Hiding Behind a *Woman*

Using woman-owned or minority-owned businesses as pass-throughs for public-works contracts can ruin your reputation and your bank account.

BY ANDREW SMITH

According to the Code of Federal Regulations, at least 10% of all construction projects awarded through the Department of Transportation must be awarded to disadvantaged business enterprises (DBEs). A DBE is generally defined as a for-profit small business in which socially and economically disadvantaged individuals own at least 51% interest and control daily business operations.

In recent years, a number of cases and settlements related to DBE fraud have arisen, primarily involving fraudulently categorized woman- and minority-owned businesses. Many companies and general contractors attempt to complete projects without fully complying with DBE requirements set by the government. When they get caught, the penalty is steep.

Newsworthy Examples

Recently, there have been several notable cases in which disadvantaged business enterprises have acted as pass-through subcontractors for general contractors, submitting fraudulent documents to oversight agencies. In other cases, general contractors simply create their own fraudulent documents and present them to oversight agencies. Collectively, these activities have been classified as the "gray bag."

A pass-through DBE is described as any disadvantaged business enterprise representing itself as performing legitimate services on public-works projects though it is not actually doing any of the work. The false representation allows general contractors to secure public-works projects they might not otherwise win. »

A recent example of a DBE acting in a pass-through capacity appeared in the case of *United States v. Perino*. In *Perino*, the DBE, a subcontractor doing business as Perdel Contracting Corp., agreed to act as a pass-through company for a large contractor, McHugh Construction, bidding on multiple government projects in Chicago. Though documentation showed that Perdel would be a subcontractor on the projects, McHugh did the work, and no Perdel equipment or personnel was actually used. In one of the projects—at O'Hare International Airport—Perdel placed the general contractor's employees on the payroll and used the general contractor's equipment to complete the project. In return, Perdel—specifically owner Elizabeth Perino and her partner—expected to receive payment equivalent to the percentage of work that Perdel was supposedly completing.

Perino was convicted on June 17 this year in a jury trial in U.S. District Court in Chicago. The jury found her guilty of three counts of wire fraud and one count of mail fraud, convictions punishable by a maximum sentence of 80 years in prison. The judge deferred sentencing to a later date, unspecified by press time.

The general contractor, McHugh, had previously agreed to pay $12 million to settle a whistleblower lawsuit that unearthed the Perdel-McHugh fraud and led to a broader investigation of the general contractor involving $150 million in McHugh contracts for public works in the Chicago area. In the settlement, McHugh admitted no wrongdoing, will not be barred from future government contracts, agreed to implement a compliance program and submit to independent oversight of its contracting processes for three years, and said it will donate an additional $2 million to the city to support programs for DBEs.

The Paper Trail

When general contractors create fraudulent documents claiming they have used DBEs, they can do so by: (1) including an existing DBE on paperwork filed with local agencies; or (2) using a shell DBE in their documents.

An example of the former would be the recent situation in New York involving contractor ING and local government agencies. In this instance, a $1 million settlement agreement was reached between the government and ING. The construction company, ING, was preparing to submit a bid to complete a bridge in the city of Cohoes, N.Y. The owner of ING, Corey Ingerson, sought the help of John Leary of RAMSCO to provide materials for the project. Leary informed Ingerson he could provide the materials through the DBE, American Indian Builders & Suppliers (AIB), so Ingerson could meet his required DBE status.

When Ingerson was awarded the contract, he filled out preliminary paperwork stating he would receive materials from AIB, but these purchases were never made through AIB. Ingerson instead purchased all of the materials from RAMSCO and began work on the bridge. When government officials asked for proof of AIB's involvement in the project, Ingerson and Leary forged documents to create the appearance Ingerson purchased the materials from AIB. Officials soon concluded the documents were falsified and AIB had no involvement in the construction project.

