

**United States Small Business Administration  
Office of Hearings and Appeals**

SIZE APPEAL OF:

DHS Systems LLC

Appellant

Appealed from  
Size Determination No. 01-SD-2011-001

SBA No. SIZ-5211

Decided: March 14, 2011

APPEARANCES

Patrick K. O’Keefe, Esq., Howard Stanislawski, Esq., Sidley Austin LLP, Washington, D.C., for Appellant.

Jack Thousand, Senior Vice President, for Applied Companies.

Garry S. Grossman, Esq., Gabriel D. Soll, Esq., McCarthy, Sweeney & Harkaway, P.C., Washington, D.C., for the National Venture Capital Association.

DECISION<sup>1</sup>

I. Jurisdiction

This appeal is decided under the Small Business Act of 1958, 15 U.S.C. § 631 *et seq.*, and 13 C.F.R. Parts 121 and 134.

II. Issue

Whether there was clear error of fact or law in the Area Office’s determination that an investor controls the small concern through its parent’s board. *See* 13 C.F.R. § 134.314.

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<sup>1</sup> This Decision was originally issued under a Protective Order. On March 14, 2011, I issued an Order for Redactions directing each party to file a request for redactions if that party desired any information redacted from the published Decision. No party requested any redactions. Thus, OHA now publishes the Decision in its entirety.

### III. Background

#### A. The Solicitation and Protest

On September 28, 2010, the Department of the Army, Mission and Installation Contracting Command, issued Solicitation No. W911S7-10-T-0337 to purchase Environmental Control Units. The Contracting Officer (CO) set the procurement aside for small business and designated North American Industry Classification System (NAICS) code 333415, Air Conditioning and Warm Air Heating Equipment and Commercial and Industrial Refrigeration Equipment Manufacturing, with a corresponding 750 employee size standard, as the applicable NAICS code for the procurement.

On September 30, 2010, the CO awarded the contract to DHS Systems LLC (Appellant), and notified the unsuccessful offerors. On October 1, 2010, Applied Companies (Applied) submitted a size protest, alleging Appellant had been acquired by The Carlyle Group (Carlyle), a large business, in 2004. Further, Mr. Francis Finelli, a managing partner of Carlyle, sits on Appellant's Board. The CO referred the protest to the Small Business Administration (SBA) Office of Government Contracting--Area I (Area Office) for a size determination.

#### B. The Size Determination

##### 1. Appellant's Ownership

On November 23, 2010, the Area Office issued Size Determination No. 01-SD-2011-001 finding Appellant other than small. The Area Office found that Appellant is 100% owned by DHS Technologies LLC (DHS Tech). DHS Tech owns 100% of six other concerns: DHS Services Corporation, DHS Logistics LLC, DHS Systems International Ltd., Reeves Emergency Management Systems LLC, CAMP Technologies LLC, and Southeast Industries, LLC. The Area Office thus found Appellant affiliated with DHS Tech and all six concerns.

The Area Office further found that DHS Tech's two largest shareholders are A. Jon Prusmack (59.8%) and DHS Technologies Holding Corporation (DHS Holding) (28.79%). The Area Office further found that Mr. Prusmack has the power to control DHS Tech, and that Mr. Prusmack and his wife have the power to control ten other concerns. These firms are: 33 Kings Highway LLC, American International Lifestyles LLC, Apogee Food Services LLC, American International Media LLC, Apogee Lifestyle LLC, Rugby Magazine LLC, USA Stevens LLC, Power Pilates LLC, Premier Home Development Group LLC, and The Patrice and A. Jon Prusmack Foundation. The Area Office found Appellant affiliated with all ten concerns.

##### 2. DHS Holding's Control of DHS Tech

The Area Office then turned to the question of DHS Holding's ability to control DHS Tech, by examining DHS Tech's Operating Agreement and its Members Agreement. DHS Holding is DHS Tech's second largest interest holder, and is the majority owner of DHS Tech's Class B interest.

