Reining In Runaway Loss Calculations For Procurement Fraud

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Regardless of the political winds, the criminal prosecution of contracting fraud perpetrated against federal government agencies — and associated federal civil actions brought under the False Claims Act — remain high on the list of the U.S. Department of Justice's enforcement priorities, as prosecutors view such crimes as reaching directly into the U.S. Treasury and undermining government integrity.[1]

This article explores a recurring problem in criminal prosecutions of procurement fraud cases involving federal government set-aside contracts such as those awarded under the U.S. Small Business Administration's Section 8(a) program, designed to help small, disadvantaged (e.g., minority-owned or disabled veteran-owned) businesses compete in the American economy and access the federal procurement market. Specifically, prosecutors frequently argue in such cases (sometimes successfully) that the victim's loss attributable to the offense under the United States Sentencing Guidelines is the total face value of the wrongfully awarded contracts.

In other words, these prosecutors argue, the sentencing guidelines loss amount is the entire amount the government paid on a claim or for a contract to a Section 8(a)-ineligible business (i.e., "inclusion fraud), regardless of, and without any deduction for, the value of any services or goods actually provided to the government under the contract.

This position, if adopted by the sentencing court, can have catastrophic consequences to defendants in such cases because the sentencing guidelines loss calculation is usually the primary driver of the length of a white-collar criminal defendant's federal prison sentence. The total face value of even relatively modest federal government contracts can run into the millions of dollars, and thus result in astronomical increases in a defendant's sentencing range.

The Legal Backdrop: Government-Benefits Rule, Credits-Against-Loss Rule and the Small Business Jobs Act of 2010

Under the sentencing guidelines, the victim's loss resulting from the offense is the greater of actual loss or intended loss.[2] Actual Loss is "the reasonably foreseeable pecuniary harm that resulted from the offense," whereas intended loss is "the pecuniary harm that the defendant purposely sought to inflict."[3]

Importantly, while the sentencing guidelines require only that the sentencing court make a reasonable estimate of loss, the practical application of these general principles is not always straightforward. To that end, the guidelines provide for special rules of construction to help courts determine loss in certain types of cases.

The guidelines provide for a special rule in procurement fraud cases that defines loss to include the reasonably foreseeable administrative costs of redoing or correcting the affected procurement action and any increased costs to procure the particular product or service.[4] Under the government-benefits rule, the guidelines provide that for cases involving

government benefits such as grants, loans and entitlement program payments, loss shall be considered to be not less than the value of the benefits obtained by unintended recipients or diverted to unintended uses."[5]

A different rule, the credits-against-loss rule, requires the sentencing court to reduce the loss amount by "the fair market value of the property returned and the services rendered ... to the victim before the offense was detected."[6] And finally, while not part of the sentencing guidelines, a 2010 amendment to the Small Business Act established a presumption in set-aside cases, for companies other than small businesses, that the loss to the government is the total amount of the contract "willfully sought and received ... by misrepresentation."[7]

There is no guidelines provision or commentary specific to inclusion-type government contracting fraud cases.

The correct measurement of loss in such cases is currently the subject of a federal circuit split. The U.S. Court of Appeals for the Fourth Circuit, the U.S. Court of Appeals for the Seventh Circuit and the U.S. Court of Appeals for the Eleventh Circuit apply the government-benefits rule to treat the total face value of the misdirected or fraudulently-awarded contracts as the loss amount,.[8] The U.S. Court of Appeals for the Third Circuit, the U.S. Court of Appeals for the Fifth Circuit and the U.S. Court of Appeals for the Ninth Circuit reject that rule in favor of the credits-against-loss rule requiring the fair market value of the goods or services provided to be deducted from the loss amount.[9]

A careful analysis of these cases, the relevant guidelines and Small Business Act provisions, and basic breach of contract and fraud principles, reveals that the circuits applying the credits-against-loss rule to determine loss in set-aside fraud cases have the better of the arguments. Here's how to attack the government's overzealous loss calculations in a set-aside case if prosecutors insist on a total face value measure of loss based on the government-benefits rule.

How to Attack Overzealous Loss Calculations Based on the Government-Benefits Rule

Prosecutors arguing for a total face value measure of loss in inclusion-type contracting fraud cases — and courts accepting such arguments — advance the following reasoning: (1) Set-aside contracts constitute a benefit within the meaning of the government-benefits rule because the primary purpose of preferential contracting programs is to benefit small, disadvantaged businesses, and such programs serve no useful commercial purpose if the contracts are diverted to unintended recipients;[10] (2) the government-benefits rule does not permit any offset to loss for goods or services rendered; and (3) the face-value loss presumption enacted as part of the 2010 amendments to the Small Business Act and interpretive federal regulations support the above propositions and show that this presumption is not rebuttable.

However, this reasoning cannot survive basic scrutiny.

Set-aside contracts are not government benefits within the meaning of the guidelines.

As a threshold matter, the guidelines provide examples of the types of benefits contemplated by the government benefits rule in the text of the rule itself (e.g., grants, loans and entitlement program payments) and do not include any reference to government

contracts. Yet, elsewhere in the guidelines, the U.S. Sentencing Commission specifically addressed "procurement fraud, such as a case affecting a defense contract award."

