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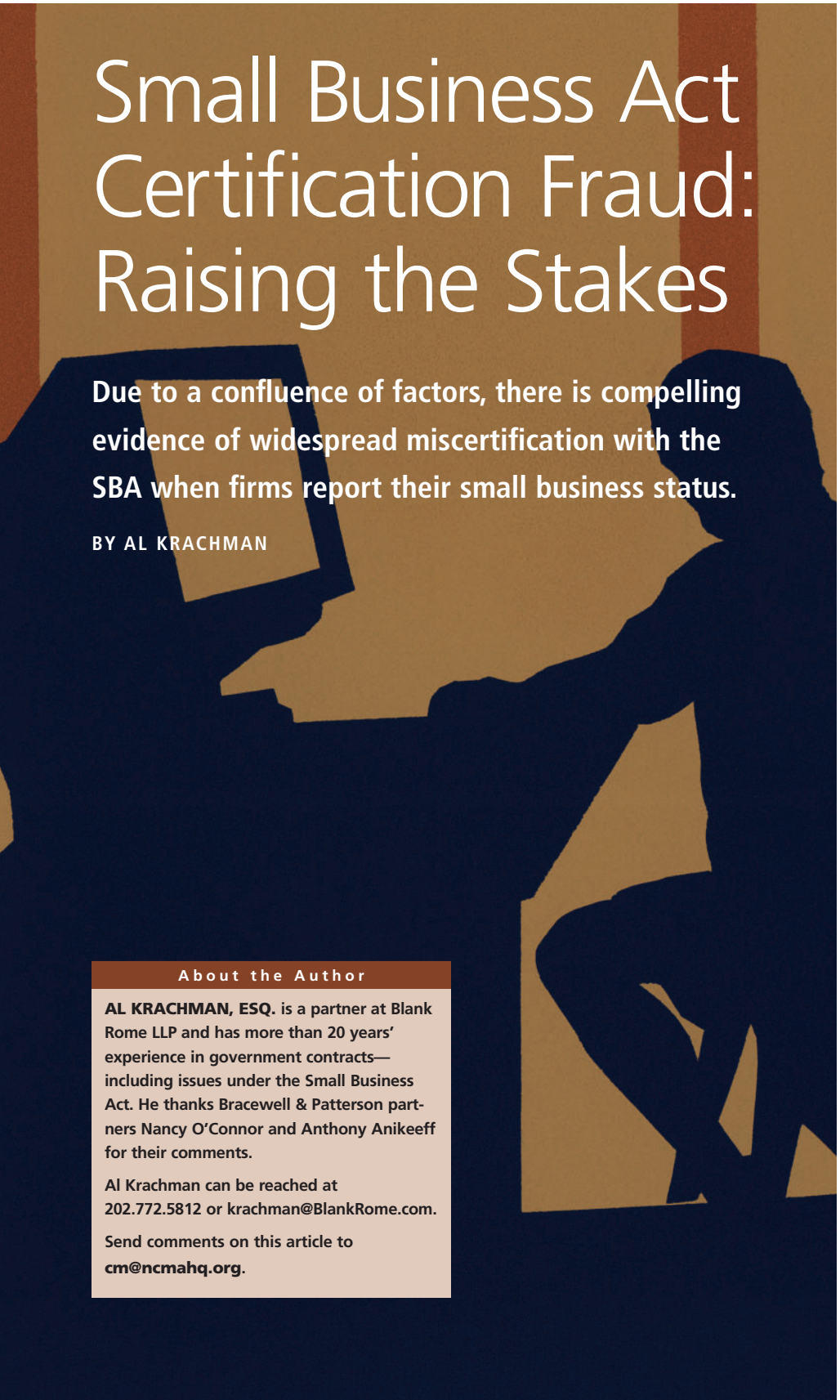
Small Business Act Certification Fraud: Raising the Stakes

Due to a confluence of factors, there is compelling evidence of widespread miscertification with the SBA when firms report their small business status.

BY AL KRACHMAN



About the Author

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"Houston, the Small Business Act has a problem." An escalating number of firms are routinely miscertifying their small business status, to the detriment of both "true" small businesses and more honest larger businesses.[1] Although misrepresentation of a firm's status as a small business concern can be a felony, recent statistics suggest that the practice is pervasive and growing.

