An Ounce of Prevention: A Guide for Combating Fraud in Construction

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The term *fraud* can evoke images of clever schemes, exciting investigations, and going to battle against evil corporate interests. Fraud is often glorified in Hollywood TV shows and movies like *The Sting*, *Dirty Rotten Scoundrels*, *The Sopranos*, *American Hustle*, and *Ocean's Eleven*. Many such plots end with the lovable fraudster duping the evil corporate empire, outsmarting the law, and disappearing to a tropical paradise with the ill-gotten gains.

But the fraud of the silver screen should not distract us from the fraud that happens every day. As we know from the nightly news and scandals such as those involving Bernie Madoff and Enron, fraud is nothing more than a theft, a criminal act with real victims. Fraud hurts corporations and real people and is rampant in all industries, including, and maybe especially, construction.

With this in mind, this article is intended to provide:

1. An understanding of who commits fraud and, more specifically, occupational fraud and how it manifests itself in organizations within the construction industry;
2. An account of some of the unique legal exposures that construction companies face, especially where many projects receive some government funding; and
3. A discussion of proactive and remedial measures to prevent fraudulent behavior, detect problems early, and minimize the impact of fraud within a project or organization.

Most fraud is performed not by clever evil geniuses, but by normal people who see a weakness in a control system and decide to take advantage of it for their own gain. It is the scale operator at the scrap metal plant who discovers he can write a check to himself or a fictitious subcontractor without anyone noticing. It is the bookkeeper for the small subcontractor who colludes with vendors to pay invoices for fictitious work while taking kickbacks. It is the contracts manager who provides winning bid information to his friends and then arranges change orders to make up for losses.

Some fraud may be viewed as harmless or understandable, such as the bookkeeper who borrows money from the firm without asking but then pays it back. But often, seemingly innocuous events are the tip of the iceberg or evidence of early efforts to test control systems to see if anyone notices. After all, many fraud schemes start with someone doing something small that they perceive as harmless, or at least justifiable.

We often hear of fraud on Wall Street or in the health care system, but what about the construction industry? In our industry, fraud can take on many forms, affecting owners, contractors, subcontractors, and sureties. The following are examples of fraud in the construction industry that have recently hit the headlines:

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- In Wheeling, Illinois, an employee of contractor Universal Restoration was arrested for conspiring with a Milwaukee County safety coordinator to use county insurance money to fund work done on their personal properties.[1]
- Two construction company operators in Sunnyvale, California, underrepresented the number of company employees to their insurance company and now face four counts of felony workers' compensation fraud.[2]
- In Boise, Idaho, the owner of a highway construction company and former Associated General Contractors president was convicted of 22 criminal counts, including conspiracy to defraud the government and filing false tax returns. Over a period of 11 years, the owner submitted false tax information to qualify for federal programs designed to benefit disadvantaged companies. She faces seven years in prison and $3.1 million in restitution.[3]

Whether simple or complex, the risks to the players in the construction industry have never been higher. First, the financial impact can be significant and—depending on the extent of the damage—sometimes crippling. But even if a company can survive the immediate financial impact, its reputation can be damaged beyond repair, it may lose potential reimbursements, and if it works on projects with government money, it risks suspension, debarment, or jail time.

The world is changing. Technology has made the opportunities for fraud both more prevalent and potentially more harmful. There is also a new focus on waste, fraud, and abuse at all levels of government, which increases the risks to construction firms. Gone is the era of only reacting to potential fraud after it is found. Players in the construction industry must carefully consider how to institute robust programs to detect and prevent fraudulent behavior to protect themselves and their companies.

Studies of Occupational Fraud

Understanding what fraud and occupational fraud are helps create the framework for a discussion of both pioneering and contemporary research to identify the characteristics of fraud perpetrators and victim organizations.

Fraud is "any illegal act characterized by deceit, concealment, or violation of trust."[4] Fraud is not dependent upon the threat of violence or physical force and is perpetrated by parties and organizations to obtain money, property, or services; to avoid payment or loss of services; or to secure personal or business advantage.[5] The subset of fraud identified as *occupational fraud* is frequently used to signify some sort of fraud occurring in the workplace. Definitions of occupational fraud vary, but generally it is "the use of one's occupation for personal enrichment through deliberate misuse or misapplication of the employing organization's resources or assets."[6] Occupational fraud can include a broad range of illicit conduct by individuals at all levels of an organization—executives, employees, managers, and principals. It may encompass activities ranging from high-tech intellectual property theft and financial investment schemes to petty thievery.

Pioneering Fraud Research

The underlying conditions that give rise to fraud and occupational fraud are numerous and complex. For decades this area has been a fertile area of study by criminologists and investigators seeking to better understand both the individuals who perpetrate fraud and the types of employers that are most often their victims. Although an in-depth discussion of this research is beyond the scope of this article, an outline of these studies begins to provide examples of the typical fraudster in an occupational context.

By their very nature, fraudulent acts are clandestine, and occupational fraud is typically thought of as *white-collar* crime. This term was coined by Dr. Edwin H. Sutherland, a criminologist from Indiana University, in 1939.[7] Sutherland's chief contribution to criminology is known as the differential association theory, which posits that criminal behavior is learned and, further, that the more messages promoting antisocial or criminal behavior that an individual is exposed to over and above prosocial messages, the more likely the individual is to gravitate toward crime.[8]

Dr. Donald R. Cressey, Sutherland's protégé at Indiana University, was intrigued by embezzlers, a special class of occupational fraudsters who not only steal from their employers but are authorized and entrusted with custody of the assets they steal—a violation of their fiduciary duty. Cressey sought to better understand the circumstances leading embezzlers, whom Cressey called

