



Construction Fraud

Fraud and corruption in the construction industry is endemic. Improper gains by constructors are often shared with the customer's employees through hidden rewards, ranging from cash to more subtle benefits such as building work carried out for nothing at the employee's home, pseudo consulting assignments or part time work. This article highlights the 'top five' types of fraud in the construction industry and provides some helpful hints and lessons to assist in the justification of negating a claim or to limit the damage that the claim can cause.

In January 2001, the National Audit Office conducted a report entitled "Modernising Construction", which stated that the industry in the UK is worth £65 billion per annum. The significant statistic is that approximately 10%, or £6.5 billion, is reported to authorities as lost to fraud; equate this figure with the 163,000 construction industry companies incorporated in the UK (some of which are virtual and rely on subcontractors), then on average each company loses approximately £40,000 to fraudulent behaviour.

This has worrying ramifications for the insurance market and, whilst not wishing to be accused of taking a negative view of the construction industry, the question has to be asked, "How much of this £6.5 billion is being passed on to insurers?"

Underwriters are all aware that detailed risk analysis, careful policy wording and loss history analysis are to be ignored at their peril. There are several examples of large losses suffered by insurers that were, by no means, badly written risks. The underwriter can only assess the information he is provided with and relies on the broker to provide him with good information and honest answers.

When the underwriter is carrying out the analysis for a new risk or renewal, there are areas of the risk analysis that can indicate fraudulent activity:

- Loss history, has this client suffered similar losses, are there patterns to these losses?
- Were the claims investigated adequately and by whom?



- Was the company in question suffering financial difficulties at the time of the loss?

Whilst the manifestation of each incidence of fraud will be complex and unique, there are broadly five categories to consider:

Improper Justification

The first question to ask is “Is the building project justified”? This is true whether the decision concerns a new factory or repairs to a leaking roof. The apparent justification may be based on a long term strategy set down by the directors or at the whim of a Building Services Manager. The costs can be covered in a capital budget, maintenance expenses or contingency fees.

Lessons

- Always check the justification for construction projects and building expenditure
- Pay particular attention when the work favours one constructor or a small group

Unwarranted Discretion Shown To A Vendor

Unjustified discretion shown to a constructor is an obvious symptom of fraud. This can sometimes be covert, such as the release of confidential bid information or the arbitrary disqualification of the lowest bidder to open the door for the favoured vendor. It may also be overt, such as allowing a constructor to substitute a bid on grounds, which appear plausible, or by dividing a large project into arbitrary packets which best suit the experience of the favoured vendor.

Lessons

- Examine the vendors who were invited to bid and their pre-qualification
- Consider the logic of the bid packages and any breakdowns
- Look for exceptions and deviations from standard procedures



- Make sure the contract conforms to an approved template

Competitive Bidding And Negotiation

The risks of overcharging are more or less equal in fixed price and cost plus contracts. Under fixed price contracts, the vendor agrees to complete the job for a set price, come what may. Most constructors try to avoid setting a fixed price, and, when they do, they make sure that any changes to specifications can be additionally invoiced.

Lessons

- Do not automatically accept the lowest bid, without first checking with previous customers the constructor's track record for charging extras
- Agree in the contract that all changes to specifications must be in writing
- Make sure the contract permits the constructor to charge for subcontractors actually paid. When, for cash flow reasons, this is not practicable, obtain certificates from the constructor and its subcontractors to that effect

Collusive And Courtesy Bidding

Competitive bidding, whether on fixed or variable priced contracting, can be manipulated. Contractors sometimes work together and submit collusive bids in what are effectively cartels. Evidence of this can be found by identifying similarities in detailed cost breakdowns, estimates of quantities required or common mistakes made by different vendors.

One member of a cartel will often deliberately bid high through what is sometimes referred to as a "courtesy bid". Vendors submitting courtesy bids are usually rewarded by being allocated subcontracts by the successful contractor. This is a typical profile of fraud.



Lessons

- Always review bids and other documentation for signs of collusion
- Watch out for constructors who have failed to win a major package appearing as subcontractors

Information Brokers

In recent years, corruption in the construction industry has become more subtle with the emergence of intermediaries sometimes described as “Information Brokers”. These are usually small businesses or individuals who know a local market, have established corrupt relationships and act as the link between contractors and the customer’s employees, some of whom have been corrupted. Typically, information brokers work on a percentage - ranging from 2 to 20 per cent of the contract amount - which is usually shared with the customer’s compliant employees.

Information brokers have to take care to ensure that, having won a contract for their principal, they get paid. To minimise their risks, they may enter into pseudo joint ventures or dummy contracts (and will often act for more than one in relation to a customer in which co-operative employees have been identified). Sometimes they will appear on the bid documentation or contract at the last minute, and without any obvious justification. Through the joint venture, they ensure their commissions are secured, often being paid a deposit or other advance before work commences. This is a typical profile of information brokering.

Lessons

- In all major projects remain on the lookout for signs of information brokering
- Watch out for substitution of constructors or the addition of new names at the contract stage
- Take care to identify the true beneficiary of advance payment



Comments

If the underwriter is not satisfied with his findings, then he should decline the risk or renewal. However, business is not always that black and white as the risk may offer a good level of income and may only seem unsatisfactory in a few areas. In this situation, it is wise to conduct some low level covert enquiries. Intelligence gathered through these enquiries enables the underwriter to make an informed decision.

In the event of a claim the underwriter needs to ensure the following:

- Was there a loss?
- Has the claimant complied with the policy i.e. agreed procedures etc?
- Is the underwriter completely satisfied with the claimant's version of events and any witness statements corroborating these events?

Here again there is an opportunity to negate the claim or limit the damage that the claim can cause.

Construction fraud is a serious problem and is subject to perhaps more litigation than anything except perhaps extra-marital impropriety!

About the author:

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