

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

SIZE APPEAL OF:

Washington Patriot Construction, LLC,

Appellant,

Appealed From  
Size Determination No. No. 6-2013-039

SBA No. SIZ-5491

Decided: August 12, 2013

APPEARANCE

Jonathan A. DeMella, Esq., Dorsey & Whitney LLP, Seattle, Washington, for Appellant

DECISION<sup>1</sup>

I. Introduction and Jurisdiction

On May 29, 2013, the U.S. Small Business Administration (SBA) Office of Government Contracting, Area VI (Area Office) issued Size Determination No. 6-2013-039 finding that Washington Patriot Construction (Appellant) is not a small business due to affiliation with Wade Perrow Construction, LLC (WPC). The Area Office examined Appellant's size in conjunction with Appellant's request to be recertified as a small business pursuant to 13 C.F.R. § 121.1010.

Appellant maintains that the size determination is clearly erroneous, and requests that SBA's Office of Hearings and Appeals (OHA) reverse. For the reasons discussed *infra*, the appeal is granted, and the size determination is remanded for further review and analysis.

OHA decides size determination appeals under the Small Business Act of 1958, 15 U.S.C. § 631 *et seq.*, and 13 C.F.R. parts 121 and 134. Appellant filed the instant appeal within fifteen days of receiving the size determination, so the appeal is timely. 13 C.F.R. § 134.304(a). Accordingly, this matter is properly before OHA for decision.

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<sup>1</sup> Appellant requested confidential treatment of this appeal. *See* 13 C.F.R. § 134.205. After reviewing the original decision, Appellant proposed certain redactions to protect its confidential information. Having considered these suggestions, I now issue this redacted decision for public release.

## II. Background

### A. Procedural History

In November 2012, the Area Office issued Size Determination No. 6-2013-008, finding Appellant affiliated with WPC through common ownership and management, negative control, and the totality of the circumstances. At the time of this earlier size determination, WPC held a 49% ownership interest in Appellant. Appellant subsequently appealed to OHA, and OHA denied the appeal. *Size Appeal of Washington Patriot Construction, LLC*, SBA No. SIZ-5447 (2013) (*Washington I*).

After Size Determination No. 6-2013-008 was issued, Appellant purchased WPC's 49% ownership interest and undertook certain changes to its company structure. On February 5, 2013, Appellant requested recertification as a small business.

### B. Appellant's Operating Agreement

The record contains a copy of Appellant's Operating Agreement, dated June 16, 2009, which was in effect at the time of Appellant's buyout of WPC. The Operating Agreement states that “[n]o Member may withdraw from the Company, or demand the balance of its capital account, except as otherwise provided in this Agreement,” and further stipulates that “[n]o Member will transfer, sell, give, pledge, encumber or otherwise dispose of any or all of its Percentage Interests, in any manner whatsoever, except in accordance with the terms of this Agreement.” (Operating Agreement §§ 2.5 and 6.1.) Article VI of the Operating Agreement, entitled “Withdrawal, Transfers of Interests”, contains the following provisions pertinent to this appeal:

**6.2 Withdrawal of a Member.** A Member may withdraw from the Company only with consent of the holders of 51% of outstanding Percentage Interests with such consent not [to] be unreasonably withheld. In such an event, the Company will purchase the Percentage Interests of the withdrawing Member at Fair Market Value (as defined herein.)

**6.3 Voluntary Sales.** In the event a Member receives and desires to accept a bona fide offer for any portion of its Percentage Interests, the Member will first offer (by written notice) such Percentage Interests to the remaining Members and the Company, who will have the option, on the terms described Section 6.6 below, to purchase any or all of the Percentage Interests at the lesser of the price set forth in the bona fide offer or Fair Market Value (the latter to be determined by an independent appraiser without considering the terms of the offer).

...

**6.7 Fair Market Value of Percentage Interests.** The ‘Fair Market Value’ of any Percentage Interests, for purposes of this Article VI, will be the amount of the

capital account of the Selling Member when the Purchasing Member gives written notice of its intent to exercise its option.

(Operating Agreement, Article VI, at 7-8.)

### C. The Instant Size Determination

On May 29, 2013, the Area Office issued Size Determination No. 6-2013-039 concluding that Appellant is not a small business due to affiliation with WPC. The Area Office examined Appellant's size as of February 5, 2013, the date Appellant requested recertification as a small business. (Size Determination No. 6-2013-039, at 6.)

