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PRATT'S
**GOVERNMENT
CONTRACTING
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REPORT



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DEVELOPMENTS AND COMPLIANCE**

Victoria Prussen Spears

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Preparing for a DoD OIG Audit: DoD’s Focus on Small Business Set-Aside Contracts and Certifications

*By Sarah M. Hall, Joseph Berger, and John O’Hara**

The Department of Defense is auditing contractors’ compliance with set-aside and sole source requirements for Service-Disabled Veteran-Owned Small Business contractors. This audit, along with a steady stream of enforcement actions, signals increased scrutiny of contractor eligibility certifications. This article summarizes the Department’s initiative, along with recent criminal and civil government enforcement actions targeting allegations of fraud related to these contractor certifications, and provides guidance for contractors to prepare for audits and further reviews.

The U.S. Department of Defense (“DoD”) is taking action to validate and assess contractor and subcontractor compliance with set-aside or sole source contracts awarded to Service-Disabled Veteran-Owned Small Businesses (“SDVOSB”). DoD announced this audit initiative amidst several recent enforcement actions in which contractors have been indicted and convicted for defrauding the Small Business Administration (“SBA”) and U.S. military branches by fraudulently bidding on set-aside contracts, and for violating the False Claims Act (“FCA”). As illustrated by these recent enforcement actions, companies that self-certify as qualifying for one of the small business classifications discussed in this article and prime contractors submitting a subcontracting plan as part of a government contract should conduct the appropriate level of due diligence to satisfy regulatory obligations and reduce the possibility of FCA liability and criminal investigations.

BACKGROUND

On October 9, 2018, the DoD Office of Inspector General (“DoD OIG”) announced that it was initiating an audit to evaluate whether DoD properly

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awarded set-aside or sole source contracts to businesses classified as SDVOSB.¹ This audit comes six years after the DoD OIG released a report detailing an earlier audit, which found that over \$300 million was set aside to “potentially ineligible contractors.”² The 2012 report highlighted inadequate controls that DoD employed at that time for awarding and managing contracts, while finding that the DoD Office of Small Business Programs did not adequately verify contractor status before awarding set-aside and sole source contracts to SDVOSB contractors.³

The Government Accountability Office (“GAO”) echoed the DoD OIG’s sentiment in its own report released later in 2012, titled *Service-Disabled Veteran-Owned Small Business Program Vulnerability to Fraud and Abuse Remains*. The GAO report cited many issues, ranging from the inability of the Department of Veterans Affairs (“VA”) to track its inventory of eligible firms, to inconsistent reporting and inefficient processes to verify contractor status.⁴

Although the DoD OIG audit that commenced in 2018 focuses on SDVOSB contract awards, it serves as a reminder for all small business and set-aside contract award holders to confirm their current status and ensure the validity of certifications previously made (and the underlying details surrounding their classification).

SMALL BUSINESS SET-ASIDE AND SOLE SOURCE CLASSIFICATION TYPES

The Small Business Act established a government-wide goal that 23 percent of all prime contracts be awarded to small businesses each year.⁵ Small businesses include the following major types:

Service-Disabled Veteran-Owned Small Businesses. The Veterans Benefit Act of 2003 created the procurement program for small business

¹ Dep’t. of Def. Office of the Inspector Gen., *Audit of DoD Service-Disabled Veteran-Owned Small Business Contract Awards (Project No. D2019-D000AX-0019.000)* (Oct. 9, 2018) <https://media.defense.gov/2018/Oct/12/20020506071-1/-1/1/D2019-D000AX-0019.000.PDF>.

² Dep’t. of Def. Office of the Inspector Gen., Report No. DODIG-2012-059, *Inadequate Controls Over the DoD Service-Disabled Veteran-Owned Small Business Set-Aside Program Allow Ineligible Contractors to Receive Contracts* (Feb. 29, 2012).

³ *Id.* at i.