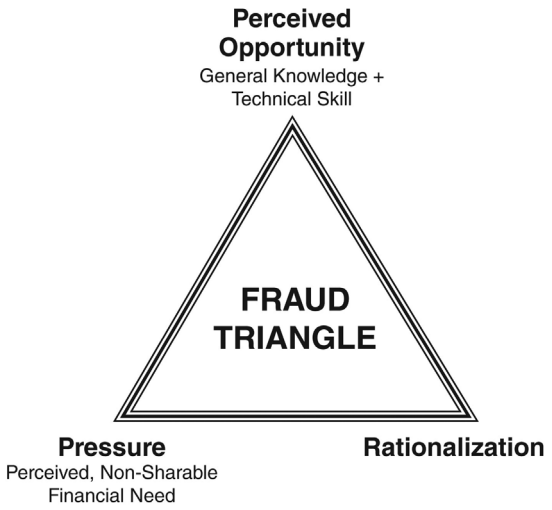

Figure 1 – Cressey's Fraud Triangle

"trust violators," to be overcome by temptation.[9] Over time, Cressey's work has become known as the Fraud Triangle (Figure 1), which has been accepted as a basic conceptual framework for understanding the act of fraud.[10] According to Cressey's central hypothesis, trust violators typically

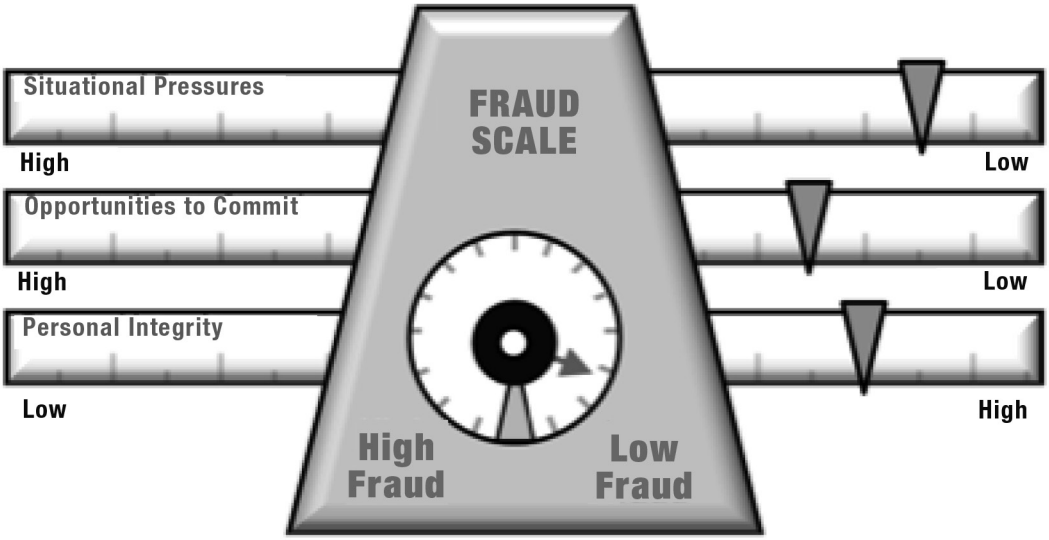

Figure 2 – Albrecht's Fraud Scale

share three key attributes, represented by the vertices of the Fraud Triangle: (a) perceived opportunity, (b) pressure, and (c) rationalization.

As defined by Cressey, perceived opportunity is the combination of general knowledge of how to defraud the organization and technical skill to deceptively execute the fraud.

Cressey's element of pressure is a perceived "nonsharable" problem or financial need that the fraudster wants to resolve. These pressures are classified into six basic categories:

1. Violation of ascribed obligations,
2. Problems resulting from personal failure,
3. Business reversals,
4. Physical isolation,
5. Status gain, and
6. Employer-employee relations.[11]

Lastly, rationalization allows the perpetrator to justify his fraud. It is the corruption of the fraudster's own principles and beliefs in order to psychologically justify committing fraudulent acts.

Cressey's central premise was that individuals who committed occupational fraud were influenced by these three factors of the Fraud Triangle. The Fraud Triangle helped create a framework for understanding and deterring fraud.

Another pioneer in this area was Dr. W. Steve Albrecht, whose studies initially concentrated on motivations of fraud perpetrators as related by auditors during interviews at victim organizations. Albrecht identified fraudster motivations that had similarities to Cressey's nonsharable pressures, which Albrecht called *situational pressures*:

1. Living beyond their means,
2. Overwhelming desire for personal gain,
3. High personal debt,
4. Close association with customers,
5. Feeling that pay was not commensurate with responsibility,
6. Wheeler-dealer attitude,
7. Strong challenge to "beat the system,"
8. Excessive gambling habits, and
9. Undue family or peer pressure.[12]

Albrecht's research ultimately took shape as the Fraud Scale (Figure 2).

Albrecht's Fraud Scale helps identify organizations that may give rise to fraud. According to the Fraud Scale, organizations with high situational pressure, high opportunity to commit fraud, and employees with low personal integrity are more likely to fall victim to fraud. According to Albrecht's research, the top characteristics of organizations victimized by fraud are:

1. Placing too much trust in key employees,
2. Lack of proper procedures for authorization of transactions,
3. Inadequate disclosures of personal investments and incomes,
4. No separation of authorization of transactions from the custody of related assets, and
5. Lack of independent checks on performance.[13]

Because of the nature of the construction industry, including the constant flow of funds among various parties, construction companies can find themselves in environments with these organizational deficiencies. Untrustworthy employees may readily find areas in the system in which to commit fraud. In fact, one need only look at the few examples of recent construction frauds summarized at the beginning of this article to see evidence of the types of organizational deficiencies revealed by Albrecht's research.

