

Small Business Set-Aside Contracting Fraud Costs the Government, and Thereby Taxpayers, Billions of Dollars Each Year

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The federal government’s system for awarding set-aside contracts to small businesses is well-intended, hugely successful—and also rife with fraud. In this article, we’ll list and describe the five most common forms of set-aside contracting fraud. Then, we’ll explain how whistleblowers can help the government fight back against set-aside fraud, while also earning substantial monetary rewards, by bringing [qui tam cases](#) under the False Claims Act.

The types and scope of federal small business set-aside contracting

First, some background on the contracting programs at issue. According to the annual Small Business Procurement Scorecard compiled by the Small Business Administration (SBA), in fiscal year 2023 the federal government awarded \$178.6 billion worth of small business set-aside contracts. This amount includes both simple small business set-asides contracts (where any business that is “small” may compete for the contract), and also those contracts set aside for small businesses that have one of three particular types of ownership and management:

- Small disadvantaged businesses (SDBs), also sometimes known as 8(a) businesses;
- Women-owned small businesses (WOSBs); and
- Service-disabled veteran-owned small businesses (SDVOSBs).

This amount also includes contracts set aside for small businesses that are located in historically underutilized business zones (HUBZones).

The \$178.6 billion worth of contracts awarded to such small businesses in FY2023 represented more than 28% of all federal [government contracts](#) – literally thousands of contracts awarded for all types of services, supplies, and equipment purchased by all government agencies. In 2023, the SBA recognized over [33 million small businesses](#), employing over 61.6 million Americans, employing 5.9% of all U.S. employees. The goal of these contracts is to provide continued growth opportunities for the

millions of companies employing millions of Americans.

FY 2023 Total Federal Awards to SDBs	FY 2023 Total Federal Awards to WOSBs	FY 2023 Total Procurement to SDVOSBs	FY 2023 Total Federal Awards to HUBZones
\$76.2 billion	\$30.9 billion	\$31.9 billion	\$17.5 billion

Press Release 24-41, [Biden-Harris Administration Awards Record-Breaking \\$178 Billion in Federal Procurement Opportunities to Small Businesses](#), U.S. Small Business Administration (Apr. 29, 2024)

The government's [set-aside contracting system](#), however, is highly susceptible to fraud. This is because, in most cases, the government relies upon the contractor's own representations about factors such as size, ownership, management, and location, and in the vast majority of cases does not independently confirm that information. If a mere 1% of the set-aside contracts awarded by the federal government in FY2023 went to businesses that did not actually qualify for the set-asides, that would be more than \$1.7 billion of fraud. The actual amount, although unknown, is likely much higher given that the Government Accountability Office (GAO) estimates that somewhere between 3 and 7 percent of all federal government spending is lost to fraud. Whatever the exact number, clearly billions of dollars worth of federal set-aside contracts are obtained fraudulently every year.

The five common types of fraud in small-business set-aside contracting

How do government contractors commit fraud in connection with bidding on or performing small business set-aside contracts? We conducted a review of all of the publicly announced False Claims Act settlements entered into by the Department of Justice involving allegations of such fraud, from 2014 through now. [A chart of those settlements can be seen here.](#) What we learned from that review is that those settlements resulted from cases involving five main types of fraud.

1. Misrepresentation about the "size" of the business

The most basic requirement of all the set-aside programs is that contracts be awarded to businesses that are "small" under the "size standards" established by SBA. The size standards can be focused either on the business's employee count, or on its annual revenues, and is not "one size fits all." The size standards vary by industry, categorized under the [North American Industry Classification Systems \(NAICS\)](#). Each industry has a unique NAICS code that has an associated size standard. A company could commit fraud by underreporting either its employee count or its annual receipts, thereby claiming to be "small" under the applicable size standard when, in fact, it is not.

In practice, however, most of the set-aside fraud cases in our sample that involved misrepresentations of size also involved misrepresentations about "affiliation," and so let's take a look at that related issue.

2. Misrepresentations about affiliations between or among commonly-controlled businesses

As discussed above, whether a business is “small” is determined by the “size standard” applicable to the particular business, and the standard can be either one based on average annual receipts, or by average number of employees. But in either case, SBA regulations state that the receipts or employees that count towards the size standard are those of the business concern plus those of any “affiliate” of the business concern.