The Area Office explained that Mr. Michael Traugutt currently is president and sole owner of Appellant. At the time of the earlier size determination, Mr. Traugutt owned 51% of Appellant, with WPC holding the remaining 49%. (*Id.* at 2.) Effective November 21, 2012, Appellant purchased WPC's 49% interest. The Area Office found that "as of the date of [Appellant's] recertification request, [Mr.] Traugutt owns 100% of [Appellant]." (*Id.* at 3.) The Area Office further determined that the owners and managers of WPC — Mr. Wade Perrow, Mrs. Elizabeth Perrow, and Mr. Dan McKinney — are no longer officers or managers of Appellant. As a result, Appellant is not affiliated with WPC through common management. (*Id.*)

Next, the Area Office indicated that Appellant and WPC may be affiliated under the newly organized concern rule, 13 C.F.R. 121.103(g). The Area Office noted that the two companies are in similar industries; that Mr. Traugutt was employed by WPC from November 2007 to March 2011; that Appellant leases office space from the Perrows and Mr. McKinney; and that WPC provided bonding assistance to Appellant during its startup operations. (*Id.*) The Area Office stated that it asked Appellant to demonstrate a clear line of fracture between itself and WPC to show there is no affiliation under the newly organized concern rule. Appellant responded that Mr. Traugutt never served as a key employee at WPC, and that since May 2010 Appellant has leased office space from Donkey Creek Holdings (DCH), which is partially owned by the Perrows' children. Further, Appellant provided evidence that will obtain bonding from Liberty Mutual Insurance Company, not WPC. (*Id.* at 4.) The Area Office also noted that between 2009 and 2012, Appellant did not receive any contracts or subcontracts from WPC or its affiliates. After reviewing the evidence, the Area Office declined to decide whether Mr. Traugutt was ever a key employee at WPC, or whether Appellant is affiliated with WPC under the newly organized concern rule. (*Id.*)

The Area Office found that, during 2011 and 2012, Appellant outsourced much of its administrative support, accounting, payroll, and information technology needs to WPC. These services accounted for approximately 3.5% of Appellant's revenues. (*Id.*) Although Appellant maintained that the agreement for such services expired on December 31, 2011, the Area Office found that WPC continued to perform these services for Appellant through the end of 2012. (*Id.*) Additionally, the Area Office determined that Appellant subcontracted approximately 22% of its total revenues to WPC in 2010, 11% in 2011, and zero percent in 2012. (*Id.*)

The Area Office next examined the sale of WPC's ownership interest to Appellant. The

Area Office found that Appellant's Operating Agreement requires that any sale of a member's interest be at "fair market value". (*Id.* at 5.) The Operating Agreement defines "fair market value" as the amount of the capital account of the selling member. (*Id.*) The Area Office determined that Appellant issued two checks (one for \$[XXXX] in December 2012 and another for \$[XXXX] in February 2013) to WPC which accounted for WPC's capital account. (*Id.*) However, Appellant and WPC also entered into a Redemption Agreement (RA) and promissory note, which provided for additional payments to WPC. Pursuant to these arrangements, Appellant must pay WPC "a minimum of \$[XXXX] to \$[XXXX], depending on profits, to a maximum of \$[XXXX]." (*Id.*) The Area Office noted that Appellant offered no explanation why there would be further payments from Appellant to WPC, beyond the payment of the capital account as required by the Operating Agreement. (*Id.*)

The Area Office stated the promissory note requires Appellant to quarterly pay WPC the greater of \$[XXXX] or [XX]% of its net profits, provided that the reported net profits allow Appellant to maintain a minimum of \$[XXXX]. (*Id.*) The promissory note lasts for [XX] years, but will expire once WPC collects payments totaling \$[XX]. The Area Office observed that the promissory note does not call for fixed payments. Rather, the note depends on Appellant's future profitability, which renders the amount of the note uncertain. The Area Office expressed concern that the RA and promissory note enable WPC to share the profits from procurements that are intended for small businesses. (*Id.*) The Area Office concluded the RA and promissory note are not arm's-length transactions, and therefore are indicative of affiliation. Further, the Area Office asserted that WPC exerts negative control over Appellant based on WPC's receiving continued payments "above and beyond its capital account." (*Id.* at 6.) The Area Office stated that, after subtracting the requisite payments to WPC, Appellant would have only [XX]% of its profits remaining to reinvest in the business operations of the company.