Modern-Day Fraud Research

Cressey's Fraud Triangle, Albrecht's Fraud Scale, and other research have paved the way for the development of modern-day occupational fraud detection and deterrence

methods. These approaches essentially seek to tip the scale in favor of minimizing opportunities that could give rise to fraud. Current research has moved further into the mind of the fraud perpetrator to help explain occupational fraud occurring in today's sophisticated and increasingly information- and technology-based environment. Newer fraud models are linking occupational fraud with research involving motivation, behavioral type, emotion, and even mental illness.

One such model—introduced in 2010 and called *MICE*—is an outgrowth of the Fraud Triangle. The MICE model expands on the Fraud Triangle and seeks to better explain the motivations of high-level, very skilled fraudsters whose motivations may not necessarily be represented in the Fraud Triangle. The MICE model posits that motivations of fraud perpetrators can be categorized as follows:

- *Money*: this most traditional motivator is fairly self-explanatory;
- *Ideology*: these fraudsters justify fraud to achieve some "greater good" that is consistent with their personal beliefs;
- *Coercion*: these fraudsters are unwillingly pulled into crime and can be turned into whistle-blowers; and
- *Ego*: these fraudsters commit fraud to avoid harm to their social standing or reputation.[14]

Today, still other fraud models are being developed to further distinguish types of fraudsters such as *predatory fraudsters*, who decide to coerce and harm others with intimidation; and *accidental fraudsters*, who may simply stumble upon an opportunity and decide to commit a fraud.[15]

As these fraud models evolve to understand and identify the motivations and actions of contemporary fraudsters, corporations can use the research to develop controls or policies to better predict, prevent, and detect occupational fraud.

Unique Fraud Exposures Involving Construction Contracts

In the construction industry, money is often free-flowing, and transactions may not be as tightly controlled as in other industries. This environment, coupled with laws that are not always intuitive, creates risk for companies to be both victims and even perpetrators of fraud or other fraud-related crimes. Construction companies cannot detect fraud or develop effective compliance programs without first understanding the legal parameters within which the government expects companies to perform. This section outlines some of the most pertinent legal principles or statutory schemes.

Common Law Liability for Occupational Fraud

Traditional fraudulent activity is punishable under existing state criminal statutes barring fraud and theft. The specifics and elements of these crimes vary based upon jurisdiction, but general characteristics of legal violations common in the construction industry include the following:

- *Embezzlement*: dishonestly withholding assets for the purpose of theft by someone entrusted with those assets.
- *Theft*: taking another's property without permission or consent with the intent to deprive the rightful owner of it, such as an employee taking supplies from a construction site for his own personal use.
- *Tax fraud*: deliberate misrepresentation of a company's financial affairs to tax authorities, to either reduce tax liability or gain some beneficial tax status, such as federal small business certification.
- *Bribery*: money or favor given to influence the behavior of someone in a position of trust, such as someone responsible for awarding contracts.
- *Insurance fraud*: any act done to dishonestly obtain some benefit or advantage to which one is not entitled, such as misrepresenting the number of employees to save on workers' compensation insurance.

Federal Statutes and Regulations Concerning Occupational Fraud

In addition to state laws, construction contractors should be aware of federal laws even if the project is not federally funded. Some federal laws, like the Foreign Corrupt Practices Act, 15 U.S.C. sections 78dd-1 et seq., apply regardless of whether a construction project uses public funding. In the context of construction projects involving public funds, the potential sources of liability are far-ranging, including the False Claims Act, 31 U.S.C. sections 3129 *et seq*., and the Anti-Kickback Act, 41 U.S.C. sections 8701 *et seq*. Furthermore, some states have enacted statutes mirroring these federal laws, creating another layer of potential liability. A summary of some of the most likely risks for fraud on construction projects is set forth here.

False Claims Act

The False Claims Act (FCA), 31 U.S.C. sections 3729–3733, creates liability for knowingly presenting, or causing to be presented, a false or fraudulent claim to the US government for payment.[16] It also creates liability for knowingly making, using, or causing to be made or used, a false record or statement material to a false or fraudulent claim.[17] Since its amendment in 1986, the FCA has been a powerful tool in the government's arsenal against fraud on federal construction projects.

Construction companies must be mindful of the FCA because its steep penalties include mandatory treble damages (which are reduced to double if a company self-discloses and cooperates, as discussed further below) and mandatory civil penalties of up to $11,000 per false claim.[18] Furthermore, the FCA's strong whistle-blower incentives provide private litigants up to 30 percent of any recovery, depending in part on whether the government

decides to intervene in the action.[19] Also, FCA liability is not limited to prime contractors but extends to subcontractors and other third parties.[20] Practitioners should also be aware that more than 30 states and municipalities have enacted FCAs of their own.[21]

The FCA also has a broad knowledge standard, so companies can be found liable even where they do not have actual knowledge but mere deliberate ignorance or reckless disregard of the truth or falsity of the information provided.[22] This means that it is not only sound business practice to implement a program of preventative and corrective measures, including training and reporting as outlined below in this article, but it also could provide a defense to an FCA claim. A company with good preventative and corrective measures could argue that the unlawful act was not done with the company's deliberate ignorance or reckless disregard of the unlawful act, but instead was done by a rogue employee not only without the company's knowledge, but also without it turning a blind eye to the conduct.

