



The Presumed Loss Rule: Bounty Hunting Meets Small Business Mis-Certification

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There is a new federal law in town that will bring Qui-Tam bounty hunters into the field of mis-certification of small business status. Without question, both large businesses contracting with small businesses and small businesses themselves need to take protective measures to limit this new exposure.

The "Presumed Loss Rule" in the Small Business Jobs Act of 2010 ("Jobs Act") 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 government received value for the contract work and the contractor fully performed the contract to the satisfaction of the government. Large companies bidding with small businesses, and small businesses, are on notice to carefully review their compliance status, or perhaps face business ending U.S. Department of Justice ("DOJ") or Qui-Tam whistleblower litigation.

The Small Business Act ("SBA") has always contained sanctions for misrepresentation of small business status. A false certification can lead to a fine in excess of \$500,000 and imprisonment. 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.

For example, assume that a contractor ineligible for small business status nonetheless represented that it was a small business and won a \$5 million small business set aside contract to build a cardiology monitoring system for a VA hospital. The contract called for two payments of \$2.5 million 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 million in milestone payments. The contractor delivered the system 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 would not include the \$5 million in contract earnings because the government received a conforming cardiology system. Instead, only the "invoice penalty" of \$5,500 would be applied to the two invoices, making an FCA case worth only \$11,000. 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 million loss irrespective of whether the contractor fully performed and irrespective of whether the government received value. An FCA case against the contractor now could be worth \$15,011,000, based on a trebling of the \$5 million presumed loss, plus the two penalties of \$5,500 per invoice. In short, the exposure jumps from \$11 million to \$15,011,000. This FCA action probably would be brought!

Impacts on Large Business

The Presumed Loss Rule 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.

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.

Impact on Small Business

Small businesses must review their employee levels and three-year revenue numbers against the applicable NAICS codes to be sure they are, or were compliant at the time of their proposal submissions. They should also examine whether they may have inadvertently 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.**

An in-depth legal analysis of the Presumed Loss Rule can be found at <http://www.blankrome.com/index.cfm?contentID=37&itemID=2427>.

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