The Area Office explained that Appellant has a non-cancellable lease for its facilities via an agreement with a concern that shares an identity of interest with WPC. (*Id.*) The Area Office noted that this lease agreement expires in 2022, with Appellant paying \$[XXXX] in 2011, \$[XX] in 2012, \$[XXXX] per year between 2013 and 2016, and a total of \$[XXXX] for the remaining years through 2022. The Area Office concluded that these dollar amounts are not indicative of an arm's-length agreement. (*Id.*) The Area Office noted that Appellant and WPC also appear to have entered into a joint employee profit sharing plan. (*Id.*)

Lastly, the Area Office determined that even if these factors did not individually provide a basis for affiliation, they together show affiliation between Appellant and WPC based on the totality of the circumstances. The Area Office pointed in particular to "the obligation of [Appellant] to distribute a large percentage of its net profits to the former owner for [XX] years or until \$[XX] is paid." (*Id.*)

The Area Office then aggregated Appellant's average annual receipts with those of WPC. The Area Office determined that Appellant, by itself, is a small business, but that Appellant exceeds the applicable \$33.5 million size standard once its receipts are combined with those of WPC. As a result, Appellant is not a small business.

#### D. Security Agreement

To effectuate Appellant's buyout of WPC, Appellant and WPC entered into a Security Agreement in addition to the RA and promissory note. The Security Agreement characterizes Appellant as the “Debtor” and WPC as the “Secured Party,” and pledges Appellant's assets — including all operating equipment and all accounts receivable — to WPC as collateral for Appellant's payments under the promissory note. WPC may seize these assets if Appellant defaults on payments. (Security Agreement at ¶¶ 11-12.) The Security Agreement requires Appellant to insure its property for the benefit of WPC, to keep the property “in good repair,” and to allow WPC to inspect the property “at reasonable times and intervals.” (*Id.* at ¶¶ 6-7.) Appellant may not sell, lease, or transfer property out-of-state without WPC's prior written consent. (*Id.* ¶ 8.)

#### E. Appeal

On June 13, 2013, Appellant filed its appeal of Size Determination No. 6-2013-039 with OHA. Appellant maintains that the size determination is clearly erroneous and should be reversed.

Appellant states that it underwent a corporate reorganization in an effort to remedy its affiliation with WPC as discussed in the prior size determination and in *Washington I*. Appellant states it believed the reorganization was in accordance with SBA's affiliation rules regarding ownership and control, and as such the Area Office's findings of affiliation are misplaced.

Appellant argues that the purchase of WPC's interest in Appellant was an arm's-length agreement which reasonably compensates WPC for the value of future earnings that WPC would have enjoyed if it had retained its interest in Appellant. Appellant asserts that as a result of the sale of WPC's interest, and as evidenced by Appellant's First Amended and Restated Operating Agreement dated November 21, 2012, Mr. Traugutt is now the sole Member and manager of Appellant, as well as Appellant's 100% owner. (Appeal at 4.) Appellant explains the promissory note establishes a maximum payment of \$[XXXX] and a minimum of \$[XXXX] to WPC. It also provides that payments will be made in installments on a quarterly basis but contingent on Appellant maintaining \$[XX] in equity, as well as capping installment payments at [XX]% of Appellant's net profit. Additionally, quarterly payments would, at a minimum, be at least \$[XX]. Lastly, the promissory note provides for a [XX] year term. (*Id.*)

Appellant also explains that the two payments pertaining to WPC's capital account reflected “WPC's [XX]% share of [Appellant's] profits in WPC's capital account *from the time of [Appellant's] formation through the time of WPC's withdrawal in 2012.*” (*Id.* at 5, emphasis in original.) Appellant adds that the payments did not take into consideration ongoing projects or expected future profits, which would not come to fruition until 2013 or 2014. (*Id.*) Appellant states that the Area Office erred in characterizing the sale of WPC's interest as not an arm's-length transaction, and that any concerns regarding Appellant's reorganization could have been addressed to the Area Office's satisfaction, if the Area Office had sought more information.