The FCA also provides a company with a financial incentive to self-disclose fraud once it is discovered. If within 30 days of learning of the fraud the company furnishes all information regarding the violation and cooperates with the investigation, a court may assess double—rather than treble—damages.[23]

Foreign Corrupt Practices Act

The Foreign Corrupt Practices Act of 1977 (FCPA) prohibits giving bribes and other gifts of value to foreign officials, parties, and candidates. Its application is broad: it applies to US citizens, nationals, and residents; companies and businesses either organized under the laws of the United States or having their principal places of business in the United States; and foreign companies that violate the Act while physically present in the United States.[24] The antibribery provisions prohibit a contractor from giving gifts or bribes to foreign officials, or promising to do so, to gain business or otherwise influence the contractor's business in that country.[25]

To fall under the FCPA, a payment or gift must be made to "corruptly" influence the foreign official, meaning that the contractor intended the official to misuse his position or power.[26] The Department of Justice (DOJ) has criminal and civil enforcement authority for the FCPA, concurrently with the Securities and Exchange Commission for publicly held companies, which has only civil authority. Corporations and other business entities are subject to criminal fines up to $2 million for FCPA antibribery violations.[27] Individuals, including company agents, can be criminally liable for fines up to $250,000 and five years in prison.[28] Civilly, violations of the bribery provisions carry a $16,000 fine per violation, for both individuals and businesses.[29]

The broadening international reach of US-funded construction projects abroad (e.g., the reconstruction efforts in Iraq) have triggered FCPA concerns for a variety of US construction firms. Moreover, the standard construction practices in some foreign countries are in direct violation of the provisions of the FCPA. So, even a well-intentioned but ill-informed employee can create problems for his company under the FCPA.

Recently, the DOJ has pursued several FCPA violations in Nigeria. A deferred prosecution agreement (DPA) filed by DOJ in the Southern District of Texas alleges that in 2013, Bilfinger SE, a German company providing international engineering and related services, committed an FCPA violation in Nigeria. According to the DPA, Bilfinger conspired with a consortium of contractors to pay more than $6 million in bribes to Nigerian officials to obtain and retain work constructing a natural gas pipeline, the Eastern Gas Gathering System. To cover the expected bribes, the consortium inflated its bid by 3 percent. When the consortium was awarded the contract, it made cash payments to multiple Nigerian officials through various employees of the consortium. In exchange for deferred prosecution by DOJ, Bilfinger agreed to pay a $32 million fine, institute strict internal controls, and subject itself to independent compliance monitoring for 18 months.[30]

Training and education programs like those discussed later in this article can be highly effective in heading off FCPA violations. These programs are of heightened importance when a construction company is embarking on international construction projects in countries where it previously has not worked. Detailed research into the local construction practices is essential in such circumstances. Dissemination of that information to the employees prior to commencing work on the project can help the company avoid FCPA problems.

Federal Acquisition Regulation

Preventative and corrective measures to eliminate fraud discussed later in this article, as well as the self-reporting of fraud, are not only good practice but may be required by the Federal Acquisition Regulations (FAR), the primary regulation governing the federal government's purchasing process. Section 52.203-13 of the FAR created a "Contractor Code of Business Ethics and Conduct" that specifically requires institutional programs such as a written code of business ethics and conduct, an ongoing business ethics awareness and compliance program, and an internal control system to help discover improper conduct and institute and carry out corrective measures.[31] The FAR also requires timely disclosure if you have credible evidence that a principle, employee, agent, or subcontractor has committed a violation of federal criminal law involving fraud, conflict of interest, bribery, or gratuity violations or has violated the False Claims Act.[32]

American Recovery and Reinvestment Act

The American Recovery and Reinvestment Act of 2009 (ARRA) was a stimulus package designed to create jobs and provide relief during the recession through direct government spending on infrastructure and education,

tax breaks, increased social welfare benefits, and other measures.[33] The ARRA allocated significant sums to the construction industry: $39.2 billion to transportation, $33.8 billion to other infrastructure like rural water projects, and $14 billion to housing, among other areas of investment.[34]

However, this money was not without strings and potential pitfalls for construction companies. ARRA funds come with a variety of obligations to both the government and contractors' employees. Significantly, the ARRA now extends to state and local contractors many obligations that in the past have only applied to federal contractors.

For example, any contractor receiving ARRA funds, whether working on a federal or state government contract, is subject to the following:

- False Claims Act;
- Whistleblower protection requirements;
- Quarterly reporting requirements on the usage of ARRA funds;[35]
- Buy American provision in public works contracts, requiring contractors to buy only US-manufactured construction materials unless unavailable or 25 percent more expensive than foreign equivalents;[36]
- Davis-Bacon Act wage rates;[37]
- Federal government audits of primes and subcontractors;[38]
- Federal environmental laws and energy requirements; and
- Federal antidiscrimination, civil rights, and equal opportunity program requirements.

In short, the federalization of a wide variety of traditionally state-funded projects poses risks to construction companies unfamiliar with the requirements. With these risks may come pressure to conceal unlawful activities or falsify compliance, creating new exposures for construction companies.

Anti-Kickback Act of 1986

The federal Anti-Kickback Act, 41 U.S.C. sections 8701 *et seq*., prohibits attempted and completed payments or receipt of money, commission, credits, gifts, or other things of value in exchange for favorable treatment with respect to a government contract.[39] Even kickbacks built into contract or subcontract prices are prohibited by the statute.[40] To be liable under the Act, a person must act knowingly and willfully.[41] Further, contractors awarded government contracts of more than $100,000 must have procedures in place to detect and prevent violations of the Anti-Kickback Act and are required to inform the contracting agency of any reasonable grounds to believe a violation has occurred.[42]

Construction contractors may feel they have no choice but to provide kickbacks where there is government corruption, but they do so at their peril. For example, in California six former government contractors pleaded guilty in January 2014 to a kickback scheme in connection with construction contracts at the Marine Corps' Camp Pendelton. A former Department of Defense employee led the scheme, soliciting bribes from construction companies in exchange for granting contracts for work at the base. The corruption flowed down to the subcontractors, who arranged with prime contractors to perform discounted work on personal residences and other kickbacks in exchange for subcontracts. The six contractors were charged with violations of the Anti-Kickback Act, bribery of a public official and conspiracy thereto, and filing false tax returns.[43]

Training employees to prevent violations of the Anti-Kickback Act must include discussing situations in which the employee is approached by another party seeking a bribe. In this scenario—more common in the industry than some are willing to acknowledge—the employee must be provided with a defined internal path to report such overtures. This policy allows the company, rather than the employee, to devise an appropriate response.