Beneath the Surface

A six-year probe in the Department of Transportation alone has resulted in 40 indictments, 29 convictions, and $10.7 million in fines, based on an investigation of 42 cases in 17 states and territories for disadvantaged business enterprises (DBE) fraud. A recent study, commissioned by the SBA Office of Advocacy, identified $2 billion in prime contract awards improperly going to ineligible "small" firms on the basis of a very narrow sample.[2] The study also found that more than 55,000 consolidated parent companies received $23.2 billion in small business prime contracts in FY02. The General Accounting Office identified five unquestionably large companies that, based on miscertification, received more than 2,300 contract awards valued around $400 million over a two-year period.[3]

Why is this happening? Some firms may simply misunderstand the complex eligibility criteria in Small Business Act size regulations. Others take advantage of the apparent "loopholes" in size regulations. Difficulties in detecting fraud handicap both federal enforcement agencies and competitors who are constrained by the onerous five-day time period for filing size protests. Pressures on contracting officials to meet program

requirements, Small Business Administration budget cuts, and the appearance of lax enforcement all contribute to the fraud-friendly climate. The net effect, however, is that "true" small business contractors are not receiving their fair share of awards. Instead, billions of government contracting dollars reserved for small business are going to large or otherwise ineligible firms.

Proposal for Change

This article proposes two changes to existing laws to help level the playing field in favor of both the truly eligible contractors and the contractors honest enough to avoid miscertification.[4] The first suggested change is to elevate SBA compliance to the "priority list" of laws and regulations, which would trigger suspension or debarment under Part 9 of the *Federal Acquisition Regulation (FAR)*. The second suggested change is to modify the False Claims Act (FCA) to address a limitation on damages related to SBA violations.[5] At little cost to the government, these changes could greatly increase compliance by significantly increasing the risks of and penalties for miscertification.

Although the SBA provides criminal sanctions for miscertification, there are few reported prosecutions.[6] The statistics on certification abuse reflect that the threat of adverse action under the SBA is not an effective deterrent to status contracting fraud—especially in light of the billions of dollars available in committed contract awards. Adding debarment or enhanced FCA exposure to the arsenal of available sanctions would adjust the balance in the risk calculus for non-compliant firms and increase the competitive opportunities for hundreds, if not thousands, of true small business contractors.

Proposed *FAR* Revision

Only "responsible" contractors are eligible to receive federal contracts under the *FAR*.[7] A responsible contractor must demonstrate, among other attributes, a satisfactory record of integrity and business ethics. A contractor may lose its eligibility or be deemed "non-responsible" by committing any one of a number of enumerated violations. The *FAR* specifies procedures to suspend or debar contractors from eligibility for contract awards, once the contractor has demonstrated that is non-responsible. The contractor remains suspended or debarred unless and until it establishes that it is "presently responsible."

The *FAR* suspension and debarment regulations include a list of "priority" statutes and regulations, violations of which increase the likelihood of suspension or debarment. These protected categories include violations of the antitrust laws, the Drug Free Workplace Act, and sections of the Defense Production Act, relating to improperly affixing "Made in America" labels.[8] These regulations also contain a catch-all provision authorizing suspension or debarment for commission of "any other offense indicating a lack of business integrity or business honesty that seriously and directly affects the present responsibility of a government contractor or subcontractor."[9]

The SBA is conspicuously absent from this list of "priority" statutes and regulations. The act's absence from the list is particularly anomalous in view of 15 USC § 645(d)(2)(C), which imposes the mandatory suspension or debarment sanctions for miscertification.[10] That statute establishes that miscertification indicates a lack of business integrity, as contemplated by the catch-all suspension regulation at FAR § 9.407-2(a).

If the SBA were included on the priority list, then the possibility of suspension or debarment for detected violations of it should increase.[11] Firms claiming the benefit of preferences would have a greater incentive for exercising greater care in pursuing such eligibility, and firms found to have miscertified their status would face a more significant sanction. Importantly, in the suspension or debarment context, the principals of the offending firms and corporate affiliates can also be included in the suspension or debarment, providing another deterrent to miscertification.

In addition to adding SBA violations to the list of priority statutes and regulations, another change to existing law could provide exponentially greater compliance and significantly broaden the "police force" available to enforce the Small Business Act.

Change to the FCA

Courts have established that if a firm misrepresents itself as a small business and is awarded a contract based on that misrepresentation, then the firm's payment requests are false claims under the FCA.[12] Both civil and criminal liability can result from such a violation: damages recoverable for each claim include treble the actual damages to the government and a $5,500–$11,000 penalty. To date, the FCA has been underused as an enforcement tool for SBA violations.