Although the “affiliate” rule is technical and subject to a number of exceptions, the general rule is that “[c]oncerns and entities are affiliates of each other when one controls or has the power to control the other, or a third party or parties controls or has the power to control both.” 13 C.F.R. § 121.103(a)(1). So, typically, where two businesses are in a parent-subsidary relationship, or are both commonly owned, they are “affiliates” of each other, and both must be included in the size calculations for either one. In other words, for purposes of determining “size,” affiliated businesses are treated as a single business.

Thus, another common form of set-aside contracting fraud is for a business to claim to be “small,” while hiding the fact that it is affiliated with one or more other business entities or failing to include an affiliate’s receipts or employees in the business’s size calculation. By failing to include an affiliate’s receipts or employees in the size calculation, the business appears “small” when, under the SBA regulations, it clearly is not.

The government has settled a number of major set-aside fraud *qui tam* cases where this was a central allegation. For example, in the case of *United States ex rel. Colangelo et al. v. En Pointe Gov., Inc.*, the defendants paid \$5.8 million to settle allegations that they made false representations that En Pointe Gov. Inc. was “small” when, in fact, its affiliation with the other defendants rendered it a non-small business and, thus, ineligible for the small business set-aside contracts it had won. Another example is *United States ex rel. Ameliorate Partners, LLP v. ADS Tactical, Inc.*, in which it was alleged that ADS—a company that was not “small”—won set-aside contracts by creating a series of affiliated companies, and then claiming that those affiliated companies met the size standards. After that *qui tam* was brought, ADS paid \$16 million, and the owner of ADS personally paid another \$20 million, to settle the case. The whistleblower that brought the case was awarded more than \$6 million.

3. Misrepresentations about the ownership or control of the business

If a government contract is set aside for SDBs, WOSBs, or SDVOSBs, then a crucial requirement for eligibility is that the bidder be both majority-owned, and also controlled, by a person who falls within the specified set-aside category. Majority ownership and control are two different tests, and both must be met. Ownership is the simpler concept: the individual within the specified category must “unconditionally” own “not less than 51 percent” of the business. “Control” can be more context-specific, but it generally means that the person within the specified category must actually make the day-to-day management decisions of the business. See 13 C.F.R. § 124.101 (for SDBs); 13 C.F.R. 127.200 (for WOSBs); 13 C.F.R. § 128.200 (for SDVOSBs).

In the settlements we reviewed, misrepresentations about ownership or control were a common form of fraud. Typically, in such frauds, the business will have a “figurehead” who falls within the specified category (for example, someone who is a woman for WOSBs or a veteran for SDVOSBs), but that person will not actually have much, if any, say in how the business is run. Instead, the business is run by someone who does *not* fall within the specified category, or the profits from the business will run

primarily to people who do *not* fall within that category.

A recent \$52 million settlement involved precisely this type of fraud. In the case of *United States ex rel. Pattison v. Paragon Systems, Inc.*, the government alleged, among other things, that [Paragon Systems](#)—which was not a “small” business—controlled a number of purportedly small WOSBs, which had “figurehead” owners who were actually female relatives and friends of certain male Paragon executives. Those female relatives and friends did not actually control the WOSBs, which were in reality controlled by Paragon and its male executives. The whistleblower that brought the *qui tam* case was awarded more than \$9 million.

Similar cases have been brought, and subsequently settled for large sums, involving SDBs (for example, a \$7.8 million settlement in *United States ex rel. Sansbury, et al. v. LB&B Associates, Inc.*) and SDVOSBs (for example, a [\\$48.5 million settlement](#) in *USA ex rel. Fox Unlimited Enterprises, LLP v. Trimark USA, LLC*).