Employee training must also include situations, prevalent in certain foreign countries, where an act considered standard construction practice must be avoided because it is a violation of the Act. In this scenario, the company is responsible for researching local construction customs to identify and outline in advance those common practices that may need to be avoided.

Other Federal Laws Relevant to Occupational Fraud

- *Conspiracy to Defraud Government Act*: Similar to the False Claims Act, 18 U.S.C. section 286 prohibits conspiracy to defraud the government through any false claim. Violation of this law carries a possible fine and up to 10 years of imprisonment.[44]
- *Obstruction of a Federal Audit*: Any attempt to influence, impede, or obstruct a federal auditor in performance of his or her job duties can result in up to five years in prison and a fine under 18 U.S.C. section 1516. This applies to any project receiving more than $100,000 in funding within the period of a year from the government. This statute applies only if the obstruction or influence is made with the intent to deceive or defraud the government.[45]

Decreasing Your Fraud Exposure: Proactive and Reactive Approaches

Fraud can devastate an organization's financial health and reputation. This is especially true in construction, where there are many stakeholders with competing interests who must nonetheless rely upon each other.

Construction organizations must have strong fraud awareness, prevention, and detection programs in order to not only avoid the initial fraudulent behavior, but also avoid backlash or additional liability if a fraud occurs. Some of the most effective methods to promote fraud awareness, increase fraud deterrence, improve fraud detection, and mitigate the financial and reputational risks of fraud are examined below.

Organizational Policies and Procedures to Create an Antifraud Culture

One of the most effective and proactive approaches to fraud prevention is to create an antifraud culture within a company. In this culture the company must project that it is committed to taking active measures to prevent and detect fraud and that it will not tolerate fraud. It is critical that a company's antifraud culture is clearly and consistently demonstrated to the workforce as a method of fraud deterrence—or increasing the perception of fraud detection. Research has shown that if fraud perpetrators believe that someone is looking—even if no one actually is—they will not take the risk of committing fraud.[46]

Three simple and effective ways to create this culture are through strong company ethics policies, hotline installations, and internal training.

Company Ethics Policy

A strong company ethics policy is the first step toward communicating the importance of combating fraud to the company's employees. However, simply drafting and distributing the policy will not suffice. Many employees will simply push a button that says, "I have read the policy," and get on with daily work without ever reading the first line.

Therefore, combining a solid ethics policy with a "Tone at the Top" from senior management is the more effective method for combating fraud. Regular communications from executives that stress the importance of ethical behavior help employees keep the importance of avoiding and/or reporting fraud at the forefront of their minds. These communications reinforce that someone cares, that fraud prevention is important to firm leadership, and that someone is looking. Just as we all slow down when we see blue lights, an employee predisposed toward fraudulent behavior is less likely to perpetrate fraud if he or she thinks someone is watching.

In addition, if there is no strong Tone at the Top, other normally honest employees may be influenced if they see one of their colleagues getting away with fraud. In their frustration, they may decide that they can commit fraud as well, and the problem multiplies. A strong Tone at the Top creates a culture that helps prevent the learned criminal behavior identified by Dr. Sutherland's differential association theory discussed above.

Hotlines

A simple way to protect your firm, detect fraud, and project the antifraud culture is to install a hotline for employees to call when they suspect improper behavior somewhere in the firm. Many frauds are discovered after something is noticed and reported by a coworker. By making it easier for an employee to report fraud through a hotline, a firm can discover fraudulent behavior before significant losses have occurred. In fact, a recent survey found that frauds were considerably more likely to be detected by a tip in organizations with a hotline (51%) than in organizations without a hotline (35%).[47]

Although a hotline may be perceived as an unnecessary expense, particularly in smaller organizations, several hotline service providers, often run by former law enforcement agents, provide a monthly hotline service for a fee. These services can also provide investigatory services should the need arise.

The cost of not having a hotline could be significant. In addition to potentially losing an opportunity to stop fraudulent behavior, if a fraud does occur and a company did not have a hotline or other fraud detection system, it runs the risk of appearing to turn a blind eye to potential improper behavior. This could be used against the firm and its executives, particularly if the project is a government contract, for example, where the heightened knowledge standard applies under the False Claims Act, or internal control systems are required as in the Federal Acquisition Regulation, discussed earlier in this article.

Fraud Training

Fraud training, as with most ethics training, may be perceived by some as a waste of time. After all, if an employee didn't learn that it is wrong to steal by kindergarten, how is a company or client going to train him or her in ethics?

However, even if a company cannot train the bad employees to be good employees, a robust ethics and fraud prevention training program has several benefits:

1. It is an effective way to reinforce the "Tone at the Top";
2. It will reinforce the perception that the firm is detecting fraud, which could deter a potential perpetrator from committing fraud;
3. It ensures that employees know about the hotline and how to use it, preventing an employee from saying, "I knew he was doing something wrong, but I didn't know whom to go to"; and
4. It is economical insurance against allegations that the company had "reckless disregard" of fraud, should fraud occur.

No policy, hotline, or training will stop all fraud. However, by using these tools to create an antifraud culture, a company reduces its exposure to fraud and creates defenses should a fraud occur.

Special Audits

Audits may help identify areas where fraud is occurring. Two types of audits, *construction audits* and *operational audits*, are discussed below.

Construction Audits

Construction audits can be performed by owners or contractors at nearly every stage of project delivery including:

- Conceptual design and planning,
- Project presolicitation,
- Project solicitation,
- Project execution and administration, and

- Project close-out.

