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The Perils of Finagling Set-Aside Contracts

Service

Government Contracts

Government contractors are familiar with the rules concerning contracts set aside for specific socio-economic groups, such as small businesses, historically underutilized business zone (HUBZone) businesses, service-disabled veteran-owned small businesses, or small disadvantaged (Section 8(a)) businesses. The qualifying small business concern awarded the set-aside contract must perform the "primary and vital requirements" of the contract and at least 50 percent of the labor required.[1] A recent case, *Morris–Griffin Corp. v. C&L Service Corp.*, F.Supp.2d, 2010 WL 3221975 (E.D. Va. August 16, 2010), illustrates the perils of trying to finagle these requirements.

In *Morris*, the U.S. District Court refused to enforce a subcontract between a Section 8(a) business and its non-disadvantaged business teaming partner because the Section 8(a) business did not possess the technical expertise to perform its prime contract and the parties had entered into an arrangement under which the non-small business concern performed more than half the work. The court also declared that the Section 8(a)'s prime contract was void *ab initio* because it was tainted by fraud. The case presents a cautionary tale for those seeking to circumvent the Small Business Association's ("SBA") restrictions on small business set-asides.

Morris-Griffin Corporation was a minority-owned firm that qualified as a socially and economically disadvantaged small business concern under Section 8(a) of the SBA Act. While in the 8(a) program, Morris-Griffin was awarded a HUD contract to perform loan servicing support services. However, by the time the HUD contract was up for re-competition, Morris-Griffin no longer qualified as an 8(a) contractor. Morris-Griffin approached C&L Services about submitting a joint bid for the contract, even though C&L was a janitorial and maintenance firm with no experience in servicing loans and no technical or financial resources to fulfill the contract. In fact, Morris-Griffin selected C&L

precisely *because* C&L did not compete with Morris-Griffin. C&L submitted a bid and was awarded the contract despite the SBA's concerns that it lacked loan servicing experience and had poor financial standing. The SBA allowed the award to proceed only because HUD's contracting officer reassured the SBA that Morris-Griffin possessed the requisite experience based on its earlier contract.

C&L entered into a subcontract with Morris-Griffin that required C&L to perform 51 percent of the costs of services. However, Morris-Griffin provided the bulk of the human and capital requirements necessary to perform the contract and was responsible for such key components as leasing the loan servicing center and procuring the requisite computer hardware and software. Morris-Griffin's costs of services far exceeded C&L's and the parties' relationship deteriorated when C&L attempted to cut Morris-Griffin out of the contract. After attempts to resolve their differences failed, Morris-Griffin commenced arbitration proceedings pursuant to the dispute resolution provisions of the subcontract and sought a preliminary injunction to enjoin C&L from withholding payment or cutting it out of the contract pending completion of the arbitration.

District Court Judge Doumar privately advised C&L and Morris-Griffin to settle their dispute out of concerns for the legality of their dealings. When C&L and Morris-Griffin failed to do so, the judge essentially said "a pox on both your houses," and issued a ruling finding that C&L failed to qualify for the HUD contract because Morris-Griffin supplied the critical technical and financial capability and performed more than 50 percent of the work. This arrangement resulted in an impermissible affiliation between the two companies and amounted to fraud upon HUD because C&L falsely certified that it was a small business for purposes of performing the contemplated financial services and that it, and its affiliates, including Morris-Griffin, were qualified small businesses. This false certification rendered C&L's bid fraudulent at the time it was made.

Because he determined that the HUD contract was tainted by the parties' fraudulent activities in obtaining it, the judge ruled that the HUD contract was "void *ab initio* and unenforceable." Judge Doumar accordingly held that the subcontract between C&L and Morris-Griffin was also "contrary to public policy, [was] an agreement in furtherance of an unlawful purpose, and [was] an agreement that the parties were not authorized to enter into." He further determined that Morris-Griffin's request for an injunction was barred by the doctrine of unclean hands based on the illegality of the underlying transaction and Morris-Griffin's bad faith towards HUD. In a footnote, he also suggested that HUD was complicit in this fraud, because it pressured the SBA to reverse its initial determination that C&L was not qualified to perform the contract.

In an unusual twist, Judge Doumar concluded his opinion with a statement addressing the larger context of the practice of small business set-asides. His comments condemned such contracts, noting that "government set-aside contracts are susceptible to finagling" because they rely on self-certification of status as a small business concern, and "an individual SBA officer has little incentive, if

any, to question a particular small business' certification." He commented that the "incentives that this system creates are perverse" because small businesses enter into teaming agreements where their principal contribution is "one thing and one thing only: eligibility for section 8(a) contracts." Judge Doumar blamed the SBA in part. stating that "the SBA has invited the very problems that this case presents" because of its lax enforcement of certification requirements. "This situation harms not only the public fisc," he concluded, but also legitimate small business owners. "Surely Congress did not intend to create a class of small businesses whose chief asset is their eligibility for set-asides. Rather, Congress intended to create a class of small businesses capable of performing important federal contracts."

This case serves as a warning to contractors who are tempted to skirt the set-aside rules. Large businesses see great value in teaming with small and disadvantaged businesses for set-aside contracts because they provide access to contract work from which they would otherwise be excluded. Oftentimes, because they are incumbents on the work being set aside, large businesses bring these set-aside opportunities to small businesses—just as happened in the *Morris-Griffin* case. The temptation in such cases, however, is that the large business wants to team with a small business that does not represent any competitive threat due to its limited capabilities. And the large business wants to exert ultimate control over performance (and profits).

As Judge Doumar found, however, creating such teaming arrangements in order to circumvent the SBA rules amounts to fraud. It also is problematic—how would the large business enforce the (illegal) subcontract provisions? As this case shows, judges are hostile to attempts to use the courts to enforce contractual arrangements whose underlying purpose is to defraud the government. For these reasons, both large and small contractors should prudently construct their teaming arrangements to ensure that they withstand scrutiny for compliance with the set-aside rules.

[1] This rule applies to service contracts. 13 C.F.R. § 121.103 (ostensible subcontractor rule) and 13 C.F.R. § 125.6(a)(1) (50 percent rule). See also Federal Acquisition Regulation (FAR 52.219-3(c)(1); 52.219-14(a)(1); 52.219-27(c)(1). For supply contracts, the qualifying small business concern must perform at least 50 percent of the cost of manufacturing, excluding the cost of materials. 13 C.F.R. § 125.6(a)(2). For general construction, the qualifying small business concern must perform at least 15 percent of the cost of the contract (not including the cost of materials, and for construction by specialty trade contractors, the qualifying small business center or HUBZone contractor must perform at least 25 percent of the cost of the contract (excluding the cost of materials). 13 C.F.R. § 125.6(a)(3) & (4). A service-disabled veteran-owned small business may fulfill the 50 percent performance requirement either with its employees or employees of another service-disabled veteran-owned small business or HUBZone contractor. 13 C.F.R. § 125.6(b) & (c).

What This Means To You

Government contractors who compete for set-asides and those interested in participating in these types of contracts through teaming arrangements should evaluate their performance obligations and underlying agreements in light of Morris-Griffin. As the decision indicates, courts will not look kindly upon parties that seek to enforce rights obtained while perpetrating a fraud on the government. In addition, SBA size protests can be used to deny such contracts to others who do not comply. A contractor is at substantial risk if it wins a set-aside contract without complying with the requirements, even if agency officials know of and approve of the arrangement—as was the case in Morris-Griffin.

Contact Info

If you have questions about this or any other government contracting matter, please contact your Husch Blackwell attorney for assistance.

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