Appellant asserts that the Area Office appears to have analyzed the 2012 version of Appellant's operating agreement, rather than the 2009 version in effect at the time of the restructuring. According to Appellant, "there is nothing in the 2009 Operating Agreement that precludes WPC as the minority member from negotiating a redemption based upon the future value of its interest in the company." (*Id.* at 7.) Appellant argues such an arrangement is customary business practice. (*Id.*) Appellant states the \$[XX] amount beyond the amount of WPC's capital account is reflective of WPC's share of expected profits if it had remained a member of Appellant for the next three years. Appellant insists that the parties "adopted a commercially recommended, reasonable, and formulaic means to identify the fair market value of WPC's interest in [Appellant]." (*Id.* at 8.) Appellant further maintains that the 2009 Operating Agreement distinguishes a unilateral withdrawal of a member from a "casual sale or redemption transaction" as occurred here. Thus, the sale of WPC's interest was an arm's-length transaction reflecting "freely and intentionally negotiated" terms. (*Id.*)

Next, Appellant asserts the Area Office erred in finding that WPC exercises negative control over Appellant. Appellant argues that the Area Office incorrectly surmised that WPC could not be entitled to any payment beyond the amount of WPC's capital account. (*Id.* at 9.) Appellant states the redemption reflects "a negotiated, arm's-length agreement in which both parties bargained for and negotiated value for their competing interests." (*Id.*)

Appellant further argues that SBA's size regulations and OHA case law permit the type of transaction Appellant and WPC engaged in, and the size determination lacks any evidence showing that WPC exerts any negative control over Appellant's daily operations. Appellant cites OHA precedent explaining that negative control occurs when a minority owner can block ordinary actions essential to operating a company. Appellant asserts that none of the typical elements of negative control are found here, because Mr. Traugutt is the sole member and manager of Appellant, WPC does not provide bonding assistance for Appellant, and WPC does not exert financial control over Appellant. (*Id.* at 10.)

Appellant next argues that the Area Office erroneously determined that Appellant's lease agreement is suggestive of affiliation with WPC. Appellant states its previous lease involved 400 square feet of space for approximately \$800 per month. (*Id.*) The new lease mentioned by the Area Office is for 11,600 square feet at a rate of \$12 a square foot, approximately \$11,430 per month for 10 years, which is a fair market rate. (*Id.*) Appellant asserts the lease was "negotiated and agreed upon with the advice of independent legal counsel and are memorialized on a [standard] form commonly used in the industry." (*Id.*) Appellant further states the new space is leased from Donkey Creek Holdings (DCH), in which Mr. Perrow holds less than [XX]% interest, and that the lease does not establish that Appellant is affiliated with WPC. Appellant adds that in the prior size determination, the same Area Office found no issue with Appellant's lease, and instead concluded that the lease was at market value and at arm's-length.

Next, Appellant states that clear fracture exists between Appellant and WPC. Appellant emphasizes that Mr. Traugutt was never a key employee of WPC, the lease agreement between Appellant and DCH reflects a market value rate, WPC no longer provides bonding assistance to Appellant, WPC has not performed administrative functions for Appellant since 2012, Appellant has not received subcontracts from WPC and no longer subcontracts work to WPC, and WPC

has no continuing ownership or managerial interest in Appellant. Appellant maintains these facts show a clear fracture between Appellant and WPC, and the Area Office should have determined that Appellant and WPC are not affiliated under the newly organized concern rule. (*Id.* at 12-13.)

Appellant argues the Area Office erred in suggesting that Appellant's employee profit sharing plan indicates affiliation with WPC. Appellant explains that when Appellant started its profit sharing plan in 2010 it utilized WPC's investment agent, but as a result of the reorganization accompanying WPC's buyout, Appellant became the “parent” of the plan. (*Id.* at 13.) Appellant acknowledges that some WPC employees have been permitted to continue to participate in the plan, through an arrangement with the investment agent, in order to limit the impact on those employees. Nevertheless, Appellant insists, there is no evidence that WPC has the power to control Appellant via the employee profit sharing plan. (*Id.*)

Lastly, Appellant argues that OHA case precedent clearly establishes that in order to find affiliation based on the totality of the circumstances, one of the concerns must control or have the power to control the other. Here, Appellant argues that the Area Office has failed to show, based on the facts, how WPC could control Appellant. Appellant concludes the Area Office failed to show affiliation based on the totality of the circumstances and as such, the size determination should be reversed. (*Id.* at 14-15.)