Although construction audits are specifically not intended to detect fraud, they may reveal areas in which fraud could exist. Typical findings of a construction audit may include:

- Inflated construction project costs/contractor overbillings,
- Misstated material and supply quantities,
- Errors in pay application arithmetic,
- Duplicate invoices and back-charges,
- Lost owner deposits,
- Abusive change order pricing and practices,
- Unallocated owner credits and value engineering savings,
- Miscalculated share savings agreements,
- Inappropriate cost-shifting between different project budgets,
- Other invoice abnormalities,
- Unaccounted contingency allowance funds, and
- Premature release of contractor retention.

Construction audits must adhere to generally accepted auditing standards (GAAS), which include general standards, standards of field work, and standards of reporting.[48] *Independence*, or an auditor's ability to act with integrity and objectivity, is a central concept in construction auditing as the results of a construction audit will have value only if the auditor is perceived to be beyond management's undue influence. Owners and legal counsel should ensure that adequate "Right to Audit" clauses are included in their respective construction contracts.

Operational Audits or Process Reviews

Operational audits or process reviews can be effective, although are most often after the fact, methods for detecting weaknesses or indications of fraud. Operational audits are typically performed by internal auditing staff,[49] though they can also be outsourced, and encompass audits that are performed on operations, legal/compliance, or managerial processes. In construction, the term *process review* is often used as a catchall to distinguish these types of audits from financial construction audits.

Although the particular goals of an operational audit will vary, they are typically performed to achieve one or more of the following objectives:

- To determine the strength or adequacy of internal controls,
- To determine compliance with contract requirements or internal policies,
- To assess management oversight functions,
- To assess the efficacy of the examined processes or business functions actually achieving their stated objective, or
- To provide a baseline-level assessment for subsequent fraud-risk evaluation or analysis.[50]

An organized process review typically will focus on one element of the construction business function—for example, payroll or billing procedures. Construction-themed red flags that may be discovered during a process review include:

- Multiple awards to the same entity;
- Competitive bidder complaints and protests;
- Complaints about quality and quantity;
- Multiple contracts awarded below the competitive threshold;
- Abnormal bid patterns;
- Questionable bidders;
- Awards to nonlowest bidder;
- Abnormal contract scope changes;
- Numerous and large postaward change orders;
- Frequent urgent need of sole source contracts;
- Questionable local, small, and disadvantaged business enterprises (LSDBE) set-aside qualifications; and
- Potentially inappropriate owner/contractor relationships.

If findings warrant, abnormalities identified during process reviews can be further examined through a more detailed fraud investigation.

Fraud Investigations

Unlike a process review or audit, which may or may not detect the presence of fraud, a formal fraud investigation is typically performed only when fraud is strongly suspected. Fraud investigators are usually responsible for the detection of fraud and recovery of assets, and work closely with internal security and legal counsel in order to bring legal action against perpetrators.[51]

Support of the fraud investigation team by executives and senior management is essential. Management must let all stakeholders know the organization is ready to respond swiftly and appropriately to any fraud risks identified to encourage assistance, which is a crucial element of a successful fraud investigation.

Obtaining the necessary documentary evidence for a fraud investigation can be a challenge, may require court action or subpoena, and may encompass much more than standard business records as individuals may attempt to conceal assets or other information. Typically, after the initial financial records are obtained and analyzed, interviews with key personnel will be conducted to ascertain the extent of the fraud.

The final stage of the fraud investigation is typically a confession interview of the individual suspected of committing the fraud. If successful, a fraud investigation may increase the victim organization's chance for recovering stolen assets.

Periodic Fraud-Risk Assessments

Finally, periodic fraud-risk assessments should be undertaken to identify areas of fraud risk within the particular project or organization. Typically these assessments review each of a company's functional areas to evaluate both the risk of the occurrence of fraud and the

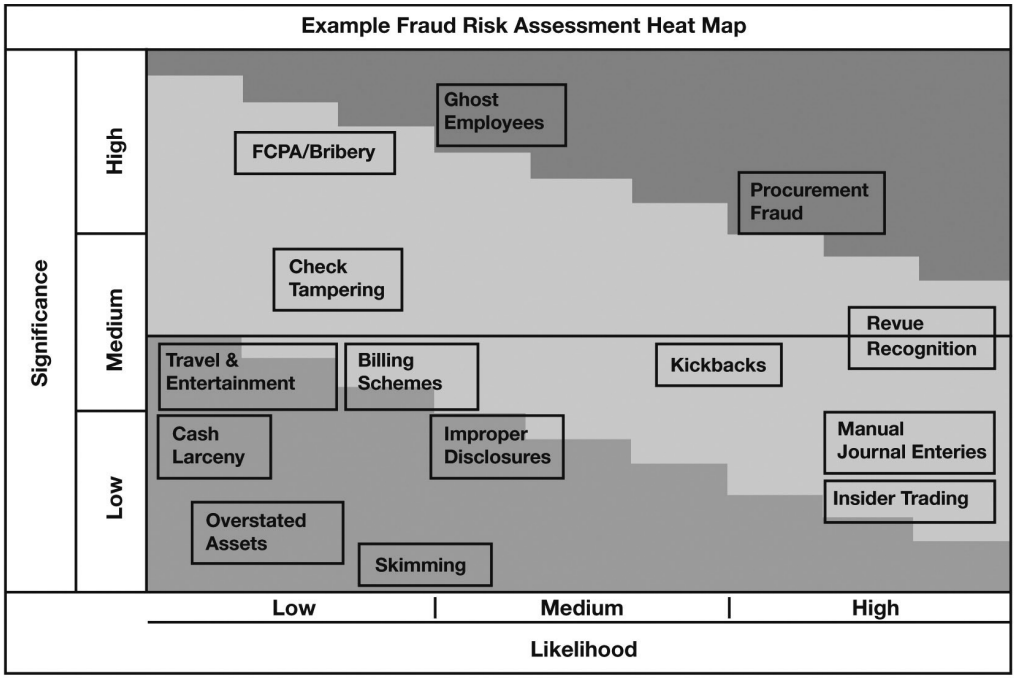

Figure 3. Fraud-Risk Assessment Results Heat Map

company's projected level of exposure in the event of fraud. A thorough review often involves surveys and interviews of knowledgeable employees at various levels to assist in the assessment of both the likelihood and the potential impact of a fraud.