A shell DBE encompasses the same principles as the fraud committed above. The only difference is the subcontractor allegedly being used is in fact not a qualified DBE. In March of 2016, New York-based Hayner Hoyt Corporation reached a settlement agreement to pay $5 million to resolve fraud allegations against its CEO and president. Hayner Hoyt was found to have committed fraud by alleging the use of a service-disabled veteran-owned small business. Hayner Hoyt created a shell company, 229 Construction, to act as a subcontractor to projects. Hayner Hoyt placed a service-disabled veteran, Ralph Bennett, as president of the shell company but in title only. Bennett had little to no involvement in the everyday operations of the company and made no important business decisions. Instead, the CEO and president of Hayner Hoyt exerted significant influence over the shell company, including bidding, supplying employees from Hayner Hoyt, and providing a considerable amount of resources to projects.

How to Detect DBE Fraud

The problem of DBE fraud begins and ends with local governmental agencies.

Lying to Feds Bars Coverage

The U.S. District Court for the Northern District of Illinois, in February 2014, ruled in *Gen. Star Nat'l Ins. Co. v. Adams Valuation Corp.*, that a dishonesty exclusion in the insured's E&O policy barred coverage for alleged violations of the False Claims Act because the insured knowingly misrepresented information to the federal government. The court agreed with the insurer that it had no duty to defend or indemnify its policyholder in this case because—for the insured to have been found liable under the False Claims Act—it would have been proven the policyholder wittingly made a false representation to the government.

A D&O policy, however, could provide coverage for defense or investigation costs under certain circumstances for privately held companies, and clawback of defense fees could be prohibited if a settlement ensues that assigns no wrongdoing by the insured. Some D&O policies narrowly restrict the fraud/willful violation exclusion such that the exclusion applies only if and when a final, non-appealable judgment, adjudication or admission of deliberately dishonest conduct in an action not initiated by the insurer has been entered. This is typically true for illegal profit or advantage exclusions as well. A question to consider is whether or not the insurer can reasonably withhold its consent to a settlement that doesn't assign wrongdoing to an insured. *—Editor*

Relaxed standards and little oversight by local governmental agencies facilitate an environment where general contractors may engage in and profit through DBE fraud. Many general contractors will submit bids for large government projects and falsely claim they were unable to find suitable disadvantaged business enterprises. General contractors then apply for good faith waivers from these local agencies and receive these waivers, allowing these contractors to proceed without the required DBE participation.

Lack of monitoring can allow the non-use of DBEs even without a good faith waiver. In these instances, general contractors often list DBEs as subcontractors in their bid proposals. Once awarded the projects, the general contractors will use their own employees and equipment in place of the DBE without advising local officials. In some instances, local officials will award contracts to general contractors without subcontractors listed in the initial bid. These general contractors then may wait until the project is nearly completed before naming subcontractors on the project.

Stricter standards and aggressive monitoring of public works projects can decrease the prevalence of DBE fraud. Following the guidelines set in place by the government and local officials will enable the prevention of DBE fraud if documentation and follow-up checks take place up until the completion of construction projects.

Insurance Coverage Is Sparse

In general, insurance policies do not provide coverage for intentional acts, criminal activity or fraud. These simply are risks insurers do not typically insure. In addition, in order to trigger coverage, an "occurrence" must be present, which depending upon the policy language usually requires accidental conduct. Accordingly, it is unlikely a policy would provide a construction company charged with DBE fraud coverage for any fines or settlements involving fraudulent conduct.

However, an analysis of the terms and conditions of each unique policy is required, including all endorsements in force. Insurers also have a greater obligation to provide a defense and pay the cost of defense of accusations under the duty to defend. These issues have largely been unresolved by courts throughout the country, and concrete answers to the coverage questions are still unknown.

Whether you are a project owner, general contractor, attorney, or another stakeholder in the construction industry, be on the lookout for fraudulent attempts to secure government-funded contracts. ■

Andrew Smith is an associate in the Cincinnati, Ohio, office of Smith, Rolfes & Skavdahl. asmith@smithrolfes.com