⁴ United States Government Accountability Office, Report to Congressional Committees No. GAO-12-697, *Service-Disabled Veteran-Owned Small Business Program Vulnerability to Fraud and Abuse Remains* (Aug. 2012) <https://www.gao.gov/assets/600/593238.pdf>.

⁵ See 15 U.S. Code § 644 (g)(1)(A)(i).

concerns owned and controlled by service-disabled veterans.⁶ The program requires that an SDVOSB company must be at least 51 percent unconditionally and directly owned by one or more service-disabled veterans.⁷ Further, the program requires that the management and daily business operations be controlled by one or more service-disabled veterans.⁸

Women-Owned Small Businesses (“WOSB”). This program was created by Section 8(m) of the Small Business Act with the intention to ensure that women-owned small business concerns have an equal opportunity to participate in federal contracting.⁹

Historically Underutilized Business Zone (“HUBZone”). The Historically Underutilized Business Zone Act of 1997 established the HUB-Zone program, which was intended to provide federal contracting assistance to qualified small business concerns located in historically underutilized areas in order to increase employment and economic development in those locations.¹⁰

8(a) Business Development Program. Section 8(a) of the Small Business Act was created to assist eligible small disadvantaged businesses to compete through business development activities.¹¹ Businesses unconditionally owned or controlled by one or more socially or economically disadvantaged individuals in good standing qualify for the program.¹²

RECENT ENFORCEMENT ACTIONS

While the DoD has been independently verifying contractor status for contracts it has selected for internal audits, the Department of Justice (“DOJ”) continues its investigations into fraud allegations across a variety of small business set-aside contract types. Over the past two years, there have been many so-called “rent-a-vet” enforcement actions targeting contractors who hire a veteran with the sole intention of securing SDVOSB set-aside contracts.

Earlier this year, a Kansas man was criminally charged with program fraud and lying to investigators after falsely holding out his company as owned by a

⁶ FAR 19.1401–1407.

⁷ See 13 CFR § 125.12.

⁸ See 13 CFR § 125.13(a).

⁹ FAR 19.1500–1507.

¹⁰ FAR 19.1301–1309.

¹¹ See 13 CFR § 124.1.

¹² See 13 CFR § 124.101.

disabled veteran. Prosecutors alleged that the company hired a service-disabled veteran with the intention of holding the individual out as the business owner. Prosecutors also alleged that the business ultimately served as a “pass-through” to earn DoD SDVOSB set-aside contracts valued at more than \$12.7 million, while other non-veteran employees made all management decisions.¹³

Another example involving allegations of criminal SDVOSB fraud occurred in 2017 when the owners of a construction company and a telecommunication company were indicted in the Southern District of California. The indictment alleged that the two companies formed a joint venture to falsely claim SDVOSB eligibility, allowing them to obtain \$11 million in federal construction contracts. As alleged by DOJ, the individual who was legitimately classified as a service-disabled veteran did not control the joint venture’s day-to-day management or long-term decision-making, as was represented to the VA and the Army Corps of Engineers.¹⁴

In a recent non-veteran-related case, a Colorado construction firm and a Maryland-based consulting firm agreed to pay the United States \$3.6 million to resolve civil allegations that they defrauded the 8(a) Business Development Program. The Maryland consulting firm had previously been a participant in the 8(a) program, but had not been eligible to bid for 8(a) set-aside contracts since 2011. The government established that the Maryland firm essentially took over day-to-day management of the Colorado-based construction firm, knowingly misrepresented to the SBA who was controlling the company and was subsequently awarded contracts by the U.S. Department of Agriculture, U.S. Army, and U.S. Navy.¹⁵

¹³ Dep’t. of Justice, U.S. Attorney’s Office—District of Kansas, *Kansas Man Charged in Government Contract Fraud Scheme* (Jan. 18, 2019) https://media.defense.gov/2019/Jan/22/2002081693/-1/-1/1/190118_KANSAS%20MAN%20CHARGED%20IN%20GOVERNMENT%20CONTRA%20FINAL.PDF.