DHS Tech's business is managed and controlled by its seven-member Board of Managers (Board). A majority of the Board is needed for any decision of the Board. DHS Holding designates two Investor Managers, who cannot be removed without its consent. There are four Common Managers designated by the majority shareholder. Further, DHS Holding must approve the selection of the Outside Manager (an independent financial expert), who cannot be removed without DHS Holding's consent. The Audit and Compensation committees have three members each, including one Investor Manager and the Outside Manager. Any other Board committee shall include the Outside Manager and at least one Investor Manager (if they desire to serve on that committee). The Area Office determined these provisions give DHS Holding the power to influence decisions made by the Outside Manager and by all Board committees, and negative control over DHS Tech's operations.

The Area Office found that DHS Tech's Members Agreement lists certain actions that cannot be taken without the prior approval of the Board, including that of both Investor Managers. These decisions are not only the extraordinary changes that affect the fundamental structure of the company, but also day-to-day operations such as the hiring, terminating or changing the compensation of executive officers. The affirmative vote of both Investor Managers is required to increase compensation to any executive officer, approve the company's annual operating budget, effect a change in the company's independent auditors or accounting methods, or amend or modify the incentive plan or employee stock ownership plan.

The Board, including at least one of the Investor Managers, has the power to approve DHS Tech's acceptance of any new members or the withdrawal of existing members, or any increase or decrease in authorized interests, reclassification of any outstanding interests, or increase or decrease in the size of the Board. The Area Office found that these powers give DHS Holding the power to control DHS Tech's financial resources.

The Area Office thus concluded that DHS Holding has the power to control DHS Tech, which controls Appellant.

### 3. Control of DHS Tech

DHS Holding is 96.33% owned by Carlyle Venture Partners II L.P. (CV Partners) and 3.67% owned by CVPII Coinvestment, L.P. (CVPII). TCG Holdings, LLC (TCG Holdings) controls both entities. TCG Holdings is controlled by a three-person Board consisting of the founders of Carlyle. Therefore Carlyle, a firm which employs more than 900 people, controls DHS Holding, which in turn controls Appellant. The Area Office thus concluded Appellant was other than small.

### C. The Appeal

On December 9, 2010, Appellant appealed the Size Determination. Appellant asserts the Size Determination is based upon errors of law and fact. Appellant further asserts the Area Office erred in basing its decision on the question of DHS Holding's control of Appellant, when this issue was not raised by the protest. Appellant's submissions to the Area Office did demonstrate that Appellant itself had not been acquired by Carlyle, and that Mr. Finelli's role as

a member of Appellant's and DHS Tech's Boards and a Managing Director of Carlyle did not create any affiliation between Appellant and Carlyle. Appellant thus argues that the Size Determination must be reversed because the grounds of the initial protest are without merit.

Appellant further argues the Area Office failed to grant it due process because Appellant was denied a meaningful opportunity to respond to the issues raised by the Area Office in the size determination.

As to the merits, Appellant asserts that DHS Holding does not have the power to exert negative control over Appellant. Appellant argues that negative control exists when a minority shareholder has the power to prevent a quorum of a concern's board of directors, deadlock the board, or otherwise prevent the board from acting thus controlling the management of the concern.

Appellant argues that OHA has also held that the mere ability of the minority to block or veto certain actions does not result in negative control. This is true when the actions in question which can be blocked or vetoed are not part of the ordinary management of the concern, but are extraordinary actions and the purpose of the minority rights is to protect the minority's investment.

Appellant asserts that OHA has held that supermajority requirements do not result in a finding of negative control when those requirements are for the protection of rights of minority investors and not control over the concern's daily operations. These were matters such as sale or disposition of assets, acceptance of new capital contributions, addition of members to an LLC, amendment of the operating agreement in a way that materially alters members' rights, amendments to bylaws, issuance of additional shares of capital stock, sale or lease of all of a concern's assets, etc.

