general engineering and general building) and is the Responsible Managing Officer (RMO) under these licenses, meaning that she is responsible for all work performed by the firm.[6] In addition, she performs a wide variety of duties that are important to the firm's operations.[7] She prepared a human resources program and employee handbook, making sure that California labor regulations are met. She has unfettered hiring and firing authority and reviews all contracts. While she does not work in the field, she reviews and approves all construction contracts. As permitted by the regulation, she delegates authority for field operations to her husband and company employees.

(c) DOT Analysis

With respect to ownership, the firm's application represents that Ms. Schulthess contributed $0 to acquire her 51 percent interest in the firm in 2003, while Mr. Schulthess contributed **REDACTED** to acquire his original 100 percent ownership in 1998.[8] From the owners' point of

[4] It should be noted that these programs have different requirements from the DOT DBE program and are administered by other agencies. Eligibility for one does not imply eligibility for another.
[5] See p. 3 of appeal and p. 2-3 of Leticia Shulthess' declaration.
[6] Mr. Schulthess does not hold such licenses. See p. 6 of the appeal and p. 2 of Leticia Shulthess' declaration.
[7] See first paragraph on p. 4 of the appeal document and p. 2 of Leticia Shulthess' declaration.
[8] Certification application, p. 6-7.

view, Ms. Schulthess' contribution for the 51 percent of the stock that Mr. Schulthess transferred to her in 2003 was "her expertise and time."[9] The firm has never claimed that there was any monetary consideration for the transfer and has always agreed that Mr. Schultless continues to play an important role in the firm, particularly with respect to field operations.

Because the firm's appeal relies heavily on the assertion that Ms. Schultless made a contribution of expertise to the company, it is important to have a correct understanding of the regulation's provisions concerning contribution of expertise, which are found in section 26.69(f):

> (*f) 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.*

The Department said the following about its understanding of this provision in the preamble to its February 2, 1999, final rule:

> *Commenters asked for more guidance in evaluating claims that a contribution of expertise from disadvantaged owners should count toward the required 51percent ownership. They cited the potential for abuse. The Department believes that there may be circumstances in which expertise can be legitimately counted toward the ownership requirement. For example, suppose someone with a great deal of expertise in a computer-related field, without whom the success of his or her high-tech start-up business would not be feasible, receives substantial capital from a non-disadvantaged source. We have modified the final rule provision to reflect a number of considerations. Situations in which expertise must be recognized for this purpose are limited. The expertise must be outstanding and in a specialized field: everyday experience in administration, construction, or a professional field is unlikely to meet this test. (This is*

[9] Site visit questionnaire, p. 2

> *not a ''sweat equity''provision.) We believe that it is fair that the critical expertise of this individual be recognized in terms of the ownership determination. At the same time, the individual must have a significant financial stake in the company. This program focuses on entrepreneurial activity, not simply expertise. While we will not designate a specific percentage of ownership that such an individual must have, entrepreneurship without a reasonable degree of financial risk is inconceivable.*[10]

In speaking to the proposals that led to this final rule provision, the Department said that the concept was to

> *…allow business owners who bring a special expertise, but relatively little capital, to a company to establish their ownership…One requirement is that the expertise be specific to the type of work the firm performs. This would exclude, in most instances, general business administration experience from counting.*[11]

The Department made the same point with respect to an earlier version of the proposal:

> *…the expertise must be in an area critical to the firm's and specific to that type of business, as well as documented in the firm's records. By specific to the type of business, we mean that the expertise must relate to the substance of the type of work performed by the firm (e.g., in computer engineering, systems analysis, or software design for a computer firm, in use of explosives for a demolition firm) rather than to generic business administration expertise (e.g., bookkeeping, office management).*[12]

Notwithstanding her contractors' licenses, the record is clear that Ms. Schulthess' expertise and functions are principally in the area of general business administration, rather than in matters specific to Cutting Edge's type of business, in the way the Department expressed its understanding of that term. However necessary and valuable her business administration expertise may be to the company's success, it is not the sort of substantive specialized expertise contemplated by section 26.69(f). Equally important, this provision calls for someone seeking to have a contribution of expertise recognized for ownership purposes to have a significant financial investment in the applicant company, without which counting expertise toward ownership is "inconceivable." Ms. Schulthess made no financial investment to obtain her 51 percent of the company's stock.[13]

This has two implications for this case. First, having made no financial contribution to the firm, and being unable under the regulation to have her general business skills count as a contribution to her ownership, there is substantial evidence in the record that she cannot carry her "preponderance of the evidence" burden of proof for ownership under section 26.69(c) of the regulation. Second, because Mr. Schulthess transferred 51 percent of the stock to Ms. Schulthess

---

[10] 64 FR 5118
[11] 62 FR 29567; May 30, 1997
[12] 57 FR 58292; December 9, 1992
[13] While her role in indemnity agreements and loan guarantees could expose her to liability in a contingency involving financial problems the firm may experience in the future, they do not involve an actual contribution of capital by her either at the time of the 2003 stock transfer or at the present time.

without consideration, while remaining involved in the company, the higher "clear and convincing evidence" of sections 26.69(h) and 26.71(l) comes into play.

Under these provisions, an applicant firm must show by this standard that the transfer of an ownership interest was not made for the purpose of obtaining DBE certification and that the disadvantaged owner controls the company. This application for DBE certification was made 14 years after the transfer of ownership[14], so the firm could possibly meet this first prong of the test. However, given the bylaw provision cited in Metro's denial letter[15] and the dominant role played by Mr. Schulthess in delivering the actual "on the ground" products and services of the company, there is substantial evidence in the record to support Metro's determination that the firm failed to meet the "clear and convincing evidence" standard with respect to control, a standard that the appeal does not discuss.

The Department's rules do explicitly permit disadvantaged owners to delegate functions to others, and the rules do not insist that disadvantaged owners perform field operations. However, there are specific requirements surrounding delegation of functions in the rule[16] and the "clear and convincing evidence" standard is an intentionally high bar. For all the roles that Ms. Schulthess plays in the company, the assertions the appeal makes concerning her functions do not overcome Metro's decision that she fails to meet these requirements at a "clear and convincing evidence" level.

IV. Conclusion

Given the information in the record, the Department concludes that Metro had substantial evidence to decide that the firm failed to meet its burdens of proof with respect to ownership and control by Ms. Schulthess. Consequently, the Department affirms Metro's decision denying the firm's application for DBE eligibility.

This decision is administratively final and not subject to petitions for review.

Sincerely,

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

cc: Leticia M. Schulthess
Shirley Wong

[14] The record reveals an earlier denial by Metro, the date of which is not clear. In addition, the 2003 stock transfer was made not long before the firm's entry into the 8(a) program, suggesting that the ownership change may have played a role in enabling the firm's successful application to SBA.

[15] See Bylaws of Cutting Edge Concrete Services, Inc., at p. 6, paragraph 6.

[16] See section 26.71(g)