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Game Changer: The Presumed Loss Rule and Mis-Certification of Small Business Status

By Albert B. Krachman, Esq.[1]

A provision in the Small Business Jobs Act of 2010[2] significantly raises the stakes for contractor misrepresentation of small business status. Now, a federal contractor that receives an award after incorrectly representing itself as a small business may face False Claims Act ("FCA") exposure for three times its total contract proceeds, plus other damages, even if the contractor fully performed the contract to the satisfaction of the government. Companies bidding as small businesses are on notice to carefully review their compliance status, or perhaps face business ending U.S. Department of Justice ("DOJ") or whistleblower litigation.

Background

The Small Business Act ("SBA") has always contained sanctions for misrepresentation of small business status.[3] A false certification can lead to a fine in excess of $500,000 and imprisonment.[4] However, the SBA has lacked sufficient resources for vigorous enforcement of these laws, and prosecutors have not been active in bringing criminal prosecutions based on misrepresentation of small business status. Section 1341 of the Jobs Act, referred to as the Presumed Loss Rule, is a game changer in the enforcement of small business certification fraud because it incentivizes the use of the FCA as a remedial measure for status misrepresentation. This new provision not only will encourage more litigation by the DOJ, but also by whistleblowers with information that their employers are misrepresenting their company's small business status. Those whistleblowers can receive between 15% and 25% of the trebled damages, plus costs, fees, and interest.

Prior Law on False Claims Act Damages

Misrepresentation of small business status has long been recognized as actionable under the FCA. The Court of Federal Claims decision in *Ab-Tech Construction v. United States*[5] made clear that misrepresenting small business eligibility is a form of contract fraud and is redressable under the FCA. But a corollary holding in *Ab-Tech* limited the damages recoverable under the FCA for misrepresentation of small business status when the misrepresenting contractor fully performed the contract to the government's satisfaction.[6] The *Ab-Tech* court ruled that even if the business had misrepresented its status to win the contract, if the contractor fully performed, the government essentially received the full benefit of its bargain and thus was not damaged. Hence, the damages recoverable under an FCA case did not include all of the contract payments received by the misrepresenting contractor.[7] Instead, the FCA plaintiff could only recover the stipulated penalty of $5,500 – $11,000 per contract invoice.[8]

By not requiring the misrepresenting contractor to disgorge all of its contract payments as FCA damages, a private claimant had less incentive to use the FCA to enforce small business status misrepresentation because the big damage dollars, represented by the total contract proceeds, were of questionable recovery.

The DOJ has previously urged a more expansive damage recovery in these fraud-in-the inducement misrepresentation cases. The DOJ has argued that all contract proceeds received by the misrepresenting contractor should be FCA damages, and all payments disgorged regardless of whether

the government received its contracted–for benefits.[9] The new law comes close to codifying the DOJ position.[10]

The Presumed Loss Rule

Title IV of the Small Business Jobs Act, "Small Business Size and Status Integrity," provides in relevant part:

(w) PRESUMPTION.

(1) IN GENERAL. In every contract, subcontract, cooperative agreement, cooperative research and development agreement, or grant which is set aside, reserved, or otherwise classified as intended for award to small business concerns, there shall be a presumption of loss to the United States based on the total amount expended on the contract, subcontract, cooperative agreement, cooperative research and development agreement, or grant whenever it is established that a business concern other than a small business concern willfully sought and received the award by misrepresentation.

(2) DEEMED CERTIFICATIONS. The following actions shall be deemed affirmative, willful, and intentional certifications of small business size and status:

(A) Submission of a bid or proposal for a Federal grant, contract, subcontract, cooperative agreement, or cooperative research and development agreement reserved, set aside, or otherwise classified as intended for award to small business concerns.

(B) Submission of a bid or proposal for a Federal grant, contract, subcontract, cooperative agreement, or cooperative research and development agreement which in any way encourages a Federal agency to classify the bid or proposal, if awarded, as an award to a small business concern.