Appellant argues that the essence of negative control is the ability of minority shareholders and their representatives on the Board to limit or prevent the management from conducting or overseeing the daily operations of the concern. Here, nothing in the record suggests that DHS Holding has the ability to block or otherwise affect the ability of DHS Tech's management to control the daily operations of Appellant. Here, Mr. Prusmack, and he alone, has the power to control Appellant. He has the majority interest, more than twice the size of DHS Holding's interest. He has the power to appoint four of DHS Tech's seven directors, and must approve one of the remaining three. The Investor Members cannot prevent a quorum and cannot block any daily operational decision approved by a majority of the Board.

Appellant further asserts that the Area Office's findings that DHS Holding has the power to hire and fire the Outside Manager, control DHS Tech's financial resources, amend its Operating Agreement, change the number of its Managers, and hire, terminate and set the compensation of DHS Tech's officers gravely misstate the facts.

Appellant asserts the Investor Managers, together with the Outside Manager, cannot prevent a quorum, or control or deadlock the Board. Even if the Investor Managers can control the Outside Manager, they still have only three votes on a seven-member Board. Appellant

asserts that the Investor Managers have the power only to approve increases in the compensation of officers, not to set compensation.

Appellant further argues that the fact that the Investor Managers must approve the hiring and firing of the Outside Manager is not the same as their actually making the hiring and firing decisions. Appellant argues that there is no basis to equate the right to have the Outside Manager be acceptable with the ability to influence any decision by that Outside Manager. Appellant asserts this is a “jaded” view of company management, and unwarranted without evidence of undue influence. This view is contrary to the Operating Agreement’s imposition of fiduciary duties on the Managers, and the fact that the Outside Manager is expressly intended to be an independent voice.

Appellant also asserts that the Area Office ignored the fact that the Outside Manager must be acceptable to the Common Managers as well as the Investor Managers. This leads to an absurd scenario where the Outside Manager is controlled by both sets of Managers. Appellant concludes that nothing in the record can justify any conclusion that DHS Holding can influence any decision of the Outside Manager.

Appellant also asserts that the Area Office’s finding that DHS Holding has the power to influence decisions of the Board’s committees and subcommittees is premised on the assumption that the Investor Managers will control the decisions of the Outside Manager. Again, where the Common Managers have equal power over the hiring and firing of the Outside Manager, Appellant argues that this is an unreasonable result. Appellant concludes that DHS Holding does not have power to control DHS Tech’s Outside Manager, and thus does not have the power to control or influence the decisions of the Board committees.

Appellant argues that the areas where DHS Holding is given control are not matters of day-to-day operations, but matters of overarching concern about the essential nature and direction of the company and the rights of the minority owners. They are decisions which could have a significant and fundamental impact on the company and the investments made by the minority investors.

Appellant further asserts that the Area Office’s finding that DHS Holding has the power to control DHS Tech’s financial resources is in error. DHS Holding’s power to approve the decision to add a new member or permit the withdrawal of an existing member is not the power to control the company on a day-to-day basis. These are merely the power necessary to protect minority investors.

Finally, Appellant asserts that the Area Office’s Size Determination reflects a lack of understanding of venture capital and private equity investors. Appellant asserts the Area Office equated the entity that establishes and manages a private investment fund with the owners of the funds. The manager is not the owner of the fund, rather the investors of the fund are the owners. The Area Office erred by assuming Carlyle not only controls the funds, but any company in which the fund are invested. The Area Office’s Size Determination will undermine the mission of SBA and prevent small businesses from relying on venture capital and private equity funds as investors.

Appellant submits with its appeal, and moves for admission into the record, new evidence.

#### D. The NVCA Memorandum

Appellant served a redacted copy of the appeal petition on Applied.

On December 21, 2010, the National Venture Capital Association (NVCA), through counsel, moved to intervene. On December 22, 2010, Appellant filed a statement in support of NVCA's intervention. On December 25, 2010, Applied objected to NVCA's Motion to Intervene. Applied asserts NVCA has no stake in the outcome of this case.