### III. Discussion

#### A. Standard of Review

Appellant has the burden of proving, by a preponderance of the evidence, all elements of the appeal. Specifically, Appellant must prove the size determination is based upon a clear error of fact or law. 13 C.F.R. § 134.314. OHA will disturb an area office's size determination only if, after reviewing the record, the administrative judge has a definite and firm conviction that 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. Analysis

The Area Office based its decision in this case largely upon its conclusion that Appellant paid substantially more than “fair market value” in acquiring WPC's 49% interest in Appellant. The Area Office reasoned that Appellant's Operating Agreement defined “fair market value” as being limited to the amount of a member's capital account. *See* Sections II.B and II.C, *supra*. Appellant acknowledged that, in addition to refunding WPC's capital account, Appellant agreed to make other large payments to WPC — cumulatively totaling \$[XX] to \$[XX] — in installments over a multi-year period. Because Appellant agreed to pay WPC so much more than “fair market value” as defined in Appellant's Operating Agreement, the Area Office concluded that the transaction was not negotiated at arm's-length, and that the two firms remained affiliates, as they had been before the buyout occurred.

Appellant counters that it is standard business practice that a selling owner be compensated for both future earnings and retained capital. Thus, in Appellant's view, it was not

improper for Appellant to agree to pay WPC more than the value of the capital account. Further, Appellant asserts that, under SBA regulations, affiliation exists when “one [concern] controls or has the power to control the other, or a third party or parties controls or has the power to control both.” 13 C.F.R. § 121.103(a); *see generally Size Appeal of Global, A 1st Flagship Company*, SBA No. SIZ-5462 (2013). Here, Appellant insists, the Area Office failed to find any facts to show that either Appellant or WPC had the power to control the other as of February 5, 2013, the date of Appellant's recertification request. On the contrary, the Area Office specifically determined that, by February 5, 2013, WPC no longer held any ownership or managerial interest in Appellant. Section II.C, *supra*. Nor did the Area Office identify any other indicia of control, such as shared resources or extensive business dealings. *Id.*

I agree with Appellant that the size determination does not clearly articulate a sound rationale for concluding that Appellant and WPC are affiliated as of February 5, 2013. First, while it may be true that Appellant substantially overpaid for WPC's interest, it does not necessarily follow that the entire transaction is inherently suspect. Such an overpayment might, for example, simply be attributable to poor business judgment on the part of Appellant, and the size determination does not explain how an overpayment establishes that the transaction was not at arm's-length. Moreover, regardless of whether Appellant overpaid for WPC's interest, the transaction occurred on November 21, 2012, approximately two months before the date to determine size. Thus, even assuming that the buyout might not have been conducted at arm's-length, the size determination does not describe how WPC could continue to control Appellant, or *vice versa*, some two months after the transaction was completed. *E.g., Size Appeal of A & H Contractors, Inc.*, SBA No. SIZ-5459, at 7-8 (2013) (historic ties do not establish current affiliation).

On the other hand, as discussed in Section II.D above, the record contains a Security Agreement executed by Appellant and WPC concurrently with the buyout of WPC. Under the Security Agreement, Appellant pledged its assets to WPC as collateral, authorizing WPC to seize those assets in the event of default. Among its other terms, the Security Agreement restricts Appellant from selling, leasing, or transferring assets out-of-state without WPC's prior written consent. Thus, the Security Agreement may provide a mechanism for WPC to continue to control Appellant even after the buyout, such as by blocking “ordinary actions essential to operating the company.” *Size Appeal of BR Constr., LLC*, SBA No. SIZ-5303, at 8 (2011). Appellant did not address the Security Agreement in its filings with the Area Office, and the size determination likewise is silent on this document. Accordingly, there remains a significant unexplored issue as to whether WPC may continue to control Appellant via the Security Agreement or otherwise.

#### IV. Conclusion

The size determination does not clearly explain why Appellant and WPC remain affiliates as of February 5, 2013. Accordingly, the appeal is GRANTED, the size determination is VACATED, and the matter is REMANDED for further review and analysis in accordance with this decision.

KENNETH M. HYDE  
Administrative Judge