By presuming the government suffers a loss based on the total amount the government expends on the contract where small business status has been misrepresented, with no offset or credit for the value or benefit received by the government, the law increases contractor exposure.

For example, assume that a contractor ineligible for small business status nonetheless represented that it was a small business and won a $5,000,000 small business set aside contract to build a government warehouse. The contract called for two payments of $2,500,000 each, upon the contractor's invoicing after meeting two milestones. The contractor properly performed the contract to the government's satisfaction, issued its two invoices and timely received the $5,000,000 in milestone payments. The contractor delivered the warehouse on time and according to specifications.

Before the Presumed Loss Rule, if the government or a Relator filed an FCA case against the contractor for the small business status misrepresentation, the FCA damages might not include the $5,000,000 in contract earnings because the government received a conforming warehouse.[11] If *Ab-Tech* was applied, the contractor might only be exposed to the per-invoice penalty of $5,500, making the total FCA damages $11,000 (assuming a penalty of $5,500 for each of the 2 invoices). This FCA action probably would never be brought.

The game changes dramatically under the Presumed Loss Rule. Now, there is an irrebuttable presumption that the government sustained a $5,000,000 loss irrespective of whether the contractor fully performed and irrespective of whether the government received value.[12] An FCA case against the contractor now could be worth $15,011,000, based on a trebling of the $5,000,000 presumed loss,[13] plus the two penalties of $5,500 per invoice. In short, the exposure jumps from $11,000 to $15,011,000. This FCA action probably would be brought!

Notably, the Committee Report states that the presumption is *irrebuttable.* The statute itself refers just to a presumption. The Report also states that it is intended to apply "in all manner of criminal civil administrative contractual or other actions which the United States government *may* take to redress such fraud and misrepresentation." The FCA fits this definition squarely.[14]

Impacts on Large Business

The Presumed Loss Rule also has significant implications for large contractors doing business with companies claiming they are small businesses:

- From an acquisitions perspective, a large business acquiring a small business government contractor must now be extra vigilant in verifying that the acquired company was truly eligible as a small business at the time it submitted its bid. Otherwise, where the acquisition is through a stock purchase, the acquiring large business could unwittingly inherit a very significant liability.
- If a large business is bidding as a major subcontractor to a small business prime on a set-aside contract, such as a construction project where the large business is performing more than 75% of the work, under a *de facto* joint venture theory, the large business could find itself as a named defendant if the small business prime misrepresented its status to win the contract.
- Large contractors who plan to team with small businesses for set aside work must, before bid, ascertain whether the teaming or subcontracting arrangement itself is likely to cause the subcontractor to lose its small business status. Among other factors, the government will look at the totality of the circumstances of the contracting arrangements between the large and small businesses, and between the companies' respective managers and owners, if any such agreements exist. If the contracting arrangements destroy the small businesses' eligibility, then under the Presumed Loss Rule, all the contract proceeds could be forfeited, and the companies could face treble FCA damages.
- A large business joint venture partner or a joint venture team member under a Mentor–Protégé agreement with an alleged small business could face liability if the small business partner or team member misrepresented its status in bidding a set–aside contract.

Plainly, large businesses doing business with firms representing that they are eligible for small business status must be extra vigilant in verifying the small business contractor's eligibility, and because of these new catastrophic financial consequences, it would be reckless to enter into a relationship without undertaking the requisite diligence.

Limiting Risk—Safe Harbor

The Act recognizes that there may be circumstances in which an innocent mistake or inadvertent error in representing small business status might be excusable and should not be the basis for application of the Presumed Loss Rule. The Act directs the SBA to promulgate regulations to provide guidance in this area.[15] It is likely that the regulation will condition any "inadvertence defense" on the contractor's showing that it met a standard of care before making the certification. There are resources available for a contractor to meet this standard of care to self check the eligibility of itself or another. The contractor could consult the SBA size regulations, the decisions of the SBA Office of Hearings and Appeals, or could refer to the services offered at www.blankrome.com/GoCoSmallBusiness. By using these resources, contractors can protect themselves by showing that they exercised reasonable diligence and should not be subject to the Presumed Loss Rule.