On December 27, 2010, Appellant responded to Applied's Objection. Appellant asserts NVCA should be permitted to intervene because any person with a general interest in the issue raised may intervene. 13 C.F.R. § 134.309(a).

On December 28, 2010, NVCA filed its Memorandum in Support of the Appeal. NVCA argues it has an interest here because the outcome of the case will have a significant impact on the capital financing of small business. NVCA essentially reasserts Appellant's arguments. NVCA argues that DHS Holding's Investor Managers on DHS Tech's Board lack the power to control the company. NVCA further argues that a denial of this appeal will harm small business, because it will prevent them from accessing capital. Finally, NVCA argues that a denial of the appeal will harm the Government, as it will not receive offers from the most innovative and promising firms, as these firms will often have private equity and venture capital investors.

On December 29, 2010, Applied moved for a full copy of the appeal petition so it could respond to it. Applied asserts that it is entitled to copies of Appellant's unredacted brief, because Appellant gave a copy to NVCA.

On December 30, 2010, Appellant opposed Applied's motion. Appellant asserted it had only supplied NVCA's counsel with an unredacted appeal. Had Appellant objected timely to the redacted appeal, or obtained counsel and sought a protective order, Appellant would have provided a copy on the same terms as it did to NVCA's counsel.

On January 3, 2011, Applied filed a reply to Appellant's December 30, 2010, Response. Applied maintains it should have the unredacted appeal.

#### IV. Discussion

##### A. Threshold Questions

Appellant filed the instant appeal within 15 days of receiving the Size Determination, and thus the appeal is timely. 13 C.F.R. § 134.304(a)(1).

Appellant provided redacted copies of its appeal to Applied, a non-governmental party, as required by 13 C.F.R. § 134.205(b). Applied had two business days to object to Appellant's

submissions, but failed to do so. 13 C.F.R. § 134.205(b). The regulations do not prevent Appellant from sharing its information with counsel for another party, if Appellant chooses to do so, and Appellant is satisfied the information is protected. Applied could have retained counsel and sought access to the appeal under a protective order. Alternatively, Applied could have filed a response to the redacted appeal. Applied chose to do neither. Applied's motions are DENIED.

In the case of size appeals, any person with a general interest in an issue raised by the appeal may file a response supporting or opposing the appeal. 13 C.F.R. § 134.309(a). NVCA has established its general interest in the issue of affiliation with a challenged firm's minority shareholders. Accordingly, NVCA's motion to intervene is GRANTED.

New evidence on appeal is not admitted unless a motion is filed and served establishing good cause for its admission, or the Judge orders its admission. 13 C.F.R. § 134.308(a). Appellant's first proffered new evidence consists of a resolution of DHS Tech's Board of Managers, which is unsigned and undated, and was not in the record below, and should have been available at the time of the size protest. I EXCLUDE this evidence. The second piece of new evidence is a spreadsheet which is not relevant to the issues in this appeal. I EXCLUDE this evidence.

Appellant has the burden of proving, by a preponderance of the evidence, all elements of its appeal. Specifically, Appellant must prove the Size Determination is based on a clear error of fact or law. 13 C.F.R. § 134.314; *Size Appeal of Procedyne Corp.*, SBA No. SIZ-4354, at 4-5 (1999). OHA will disturb the Size Determination only if the Judge, after reviewing the record and pleadings, has a definite and firm conviction the Area Office erred in making its key findings of fact or law. *Size Appeal of Taylor Consultants, Inc.*, SBA No. SIZ-4775, at 11 (2006).

#### B. The Merits of the Appeal

First, Appellant's argument that the Area Office was limited to examining the grounds raised in the protest is meritless. A size determination may be based upon grounds not raised in the protest. 13 C.F.R. § 121.1009(b). After Appellant's submission of its SBA Form 355 and other information, the Area Office properly considered the whole record before it, and made its size determination.