An action for a violation of the FCA can be brought by any person outside the contracting relationship (i.e., a whistleblower, known under the FCA as the "relator"). The FCA incentivized the reporting of contract fraud by allowing the relator to recover part of any settlement or judgment paid by the FCA violator. However, trying a FCA action can be a costly undertaking. To make such an action financially viable for a relator, the potential damages payable must be significant, and a number of other technical hurdles must be cleared.

In the most common FCA cases, involving a contractor's failure to conduct tests or failure to furnish conforming materials, the damages are readily apparent and easy to calculate. The damages can be measured by the difference between the value of the performance the government received and the contract price. These actual damages can then be trebled and per-invoice penalties calculated and assessed.

There are special problems accompanying the calculation of damages under FCA claims concerning violations of the SBA. For example, if an eligible contractor wins a small

business set-aside contract by miscertification but fully performs the contract, the government may not have any actual damages. The only FCA liability attaching to the offending contractor would be the per-invoice penalty of $5,500–$11,000.

Yet, one could assert also that the contract should be declared void as procured by fraud, and the offending contractor required to repay all its ill-gotten proceeds.[13] This view recognizes that the contractor's actions have damaged the small business program, and a remedy for that injury should include a disgorgement or forfeiture of all proceeds received by the offending contractor.[14]

This issue was litigated in *Ab-Tech Construction v. United States*, when Ab-Tech, an 8(a) contractor, misrepresented its affiliation with a large business subcontractor in connection with the award of a set-aside construction contract.[15] The affiliation, if disclosed, would have made Ab-Tech ineligible for the contract. Ab-Tech fully performed the construction contract and received payment. In a move of questionable prudence, Ab-Tech filed various claims against the government for additional contract payments. In the ensuing claims litigation, the government learned of the disqualifying affiliation and filed an FCA counterclaim against Ab-Tech—asserting that the entire contract proceeds should be disgorged as damages.[16] The court rejected that position and found rather, that since the government received the benefit of its bargain, the offending contractor could retain its proceeds and would only be exposed to the relatively small per-invoice penalty under the FCA.

By excluding the total contract proceeds from the potential damage award, the ruling essentially sidelined the FCA as a valuable enforcement tool for SBA fraud. Specifically, unless all ill-gotten gains from the certification fraud are recoverable as damages, there will generally be both insufficient incentive for relators to report miscertifications and insufficient "incentive" for aggressive contractors to avoid miscertification.[17] If the FCA were modified to put all contract proceeds at risk in the event of miscertification, then this act would serve as more of a powerful enforcer and deterring device.[18] This would have a significant deterrent effect for violations of the SBA by dramatically increasing the risk and consequences of non-compliance. The end result would be to put millions (and perhaps billions) of contract dollars back in the hands of true small businesses, and would further the policy of enhancing actual small business participation in federal contracting.

Conclusion

Due to a confluence of factors, there is compelling evidence of widespread non-compliance with the SBA in procurement programs. The level of non-compliance suggests that existing enforcement mechanisms and protest procedures are inadequate to police the system effectively. There are insufficient disincentives and risks for contractors willing to misrepresent their status to win lucrative federal contracts.

By making violations of the SBA actionable as a priority grounds for suspension or debarment, a significant new deterrent would likely impact the misconduct. Similarly, modifying the False Claims Act, to require disgorgement of all contract payments in the case of misrepresentation of small business status, would dramatically raise the cost of non-compliance and deter fraudulent conduct. ***CM***

Endnotes

1. For purposes of this article, "miscertification" refers to a firm's representing itself as eligible for a contracting preference, when the firm is actually ineligible under regulatory eligibility standards and other grounds. Representative areas of non-compliance include, in the case of small disadvantaged business or 8(a) contractors, exceeding the annual receipts, numbers of employees and/or net worth thresholds, affiliations and ostensible subcontracting issues, minority ownership, control and/or management issues, and other grounds. The term also refers to improper claims of Hub-zone, women-owned and controlled, or service-disabled, veteran-owned status due to non-compliance with eligibility criteria for those programs.
2. "Analysis of Type of Business Coding for the Top 1,000 Contractors Receiving Small Business Awards in FY-2002," Eagle Eye Publishers, Inc. (Dec. 2004). Accessed at **http://www.sba.gov/advo/research/rs246tot.pdf**.
3. "Reporting of Small Business Contract Awards Does Not Reflect Current Business Size," U.S. General Accounting Office, GAO-03-376R (May 7, 2003). Accessed at **http://www.gao.gov/new.items/d03776r.pdf**.
4. These suggestions were provided to the House Small Business Committee in December 2004. Legislation implementing the changes is being considered.
5. 31 USC § 3729 (2000).
6. Section 16(a) of the Small Business Act (the Act), as amended (15 USC § 645 (a)), makes it a criminal offense punishable by a fine of not more than $5,000 or imprisonment for not more than two (2) years, or both, to make a willfully false statement or misrepresentation to the Small Business Administration for the purpose of influencing in any way the action of the SBA for the purposes of obtaining a loan or extension thereof by renewal, deferment of action, or otherwise, or the acceptance, release, or substitution of security thereof, or for the purpose of obtaining money, property, or anything of value.