¹⁴ Dep’t. of Justice, U.S. Attorney’s Office—Southern District of California, *Government Contractors Indicted in \$11 Million Veteran Set-Aside Fraud Scheme* (Apr. 21, 2017) <https://www.justice.gov/usao-sdca/pr/government-contractors-indicted-11-million-veteran-set-aside-fraud-scheme>.

¹⁵ Dep’t. of Justice, U.S. Attorney’s Office—District of Colorado, *\$3.6 Million Settlement Resolves Procurement Fraud Investigation Against Colorado and Maryland Construction Companies Involved With SBA’s Minority Disadvantaged Business Development Program* (Feb. 6, 2019) [https://media.defense.gov/2019/Feb/12/2002088921/-1/-1/1/190206_\\$3.6%20MILLION%20SETTLEMENT%20RESOLVES%20PROCUR_.PDF](https://media.defense.gov/2019/Feb/12/2002088921/-1/-1/1/190206_$3.6%20MILLION%20SETTLEMENT%20RESOLVES%20PROCUR_.PDF).

HOW CONTRACTORS SHOULD PREPARE

Prime contractors should have an ongoing process in place to validate their subcontractors' status representations, and they should be able to articulate to the DoD OIG or another investigating entity how such due diligence was performed.

Maintaining appropriate records is key. For larger contracts that require subcontracting plans, contractors need to ensure compliance with FAR 19.704 and 52.219-9, which establish subcontracting plan requirements. Contractors who must appoint a subcontracting plan administrator, as required by FAR 19.704(a)(7), should ensure that the position is not a figurehead and is actively involved in vetting subcontractors who are incorporated into the larger plan.

Prime contractors should carefully vet all subcontractors before contract award. Conducting due diligence prior to and during the proposal stage is a best practice when creating a subcontracting plan. The due diligence should include reviews of the subcontractor's corporate structure and previous work performed on behalf of the U.S. government, along with site visits and audits, where appropriate, to verify the subcontractor's representations regarding its small business status and management structure. Pre-award due diligence should be undertaken to accurately identify the circumstances that would cause a contractor to no longer be able to certify to its small business status. Due diligence should not stop after contract award, and prime contractors should develop a routine recertification process.

SDVOSB contractors, or prime contractors who utilize SDVOSB subcontractors, should be prepared for inquiries from the DoD OIG. Government outreach might include an informal interview or a formal request for documentation that the prime contractor collected and reviewed when evaluating and making an award to a SDVOSB subcontractor. The DoD OIG may visit SDVOSB locations and attempt to validate who is managing the day-to-day business operations to confirm contractor compliance.

Prime contractors and subcontractors who have previously certified compliance with any of SBA's small business programs should ensure that all prior representations are still valid and they have documentation to support their small business status and set-aside certifications. If the business has evolved over time to meet the contract's performance requirements (e.g., additional personnel were hired), the contractor must maintain documentation verifying that the growth happened after the contract offer and award. Although the size standard may apply at the time of contract offer, prime contractors and subcontractors

need to be able to demonstrate that they met the size standard corresponding to the NAICS code designated in the contract.¹⁶

As evident in the criminal enforcement actions and civil settlements discussed above, allegations of violations can arise when an agency determines that a contractor misclassified itself to bid on and secure contracts awarded for a certain set-aside category. Contractors found to be ineligible may face consequences including potential prison time, contract termination, or financial penalties if it is determined that they fraudulently sought government contracts through misrepresentations. By proactively identifying eligibility issues in their supply chain or in their own performance, contractors may be able to mitigate potential liability by disclosing the issues to their contracting officer and, where appropriate, to the DoD OIG.

Contractors can protect themselves and ensure compliance with all applicable regulations by conducting due diligence prior to contract award and during performance. Being aware of status representation issues and their pitfalls can help a contractor avoid or at least be prepared for the possibility of a DoD OIG audit.

¹⁶ See 13 CFR § 125.14(a).