Appellant's claim of denial of due process is also without merit. OHA has held that a size determination based upon a completely different ground than that raised in the protest, e.g., upon the ostensible subcontractor rule as opposed to the amount of the challenged concern's annual receipts, then the challenged concern has not had adequate notice of the grounds of the protest against it. *Size Appeal of Alutiiq International Solutions, LLC*, SBA No. SIZ-5069 (2009). Here, however, the issue of Appellant's affiliation with Carlyle was the underlying basis for the initial protest, and thus the issue regarding Carlyle's negative control over Appellant was included in the issues the Area Office would have had to examine. It was foreseeable that such issues would arise in the examination of Appellant's relationship with Carlyle, given the careful inclusion of provisions empowering the Investor Managers in DHS Tech's documents. Appellant was represented by counsel who should have appreciated the need to clarify Appellant's relationship with all its possible affiliates, including each entity in the chain between

Carlyle and Appellant. As noted above, the Area Office had the power to go beyond the specific grounds raised in the protest, and thus Appellant's argument that the question of negative control was untimely raised is meritless.<sup>2</sup>

SBA's size regulations provide that concerns are affiliates when one controls or has the power to control the other, or a third party controls or has the power to control both. 13 C.F.R. § 121.103(a)(1). Control may be affirmative or negative. Negative control includes, but is not limited to, instances where a minority shareholder has the ability to block action by the concern's board of directors or shareholders. 13 C.F.R. § 121.103(a)(3). A minority shareholder may be found to have sufficient power to exercise negative control over a challenged concern through its ability to exercise a veto power over certain corporate actions, even though the minority shareholder lacks the affirmative ability to approve actions. *Size Appeal of Jensco Marine, Inc.*, SBA No. SIZ-4330, at 7 (1998).

Here, the Area Office found Appellant other than small because DHS Holding exercises negative control over DHS Tech, Appellant's sole shareholder, and DHS Holding is in turn owned and controlled by entities controlled by TCG Holdings, which is controlled by Carlyle, a large concern. The main issue here is whether DHS Holding, as DHS Tech's minority shareholder, has negative control over DHS Tech, Appellant's immediate parent.

DHS Holding is represented on DHS Tech's Board by the Investor Managers. The Investor Managers have the power to approve the Outside Manager. OHA has consistently held that the power to approve a board member is a veto power which gives the party with that power negative control over the board member approved. *Size Appeal of Regent Mfg., Inc.*, SBA No. SIZ-4533, at 7 (2003); *Size Appeal of Gain Electronics Corporation*, SBA No. SIZ-2779, at 7 (1987).<sup>3</sup>

All the committees of DHS Tech's Board are to consist of the Outside Manager, an Investor Manager, and a Common Manager. Accordingly, I must find that the Investor Managers named by DHS Holding have the power to control these committees, because of the veto power exercised by the Investor Managers in the selection of the Outside Member. The committees specifically identified in the Members Agreement are the Audit Committee and the Compensation Committee, which determines the compensation of the company's officers and the administration of the company's equity incentive plans. DHS Tech Members' Agreement, ¶ 1(b)(1).

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<sup>2</sup> In any event, to find for Appellant on this point would not result in a reversal, but a remand to the Area Office for a new size determination. *Size Appeal of Alutiiq International Solutions, LLC*, SBA No. SIZ-5069 (2009).

<sup>3</sup> OHA has held that certain restrictions on a minority shareholder's approval power, such as it may not unreasonably withhold its approval of management's recommendations, and may itself recommend only persons who are experienced and held in high regard in the industry, may prevent that approval power from constituting negative control. *Size Appeal of Cytel Software, Inc.*, SBA No. SIZ-4837, at 3, 6 (2007). Here, however, there are no restrictions on DHS Holding's approval power.



The DHS Tech Members Agreement contains negative covenants, which require the approval of both Investor Managers before the Board undertakes a number of actions. Among these actions are: increasing the compensation payable to any executive officer, approving the company's operating budget, affecting a material change in the company's accounting methods or policies or any change in the company's independent auditors, and amending or modifying the Incentive Plan or adopt any new Incentive Plan. Members Agreement, ¶ 2(b). Appellant is correct that the Members Agreement does not give the Investor Managers the power to hire or terminate DHS Tech's executive officers.