   Section 16(d) of the Act, (15 USC § 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 contract or 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.

7. See FAR § 9.103.
8. The full list of "priority" statutes and regulations is found at FAR § 9.406-2.
9. FAR § 9.407-2(a).
10. 15 USC § 645(d)(2)(C).
11. To implement the suggested change, a new Section (7) added to FAR § 9-407(2) could read: (7) Violations of 15 USC § 645(a) or 15 USC §645(d), related to small business program eligibility or status.
12. See, e.g., *Ab-Tech Construction v. United States*, 31 Fed. Cl. 429 (1994), aff'd, 57 F.3d 1084 (Fed. Cir. 1995).
13. The Forfeiture of Fraudulent Claims Act, 25 USC § 2574, provides in part, that a claim against the United States is forfeited by any person who corruptly practices fraud against the States in the establishment of claims against it.
14. There is precedent for this position. Where the government has been fraudulently induced into entering into a contract, the fraud vitiates the government's obligation to pay the wrongdoer, even if the government has accepted the benefits of the wrongdoer's performance. See "Restatement of Contracts" § 480(1) (1932); John D. Calamari & Joseph M. Perillo, *The Law of Contracts 298* (2d ed. 1977); *Kunkle Water & Elect. v. City of Prescott*, 347 N.W. 2d 648 (Iowa 1984) (utility which split government invoices to circumvent competitive bidding regulations not entitled to receive payment for services supplied and accepted by the government).
15. 31 Fed. Cl. 429 (1994).
16. In ruling that every invoice submitted by Ab-Tech was a false claim, the court stated:

    Do the progress payment vouchers that Ab-Tech submitted to the government represent false claims within the meaning of this statute? The answer is yes. The False Claims Act reaches beyond demands for money that fraudulently overstate an amount otherwise due; it extends "to all fraudulent attempts to cause the Government to pay out sums of money." *United States v. Neifert-White Co.*, 390 U.S. 228, 233, 19 L. Ed. 2d 1061, 88 S. Ct. 959 (1968).

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    Seen from this broader perspective, Ab-Tech's claims clearly were fraudulent. The payment vouchers represented an implied certification by Ab-Tech of its continuing adherence to the requirements for participation in the 8(a) program. Therefore, by deliberately withholding from SBA knowledge of the prohibited contract arrangement with Pyramid, *Ab-Tech* not only dishonored the terms of its agreement with that agency but more importantly, caused the government to pay out funds in the mistaken belief that it was furthering the aims of the 8(a) program. In short, the government was duped by Ab-Tech's active concealment of a fact vital to the integrity of that program. The withholding of such information—information critical to the decision to pay—is the essence of a false claim. 31 Fed. Cl. at 433-434.
17. Assume, for example, that a contractor misrepresented its status and won a $50 million contract reserved for small businesses. The contract called for payments of $25 million upon the contractor's invoicing at two milestone points. The contractor performed, submitted the two invoices and received the $50 million. Under the Ab-Tech rule, the FCA case would be limited to penalties of between $11,000 and $22,000 (two invoices @ $5,500 or $11,000 each) corresponding to the penalty associated with the two invoices. This provides little incentive to bring the action. If, however, the entire $50 million were at issue, and the realtor could receive up to 25 percent of the total recovery, then the case would be very attractive. Perhaps more importantly, however, the contractor would be commensurately less likely to have made the misrepresentation in the first instance as the downside risk would far exceed the upside benefit.
18. The change could be accomplished with the following interlineation at 31 USC § 3729(a) of the FCA:

    VA (7) Knowingly makes, uses, or causes to be made or used, a false record or statement to conceal, avoid, or decrease an obligation to pay or transmit money or property to the government, is liable to the U.S. government for a civil penalty of not less than $5,000 and not more than $10,000, plus three times the amount of damages that the government sustains because of the act of that person, provided that for violations of 15 USC 645(a), or (d), damages include all contract proceeds received by the person....