4. Misrepresentation about who will perform the work under the contract

Government contracts typically permit the winning bidder (the “prime contractor”) to hire other businesses, typically referred to as “subcontractors,” to perform parts of the contract. However, most small business set-aside contracts have limits on how much of the contract can be subcontracted to entities outside of the set-aside category. For example, if a small business wins a SDVOSB contract, it cannot turn around and have a non-SDVOSB business do all or most of the work, because that would defeat the purpose of the set-aside. Most set-aside contracts are subject to a 50% limit on subcontracting, although some types of contracts (primarily in construction projects) may be subject to a 75% or 85% subcontracting limit. 13 C.F.R. § 125.6.

In addition, many government contracts that are *not* set aside for small businesses may still be subject to “small business subcontracting plans,” where the non-small prime contractor agrees to hire various categories of small businesses to perform parts of the contract as subcontractors.

Both situations are subject to fraud. A small business may bid on and win a contract, intending to actually have a non-small business do most or all of the work. Or, a non-small business may win a contract by promising to hire small businesses as part of a small business subcontracting plan, but then not actually do so.

An example is *United States ex rel. Fox Unlimited Enterprises, LLP v. Hensel Phelps Construction Company*. Hensel Phelps, a construction company, [won a government contract](#) to construct a building. In doing so, it was required to have a “small business contracting plan.” But it had a plan to fraudulently appear to be meeting that plan without actually doing so. It entered into a subcontract with a SDVOSB for a major piece of the construction, knowing that the SDVOSB would, in turn, have a larger company do the work. The SDVOSB only kept a 1.5% fee as its share of the money it was paid under the subcontract; the rest of the money was simply passed through to the larger company that was doing the work. The *qui tam* case settled for \$2.8 million; the whistleblower received an award of approximately \$631,000.

5. In connection with HUBZone contracts, lying about the location of the business

To qualify for a HUBZone set-aside contract, a business must be “small,” must have its principal office located in a HUBZone, and must have at least 35% of its employees residing in a HUBZone. 13 C.F.R. § 126.200. So, the obvious fraud that can be committed on the HUBZone program is for a

contractor to misrepresent where its office is located or where its employees reside.

And, while not common, this does actually happen. In *United States ex rel. Hopson v. Air Ideal, Inc.*, the complaint alleged that Air Ideal's claimed that the company's principal office was in a designated "HUBZone." In reality, this address was actually their "virtual office" with no employees working from it, and their physical office located outside of a HUBZone. In support of that false claim of HUBZone eligibility, the company submitted fraudulent lease documents to the SBA. The case settled for \$250,000.

How can a whistleblower report these types of frauds, and earn monetary rewards?

As you can see, the ways in which companies can cheat their way into small business set-aside contracts are numerous. How can [whistleblowers](#) help level the playing field for honest companies? One way is by bringing a *qui tam* case under the False Claims Act—precisely the type of case that led to all the settlements discussed above. When a whistleblower brings a [qui tam case](#), the Department of Justice opens an investigation, and will vigorously pursue the case if the evidence supports the whistleblower's allegations.

If the case is successful, the whistleblower will be handsomely rewarded. Under the False Claims Act, the relator—the technical name for the whistleblower that brought the case—is entitled, in most cases, to a reward of between 15% and 30% of the government's recovery. So, for example, if the case settles for \$10 million, the whistleblower's reward will be between \$1.5 million and \$3 million. [The government does actually pay these rewards.](#) Whistleblowers in *qui tam* cases have been awarded hundreds of millions of dollars of rewards in recent years, and many of those rewards were for cases that expose small business set-aside contracting fraud. In the 10-year sample of set-aside fraud cases we reviewed, we were able to identify over \$30 million in rewards to the whistleblowers. This actually underestimates the total rewards since some are not made public. This \$30 million estimate also does not include amounts awarded to whistleblowers in non-intervened cases (ones that the government does not settle, but that the whistleblower then successfully pursues on their own), or in cases involving state governments. So, the actual amount that whistleblowers have received over the period of time is impossible to pin down exactly but must be quite a bit larger than \$30 million.

Fundamentally, the point is this: whistleblowing on set-aside contracting fraud, by bringing *qui tam* cases under the False Claims Act, is an effective means of combatting that fraud. And when those cases are successful, the whistleblowers earn large rewards all the while protecting taxpayer funds, and the small businesses that serve so many.

Emma Schilp and Emma Bass contributed to this article.

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