Basic canons of construction and interpretation teach that, if the commission intended to include contracting fraud within the government-benefits rule, it knew how to — and would have — said so. But it did not.

As a manifestation of the commission's intent, more than a decade of silence on the issue, despite a federal circuit split, is equally powerful. Indeed, we are unaware of any effort by the commission to amend the relevant rule to specifically include set-aside contracts.

And finally, as a criminal provision impacting a defendant's due process rights, the rule of lenity counsels against a disputed interpretation of an unclear provision that would lead to increased punishment.

The guidelines contemplate offsets to loss calculations under the government-benefits rule.

Even if the government-benefits rule applies to loss calculations in set-aside cases, analysis of the structure of the guidelines shows that deductions should still be allowed under the credits-against-loss rule. Application note 3(A) provides interpretive guidance and certain rules of construction to assist courts in calculating loss under Section 2B1.1(b)(1). A separate note, 3(E), sets forth the credits-against-loss rule. And yet a third note, 3(F), sets forth the government-benefits rule.

Importantly, however, the commission's introductory language in Note 3(F) states, "[n]otwithstanding subdivision (A), the following special rules shall be used to assist in determining loss in the cases indicated." By this language, the commission intended for the special rules in Note 3(F) (including the government-benefits rule) to trump inconsistent rules under Note 3(A). But notably, the commission did not include Note 3(E) in this carve-out. Once again, the commission knew how to supplant Note 3(E) if it so chose, and therefore construing the guidelines as if it did so invents an intent that does not appear to exist.

Further, the plain language of the government-benefits rule does not expressly preclude offsets, stating simply that "the loss shall be considered to be not less than the value of the benefits obtained by unintended recipients." Because the note does not define "the value of the benefits obtained by unintended recipients," the benefits obtained can plausibly be interpreted to mean the profit obtained due to fraud, and not the total contract value.

This interpretation is consistent with other white-collar sentencing guidelines provisions, such as the bribery guidelines, which define the benefit received as "the net value of such benefit," providing for example that if "[a] $150,000 contract on which $20,000 profit was made was awarded in return for a bribe; the value of the benefit received is $20,000."[11]

Finally, other special rules of construction under Note 3(F) specifically prohibit offsets for the value of goods or services received, while the government-benefits rule does not, yet another indication of the commission's intent.[12]

The Small Business Jobs Act of 2010 did not create an irrefutable or unrebuttable statutory loss presumption for set-aside cases.

Nor did the 2010 amendments to the Small Business Act, 15 U.S.C. Section 632(w)(1),

create an unrebuttable presumption that the total face value measure applies in inclusion-type contracting fraud cases. First, the text of the statute does not expressly prohibit or preclude offsets or state that the presumptive loss amount cannot be rebutted.

Second, the statute does not expressly apply the presumption to criminal cases, mention the sentencing guidelines or the sentencing commission, or define loss to indicate that the guidelines usage was contemplated.

Third, contemporaneous evidence shows that, rather than enacting an unrebuttable presumption as some courts and prosecutors seem to believe, Congress actually rejected such efforts, as recognized by the SBA at the time.[13]

Fourth, notwithstanding concomitant SBA interpretative regulations supporting the application of the statutory presumption to criminal prosecutions, federal courts owe no deference to guidelines interpretations issued by federal administrative agencies such as the SBA, which lack federal criminal law enforcement or sentencing authority.[14] Congress delegated authority to formulate the guidelines to the sentencing commission, not to other administrative agencies or stakeholders.[15]

The total face value of a contract is a reasonable measure of loss where the contract is properly performed.

Absent misconduct that deprives the government of the benefit of the bargain — such as the provision of nonconforming or useless goods or services — imposing a total face value measure of loss in inclusion-type procurement fraud cases defies the guidelines' mandate that sentencing courts make a reasonable estimate of loss, and contravenes basic fraud and contract principles.[16] Where kickbacks, collusion or other misconduct causes the government to overpay for goods or services to the detriment of U.S. taxpayers, the amount of the overpayment or fraudulent premium accurately captures the harm.

But applying a draconian face-value measure does not reasonably capture the harm to the government, the profit to the defendant or even the theoretical harm to small, disadvantaged businesses that may have been deprived of the usurped opportunity. The sentencing decisions of courts that have imposed a face-value measure of loss are perhaps the best evidence of this fact: Even in these cases, courts tend to depart downward from the guidelines sentencing range on grounds that the loss amount overstates the seriousness of the offense.[17]

Moreover, applying a face-value measure regardless of performance would illogically punish defendants who steal funds outright from a federal grant program and provide nothing to the government in return no differently from an inclusion fraud defendant who fully performs his contractual obligations, and it would arguably create unwarranted sentencing disparities by punishing a defendant more harshly if he lies to obtain a contract to which he is not entitled than if he bribes a public official to obtain a contract to which he is not entitled.

Conclusion

Inside and outside counsel for government contractors who find themselves in the government's crosshairs in an inclusion-type criminal procurement fraud investigation would be well advised to closely monitor the federal circuit split and developing case law addressing the proper measure of loss in such prosecutions.

