

Mitigating Risk After SBA's New Presumed Loss Rule

Law360, New York (August 29, 2013, 12:10 PM ET) -- The U.S. Small Business Administration recently issued its highly anticipated final rule establishing the method for calculating damages to the government when a contractor willfully misrepresents its size or status.^[1] Effective Aug. 27, 2013, the new SBA rule implements the statutory requirements of the Small Business Jobs Act of 2010 and subjects small business contractors who willfully seek and receive contract awards by misrepresentation to damages based on the total amount of the improperly obtained contract. As a result of this new reality, contractors need to take extra precautions when making size or status representations.

In the proposed version of the rule, the SBA intended that the presumption of loss to the government based on the contractor's misrepresentation would be irrefutable. After reviewing comments and thinking about this further, the SBA decided that an irrefutable presumption would be inappropriate because the presumption of loss provisions will be utilized in federal court proceedings, where due process will be provided.

The SBA also considered that its regulations limit liability in certain situations (e.g., unintentional error and technical malfunction). For these reasons, the final rule does not contain an irrefutable presumption of loss to the government. Instead, the new rule gives small business contractors an opportunity to rebut the presumption that they willfully misrepresented their size or status.

The final rule emphasizes that the question of whether a contractor willfully misrepresented its size or status is a factual determination to be decided by a judge or jury on a case-by-case basis. That said, the SBA mentioned some circumstances where a contractor might be able to rebut a presumption of willful misrepresentation. For example, an unsophisticated firm that, in good faith, misinterprets the SBA's rules and regulations may not be found to have willfully misrepresented its size or status. Likewise, a prudent firm that acts quickly to correct an erroneous representation may be able to defeat or limit liability.

The final rule does not attempt to lay out every scenario where a contractor will, or will not, be able to rebut the presumption of loss. It may be that for more sophisticated contractors, good faith misinterpretation of the SBA's affiliation rules will not be enough to avoid the new liability. Therefore, as a threshold matter, preparation for the new rule requires a firm grasp of the SBA's affiliation rules. Simply checking your tax returns before making a size representation may not suffice to rebut the presumption of loss. You should make sure you understand the affiliation ramifications of recent corporate actions, such as changes in ownership, management, mergers, acquisitions and spin-offs, before you make a size or status representation.

The final rule stresses the importance of having sound internal management procedures. For that reason, contractors should have clear policies and procedures in place that specifically address small business size and status representations and certifications. Most small business contractors already have in place certain standard policies and procedures such as an organizational conflict of interest mitigation plan and a code of ethics. Now that the new presumed loss rule is effective, it is prudent for contractors to add another document to their portfolio of company policies — that is, a small business size and status representation plan.

Prime contractors also cannot turn a blind eye to the size and status representations of their subcontractors. Indeed, the final rule reflects the SBA's intent that the presumption of loss shall apply to subcontractors who willfully misrepresent their size or status to receive a subcontract award.

Reading the final rule in conjunction with 48 C.F.R. § 19.703(b), which provides that a prime contractor acting in good faith may rely on subcontractors written representation regarding its small business size status, prime contractors should not be held liable for subcontractor size misrepresentations if they rely in good faith on a written representation from their subcontractor.

To that end, we believe the best practice will be to require a subcontractor to make an affirmative representation as to its small business size status in the subcontract agreement. In addition, it would behoove prime contractors to keep a file documenting the prime contractor's review of the subcontractor's size or status representations in the subcontractor's SAM.gov profile.

In sum, with Aug. 27 behind us, small business contractors need to be prepared. This means that contractors must be proactive to limit their exposure to the presumed loss rule.

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[1] See "New SBA Rule Imposes Stricter Size Standards Affecting Size and Status Representations," PilieroMazza PLLC Client Alert (July 2, 2013).

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