For example, a fraud-risk assessment may determine that a company's credit card issued to employees has a high likelihood of fraud occurring, but the relative monetary impact is small. It may also find that a procurement system with strong controls has a low likelihood of fraud but a significant impact should fraud occur.

The results from a fraud-risk assessment are often displayed on a "HEAT map" as shown in the diagram below. The block toward the upper right in this grayscale reproduction is traditionally red for the "hottest" risk; the center block is yellow for moderate risk, and the block on the lower left is traditionally colored green for the lowest risks.

Figure 3 helps plot and communicate the relative fraud risks and potential impact, helping management prioritize and focus resources on high-risk areas with high potential impact to rapidly reduce overall fraud risk to the company. The surveys and interviews inherent in a fraud-risk assessment have the added benefit of reinforcing management support for a fraud-free culture.

Reporting Considerations

What happens if, despite these precautions, an investigation concludes that a fraud did occur? Many interested contractual and third parties may need to be informed about the fraud. These include insurance companies, funding organizations, government agencies, and other project stakeholders.

Perhaps this is best explained by an example. Imagine a firm or client is the general contractor for a new museum being built in town. The museum is being built in a tax-advantaged enterprise zone in a distressed area. The owner of the project has agreed with the city government that 20 percent of the work on the museum will be performed by LSDBE and has passed that requirement down to the general contractor in its contract. The owner then secured financing from bonds utilizing the tax advantage for 80 percent of the cost of the project. Finally, a private donor organization issued grant money for 20 percent of the cost of the project to support the arts.

Now the bad news. Midway through the project, the general contractor's off-project executive team discovers that its project manager accepted a fraudulent LSDBE certificate from an unqualified subcontractor. In return, the subcontractor has been providing free upgrades to the project manager's house.

The discovery of this fraud may require reporting to various parties for different reasons:

- The city may need to be informed because the project may no longer meet the agreed-to LSDBE participation;
- The finance providers to the owner may need to be informed because if the LSDBE requirement is not met, the tax advantage on which the bonds have been issued may not be allowed anymore;
- The donors may need to be informed because if the 80 percent bonded financing is pulled, the project may not be finished and the donation wasted;
- The general contractor's insurance company may

need to be informed because certain provisions of the insurance may allow recovery of some, or all, of the losses from the fraud; and

- Finally, of course, law enforcement may need to be notified.

An analysis of relevant contracts, statutes, and regulations should be undertaken to determine the actual reporting requirements in a given situation. Failure to properly report could come back to haunt the firm if the fraud is discovered by another party during a close-out or compliance audit. This is an example in which the general contractor will hope it had a robust ethics and fraud prevention program in place to demonstrate that it did everything it could to prevent this fraud from occurring and that the company was not indifferent to its employees' behavior.

Insurance Against Fraud

If a company has suffered a loss due to fraud, or is contemplating additional ways to protect itself from fraud, it may consider various insurance policies. Of course, any coverage is limited by the particular language of the policy, and one should consult the specific policies to advise what coverage may be available. But this discusses general categories of available policies.

First, we look at the standard policies a firm may already own, such as builder's risk, property, and commercial general liability. As discussed further below, recovery in the event of fraud under these policies will be limited. Typically, these policies cover only theft of materials—not theft of funds—and even then coverage will be limited.

Builder's Risk Policies

A construction contract will typically require that the owner procure a builder's risk policy that will include coverage for theft of materials on the project.[52] However, this policy will likely exclude theft of money and security and only cover materials or supplies that will become a part of the project. The policy will also likely exclude theft of materials stolen from someone to whom they were entrusted, i.e., a company's own employee,[53] although it could allow coverage if a company or its employees are fraudulently induced to part with materials, such as by fraudulent bills of lading. Also, because the builder's risk policy is intended to end when the construction is complete, the coverage will be limited not just in scope but in time.

Other Property Insurance Policies

In the event of theft, a company may consider the language of applicable property insurance policies other than builder's risk policies, although these also typically exclude theft of money and security. Because these policies follow builder's risk after the completion of the project, the policy likely will not extend to most scenarios of construction material theft and, like builder's risk, these policies will also likely exclude coverage for dishonest or criminal acts by the firm, its partners, and its employees.

General Liability Policies

General liability is issued to protect a business against claims brought by a third party for bodily injury and property damage arising out of premises, operations, products, and completed operations. The language of these policies is typically crafted to exclude loss scenarios that could cover theft or fraud, so this coverage is not a likely avenue for recovery.

Therefore, typical insurance policies in a construction context, such as builder's risk, property, insurance, and CGL policies, may provide recovery for the theft of materials but otherwise will exclude theft of funds and theft by a company's own employees.

Commercial Crime Coverage Policies

For more comprehensive insurance coverage in the event of fraud or crime, companies can procure a commercial crime coverage policy. This policy may have different "pick-and-choose" options for coverage, depending on the level of coverage the client feels is appropriate.

Employee Dishonesty Coverage

The crime coverage policy can include employee dishonesty coverage, also sometimes referred to as a fidelity bond, which protects an employer from financial loss due to the fraudulent or dishonest acts of its employees. Some firms may already be required to procure this type of policy or bond by the Employee Retirement Income Security Act (ERISA) for employees who handle funds or other property of an employee benefit plan.[54] The employee dishonesty policy typically includes coverage for loss only when an employee steals from its employer, rather than others. However, coverage can be procured to cover loss to third parties or clients caused by an employee's theft, which could broaden coverage if, for example, its employee steals funds from the owner.[55]

Critically, employee dishonesty coverage and crime coverage generally are indemnity, rather than liability, policies. Employee dishonesty policies likely will not cover indirect losses resulting from the crime such as the cost of investigation, attorneys' fees, lost profit, or loss of use.