While there appears to be an emerging trend favoring application of the credits-against-loss rule over a blunt, total face-value measure, the government continues to take aggressive positions on loss in these cases.[18] Accordingly, defense counsel will have their work cut out for them to attack and rein in runaway loss calculations in these cases, whether during preindictment negotiations, in plea discussions, or in connection with a contested sentencing proceeding.

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[1] See, e.g., "Justice Department Announces Procurement Collusion Strike Force: a Coordinated National Response to Combat Antitrust Crimes and Related Schemes in Government Procurement, Grant and Program Funding," DOJ.gov (Nov. 5, 2019) ("The investigation and prosecution of individuals and organizations that cheat, collude and seek to undermine the integrity of government procurement are priorities for this administration."); "Remarks by Assistant Attorney General for the Criminal Division Leslie R. Caldwell at the Taxpayers Against Fraud Education Fund Conference," DOJ.gov (Sept. 17, 2014) ("Through our Fraud Section, we will be committing more resources to this vital area, so that we can move swiftly and effectively to combat major fraud involving government programs."); "Attorney General Eric Holder Speaks at the Financial Fraud Enforcement Task Force Press Conference," DOJ.gov (Nov. 17, 2009) ("Our enforcement priorities will continue to be informed by the realities of the crisis we face ... And we will make sure that federal stimulus funds are well-spent by vigilantly protecting the integrity of federal procurement and grant processes."); "Deputy Attorney General Paul J. McNulty Announces Formation of National Procurement Fraud Task Force," DOJ.gov (Oct. 10, 2006).

[2] Application Note 3(A) to U.S.S.G. § 2B1.1(b)(1).

[3] Id., app. n.3(C). "'[R]easonably foreseeable pecuniary harm' means pecuniary harm that the defendant knew or, under the circumstances, reasonably should have known, was a potential result of the offense." Id., app. n.3(A)(iv).

[4] Id., app. n.3(A)(v).

[5] Id., app. n.3(F)(ii).

[6] Id., app. n.3(E)(i).

[7] 15 U.S.C. § 632(w)(1).

[8] United States v. Maxwell, 579 F.3d 1282 (11th Cir. 2009); United States v. Leahy, 464 F.3d 773 (7th Cir. 2006); United States v. Bros. Constr. Co., 219 F.3d 300 (4th Cir. 2000);

see also United States v. Aldissi, No. 15-14193, 2018 U.S. LEXIS 35014 (11th Cir. Dec. 13, 2018).

[9] United States v. Harris, 821 F.3d 589 (5th Cir. 2016); United States v. Martin, 796 F.3d 1101 (9th Cir. 2015); United States v. Nagle, 803 F.3d 167 (3d Cir. 2015); see also United States v. Crummy, 249 F. Supp 3d 475 (D.D.C. 2016); United States v. Bin Wen, No. 6:17-CR-06173 EAW, 2018 U.S. Dist. LEXIS 215853, at *32 (W.D.N.Y. Dec. 21, 2018).

[10] See, e.g., Maxwell, 579 F.3d at 1306 (stating the "primary purpose" of preferential contracting programs is "to help small minority-owned businesses develop and grow" and if diverted to unintended recipients, such programs serve no "commercially useful function"); accord, Leahy, 464 F.3d at 789-90.

[11] U.S.S.G. § 2C1.1(b)(2), app. n.3.

[12] United States v. Near, 708 F. App'x 590, 604 (11th Cir. 2017) (addressing U.S.S.G. §2B1.1(b)(1), app. n.3(F)(v) ("Certain Other Unlawful Misrepresentation Schemes"), which provides, in relevant part, that "loss shall include the amount paid for the property, services or goods transferred, rendered, or misrepresented, with no credit provided for the value of those items or services.").

[13] Closing the Gap: Exploring Minority Access to Capital & Contracting Opportunities: Roundtable Before the S. Comm. on Small Bus. & Entrepreneurship, 112th Cong. 83 (2011) (statement of SBA Inspector General Peggy Gustafson); Small Business Size and Status Integrity, 78 FR 38811-02.

[14] See Blake v. Gonzales, 481 F.3d 152, 156 (2d Cir. 2007); see also United States v. Crummy, 249 F. Supp 3d 475, 487 (D.D.C. 2016) (concluding that statutory presumption under Section 632(w)(1) does not displace credits-against-loss rule in the guidelines).

[15] Mistretta v. United States, 488 U.S. 361 (1989).

[16] See, e.g., United States v. United Technologies Corp., 782 F.3d 718, 731 (6th Cir. 2015) ("When the government gets what it paid for despite a contractor's misstatements, it has suffered no 'actual damages.' That is not just the law of the False Claims Act; it is also the black-letter law of fraud and restitution").

[17] See, e.g., Harris, 821 F.3d at 587; United States v. Blanchet, 518 F. App'x 932, 955 (11th Cir. 2013).

[18] See, e.g., United States v. Evans Landscaping, Inc., No. 1:17-CR-53, 2019 U.S. Dist. LEXIS 127702 (S.D. Ohio July 31, 2019).