Conclusion

The upshot of the law is clear. First, small business companies must proactively audit their eligibility to bid as a small business before submitting their proposals. Depending on the applicable size standards, they should review their employee levels and three–year revenue numbers. They should also examine whether they have become affiliated with another entity or have otherwise run afoul of any of the other regulatory requirements, such as the ostensible subcontractor rule. **The Board of Directors of every federal contractor representing itself as a small business has a fiduciary duty to ensure that the company is not willfully or negligently exposing itself to this catastrophic liability.**

Second, a large company doing business or proposing to do business with a small business government contractor should take steps to verify the small business status of the small business before proceeding with any transaction, whether it be a subcontract, teaming arrangement or an acquisition. Large businesses also need to examine whether the proposed transaction itself could destroy the small business eligibility of their counterparty—or else both could be working for free, or worse.

Third, companies incorrectly certifying their status are now much more likely to face FCA cases by insiders who have information that the company misrepresented its small business status. As the *Longhi* case illustrated, the incentives for filing these cases are now great.

Finally, if an ineligible company bids, wins and fully performs a small business set aside contract, it may be exposed under the FCA to *three times the amount of the contract proceeds received,* plus other damages, irrespective of whether the government received value. The disincentives for using the FCA are gone, and very real high dollar cases will be possible against firms misrepresenting their size.

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2. Pub. L. No. 111-240 §1311-1347 (September 27, 2010) ("Jobs Act").
3. For purposes of this article, "misrepresentation" refers to a firm's representation of itself as a small business when the firm is actually ineligible for that status under regulatory eligibility standards. Representative areas of non-compliance include: exceeding annual receipts thresholds or numerical employee limits, violating affiliation limitations, the ostensible subcontractor rule, or other restrictions.
4. Section 16(d) of the Small Business Act, 15 U.S.C. § 645(d), makes it a criminal offense to misrepresent in writing the "status of any concern as a 'small business concern', a 'qualified [Hub–zone] small business concern', a 'small business concern owned and controlled by socially and economically disadvantaged individuals', or a 'small business concern owned and controlled by women', in order to obtain for oneself or another" any prime contractor subcontract to be awarded pursuant to various contracting programs. Violations of Section 16(d) are punishable by a fine of not more than $500,000 or by imprisonment for not more than ten years or both.
5. 31 Fed. Cl. 429 (Fed. Cl. 1994), *aff'd.,* 57 F.3d 1084 (Fed. Cir. 1995).
6. The theory is known as the benefit of the bargain approach, which has been adopted by other courts. *See, e.g.,* United States ex. rel. *Harrison v. Westinghouse Savannah River Co.,* 352 F.3d 908 (4th Cir. 2003); United States ex. rel. *Stebner v. Steward & Stevenson,* 305 F.Supp. 2d 694, 701 (S.D. Tex Jan. 30, 2004).
7. *But see United States ex rel. Longhi v. Lithium Power Techs., Inc.,* 530 F. Supp. 2d 888 (S.D. Tex. 2008); *aff'd,* 575 F.3d 458 (5th Cir. 2009) (assessing damages resulting from four contracts obtained by fraud in the inducement, and finding that the government received no "benefit of the bargain." The court analyzed the purpose of the Small Business Innovation Research Program (the program at issue in the case), and found that the value of the program was based on innovation by an *"eligible small business."* Since the defendant was not an eligible small business and instead obtained the contracts through fraud, the court found that the appropriate measure of actual damages was the amount paid out on the four contracts multiplied by three). It is important to note that on appeal, the court emphasized that procurement contracts, where the government ordered a specific product or good and did receive a tangible benefit, might not have the same total forfeiture result: the *Longhi* court thus preserved the rule set forth in Ab-Tech. *United States ex rel. Longhi v. Lithium Power Techs., Inc.,* 575 F.3d 458, 473 (5th Cir. 2009). The Presumed Loss Rule thus reflects a critical change in the law because it presumes loss on procurement contracts where the government received a tangible benefit.
8. 31 U.S.C. § 3729(a).
9. In fraud or FCA cases not involving misrepresentation of small business status, courts have ruled that a party that provided a benefit to the government could not recover from the government in law or equity when that party fraudulently induced the government to enter into the contract in the first instance. In those cases, the government is not required to restore the defrauding party back to the status quo, and is not required to restore the purchase price or reimburse the claimant for expenditures incurred or for benefits conferred. See, e.g., American Heritage Bancorp. v. United States, 61 Fed. Cl. 376 (Fed. Cl. 2004), citing Pan American Petroleum & Trans Company v. United States, 273 U.S. 456 (1927). Yet, as recently as December 2010, in an appeal of an FCA case filed against Science Applications International Corp. ("SAIC"), the Circuit Court for the District of Columbia reversed a District Court's ruling that SAIC was liable under the FCA. United States v. Sci. Applications Int'l Corp., 626 F.3d 1257 (D.C. Cir. 2010). At issue in this case was SAIC's alleged failure to make required disclosures of organizational conflicts of interest ("OCIs") as was required under two contracts that SAIC entered into with the Nuclear Regulatory Commission. *United States v. Sci. Applications Int'l Corp.,* 653 F. Supp. 2d 87, 92 (D.D.C. 2009). The district court found that "where the government alleges that it would not have accepted or paid for such advice from the defendant if it had known of the defendant's false or fraudulent claims, the government can properly contend and prove that its damages are all amounts paid because of the false claims that would not have been paid out if the defendant had not made the false claims." *Id.* at 108. The Circuit Court, however, found error in the District Court's instructions that the FCA damages did not have to take into account the value of the services provided by SAIC. Instead, according to the Circuit Court the measure of damages should have been "the amount of money the government paid due to SAIC's false claims over and above what the services the company actually delivered were worth to the government." *Sci. Applications,* 626 F.3d at 1279. On the damages issue, the DC Circuit ruled that SAIC was entitled to credit for the value of services it provided the government, similar to the *Ab-Tech* result.
10. The Committee Report from the Senate Committee on Small Business and Entrepreneurship explained the background of the Presumed Loss Rule as follows:

    > Under current law, the government has difficulty proving loss when the fraud was in the inducement to receive a contract and not in performance of the contract. The SBA IG testified that such cases still involve both the societal loss and the programmatic loss to the Federal Government. To solve this problem, the bill creates an irrefutable statutory presumption that small business size or status fraud constitutes a loss to the government of contracting dollars diverted to large firms on a dollar–for–dollar basis. The Committee intends that this presumption shall be applied in all manner of criminal, civil, administrative, contractual, common law, or other actions, which the United States government may take to redress such fraud and misrepresentation.

    Senate Report No. 111-343, 111 Cong. 2d. Session.
11. However, in this scenario, while the government received that tangible benefit of a warehouse, the work was done by an ineligible company.
12. In the SAIC case, the government requested jury instructions on FCA damages that directed the jury not to account for the value of the services SAIC furnished to the government. The Appeals Court stated that this "automatic equation of the government's payments with its damages is mistaken." *Sci. Applications,* 626 F.3d at 1278. The Appeals Court added that it saw no basis for adopting an irrebuttable presumption that treats the services provided by SAIC as worthless. *Id.* at 1280. Notably, in the small business fraud area, the Presumed Loss Rule effectively does both: it automatically equates the dollar payments with government loss, and it creates an irrebuttable presumption that such amount is the government's loss.
13. 31 U.S.C. § 3729(a)(1)(G).
14. *See generally* 31 U.S.C. § 3729(a)(1). To the extent wrongdoing occurred after the effective date of the Patient Protection and Affordable Care Act, or after May 20, 2009, the Federal False Claims Act's recent amendments apply. *See g.* 31 U.S.C. § 3729(a)(1)(A).
15. 15 U.S.C. § 632(w)(4) (2011).