As with any insurance policy, an analysis of the exact language is critical, and this includes who the policy defines as an employee. Generally speaking, covered employees are those who are regularly and permanently employed by the company, whom it compensates, and whom it has the right to direct and control.[56] This means the policy will typically exclude principals or partners of the business who dominate or control the company.[57] Similarly, the policy will not cover a company's own fraud[58] or fraud that it believes occurred but cannot prove.[59] Also, if a company regularly employs temporary employees or independent contractors, the policy should cover them, or the company should make a special request that the

coverage extend to them.[60]

Keep in mind that the policies typically terminate as to any employee once the company is aware of the employee's theft or other dishonest act, even if those acts occurred before it employed him.[61] Therefore, as soon as the company has reason to believe its employee is being or has ever been dishonest, it should immediately launch an investigation and take appropriate measures to terminate the employment if appropriate. Also, keep in mind that the policies will require that, in addition to giving prompt notice of loss, the company cooperate fully in an investigation, including being willing to submit to examination under oath.

Other Crime Coverage Policies

Crime coverage can provide coverage beyond employee dishonesty. Policies can be purchased for coverage in the event of forgery or alteration, computer fraud, funds transfer fraud, inside-the-premises theft of money and securities, and inside-the-premises robbery, to name some examples. These types of crime or fraud may be less likely to occur in the construction context than in other industries, but companies with specific concerns could contemplate procuring these policies to afford additional crime coverage.

Conclusion

Many organizations prefer to think that fraud will not happen to them, and if it does, they can deal with it when it occurs. In today's environment, waiting to react to fraud rather than proactively preventing or minimizing it poses significant legal, financial, and reputational risks. These risks are multiplied by increasingly demanding government regulation. The penalties include significant fines, jail time for involved executives, and suspension and debarment for the entire company. And the firm may not need to have actively committed or supported the fraud for it to be impacted. Deliberate ignorance or reckless disregard can be sufficient to run afoul of the law.

So what should a prudent construction company do? First, recognize that the time for a reactive mind set is over. Participants in the construction industry must plan and execute proactive risk reduction programs to avoid events that can threaten their companies' viability. A good program should include organizational antifraud policies and procedures, such as hotlines and training, that project an antifraud culture. Construction audits to periodically review individual projects for policy and regulatory compliance and process reviews to ensure appropriate systems are in place to prevent fraud also can be helpful. Periodic fraud-risk assessments also can help identify vulnerabilities within an organization.

Unfortunately, no system is perfect. A controls system that would prevent all fraud would likely be cost prohibitive to implement and, further, so overly restrictive as to cause business processes to seize up. So although some fraud will nonetheless continue to occur, a company that has not established basic protections leaves itself open to the damaging accusation that it turned a blind eye.

How should a company respond to its discovery of fraud? The first step should be to start a fraud investigation. This may require coordination with third parties, including law enforcement. It also may require the subpoena of third-party documents because evidence of fraudulent activities may not be contained in the project documents. Further, counsel should review all contractual, statutory, and regulatory requirements to be sure reporting requirements, which may be complex, are being timely met. Finally, companies that desire extra protection from fraud may procure insurance policies to provide recovery if fraud occurs.

Note

The authors give special thanks to Keeley A. McCarty of Smith Pachter McWhorter for her many contributions to this article.

Endnotes

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15. Ramamoorti et al., *supra* note 10, at 121.
16. 31 U.S.C. § 3729(a)(1)(A) (2012).
17. 31 U.S.C. § 3729(a)(1)(B). FCA also creates liability for

additional acts such as knowingly making a false record or statement relative to an obligation to pay the government and conspiracy to commit a violation of the FCA. *See* 31 U.S.C. § 3729(a)(1)(C)–(G).

18. 31 U.S.C. § 3729(a)(1).

19. 31 U.S.C. § 3730(d).

20. 31 U.S.C. § 3729(b)(2)(A).

21. *See, e.g.*, United States *ex rel*. Ge v. Takeda Pharm. Co., 2012 WL 5398564, at *1 (D. Mass. Nov. 1, 2012) (alleging violations of the federal FCA and more than twenty state FCAs).

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53. *See, e.g.*, G & C Constr. Corp. v. St. Paul Fire & Marine Ins. Co., 731 F.2d 183, 185 (4th Cir. 1984) (holding that a builder's risk policy did not cover misappropriation of materials and labor by an independent contractor because of an entrustment exception, which stated that the policy did not insure against "[m]isappropriation, secretion, conversion, infidelity, or any dishonest act on the part of the insured or other party of interest, his or their employees or agents or others to whom the property may be delivered or entrusted").

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58. *See* Levey v. Jamison, 82 F.2d 958, 960 (4th Cir. 1936) (refusing recovery under a fidelity bond where the corporation was party to the illicit transactions).

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60. *See, e.g.*, G & C Constr. Corp. v. St. Paul Fire & Marine Ins. Co., 731 F.2d 183, 186 (4th Cir. 1984) (holding that a dishonesty policy did not cover an independent contractor because the language of the policy specifically excluded contractors and limited coverage to those the insured had a right to govern/direct).

61. *See* Newhard, Cook & Co. v. Ins. Co. N. Am., 929 F.2d 1355, 1358 (8th Cir. 1991) (upholding the denial of coverage where the employer was notified on at least four occasions before the event that gave rise to the claim that the employee had been accused of fraudulent activity and noting that the termination clause encourages employers to supervise their employees and minimizes fraud).