In reviewing the question of negative control, OHA has held that supermajority requirements which are extensive and prevent the small concern from conducting business as it chooses constitute sufficient control to cause affiliation. *Size Appeal of Firewatch Contracting of Florida, LLC*, SBA No. SIZ-4994 (2008). Such controls include the hiring and firing of executive officers and the setting of compensation. *Id.* at 6. Conversely, those controls which are meant only to protect the investment of the minority shareholders and do not affect the concern's daily operations do not constitute negative control. *Size Appeal of EA Engineering, Science, and Technology, Inc.*, SBA No. SIZ-4973 (2008).

Here, many of the powers held by the DHS Holding through the Investor Managers are in the category of investor protection. Contrary to the Area Office findings, I find that the provisions of the Operating Agreement that give DHS Holding the power to approve the addition of any new members or the withdrawal of any old members, to increase or decrease the size of the Board, increase or decrease the number of authorized interests, or to reclassify interests, do not constitute control of the financial resources of the company. Rather, they are precisely the kinds of controls that OHA has held constitute protection of minority investors, and thus do not result in a finding of control. *EA Engineering*, at 5, 9-10.

However, some of the powers held by the Investor Managers go beyond what is necessary to protect the interest of minority investors, and go to the ability to exercise veto power over the operations of the company. The negative control exercised over Board committees, discussed above, particularly the Compensation Committee, means that DHS Holding can exercise negative control over the compensation of DHS Tech's officers, the choice of auditor, and any other matter referred to a Board committee. DHS Holding's Investor Managers also exercise negative control over the corporate budget, incentive plan, and choice of accounting methods. Control over these matters is not necessary for investor protection, but goes directly to the day-to-day operations of the company.<sup>4</sup> Accordingly, I cannot say the Area Office based its Size Determination on clear error.

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<sup>4</sup> Appellant's reliance on *Size Appeal of Colt Defense, LLC*, SBA No. SIZ-4943 (2008) is misplaced. The minority shareholder in that case had negative control only over certain exceptional transactions, of the type necessary for investor protection. While the plurality shareholder in that case did own twice the amount of stock as the minority shareholder, which is also the case with DHS Tech, that was not the only factor there. There was also the finding that the minority shareholder had no power of negative control over the challenged concern's day-to-day operations, which is not the case here.

Appellant's arguments claiming that the Investor Managers cannot control the Outside Manager fly in the face of OHA precedent, which holds that when a person or entity has the power to approve a director or board member, that person or entity has the power of negative control over them. While it is true that DHS Holding does not have the power to deadlock the DHS Tech Board or to affirmatively approve actions, its negative control over the committees and the key actions subject to the negative covenants of the Board are enough to give it negative control over certain key day-to-day operations of the company and thus, negative control over DHS Tech. I must thus affirm the Area Office's finding that DHS Holding has negative control over, and is thus affiliated with, DHS Tech, and therefore with Appellant which is wholly owned by DHS Tech.

Appellant is thus also affiliated with DHS Holding's owners, CV Partners and CVPII, with the entity that controls them both, TCG Holdings, and with Carlyle, a large concern whose founders comprise TCG Holdings' three person board. Appellant is thus other than small.

Appellant's arguments concerning the nature of private equity funds are inapposite here. Appellant's response to the original protest conceded Carlyle was the owner of DHS Tech. While Appellant discusses the nature of private capital, Appellant at no time offers specific evidence or argument to refute the Area Office's finding that Carlyle is other than small, and thus Appellant is, as well.

Accordingly, I find that Appellant has failed to prove the Area Office's Size Determination was based on clear error of fact or law. I must therefore affirm it.

#### V. Conclusion

For the above reasons, I DENY the instant appeal and AFFIRM the Area Office's Size Determination.

This is the final decision of the Small Business Administration. 13 C.F.R. § 134.316(b).

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CHRISTOPHER HOLLEMAN  
Administrative Judge