



# Publications

## **JIFA: How Insurers Enable Damaging Workers' Comp Premium Fraud In Construction**

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The latest *JIFA* edition comes from Matthew F. Capece, Representative of the General President of the United Brotherhood of Carpenters & Joiners of America.

By Matthew F. Capece | November 4, 2022

## Premium schemes widespread, complex

**T**he construction industry has become a crime scene for workers' compensation premium fraud, tax fraud, wage theft and other financial crimes. Regrettably, the insurance industry plays an enabling role.

The construction business is highly competitive, with projects frequently awarded to low bidders. Material costs will be similar in any given market, so a way to cut costs and win bids is by lowering labor expenses. Other than wages and benefits, employment taxes, unemployment insurance contributions, workers' compensation insurance premiums and overtime premium pay contribute to labor costs. Those labor costs, workers' compensation being the most expensive, are only due on the compensation of *employees*. Accordingly, to evade those costs, scofflaw contractors intentionally misclassify employees as independent contractors and issue a 1099 MISC report or simply pay them "off-the-books" by check or cash with no reporting to state or federal taxing authorities or workers' compensation insurers.

A recent study commissioned by the attorney general's office of the District of Columbia found that contractors who fail to report their true payroll skim 16.7 to 48.1 percent off their labor costs.<sup>1</sup> Thus, breaking the law gives cheating contractors a substantial bidding advantage over law-abiding competitors.

Fraud in the industry is aided by the layering of contractors and subcontractors. On a typical commercial or residential job site specialty subcontractors do the actual construction work. They perform specific types and phases of the construction, such as excavating, pile driving, electrical, plumbing, heating and air conditioning, concrete form work, interior systems installation,<sup>2</sup> and flooring and roofing. Above the specialty subcontractor is an owner, construction manager or general contractor. Much of the fraud occurs at the level of the specialty subcontractor, with or without the knowledge, assistance or willful ignorance of the owners, developers, general contractors, or construction managers.

There are many ways to break the law. The simplest way for a subcontractor to break the law is by paying its employees by check and reporting the earnings with a 1099 MISC form. But that leaves the contractor vulnerable, because of the direct payment to the employee and 1099 reporting. To be less-vulnerable, the subcontractor could pay employees by check without reporting. Still, there is vulnerability through bank records of detection because of the payment to workers by check.

To insulate subcontractors, the construction industry has added an additional layer — subcontract labor suppliers, or labor brokers, to pay and, many times, co-supervise employees. Specialty subcontractors with a labor brokering system will use the brokers to either supply the bulk of their labor or supplement their own directly-paid employees.

A labor broker can be a foreman of the subcontractor who has been provided a business identity and receives a check to pay the foreman's crew.<sup>3</sup> Labor brokers also know workers and supply them as labor in the requisite trade category (carpenters, electricians, laborers) to subcontractors. The broker faces most of the risk from law enforcement authorities. That is the case even when a subcontractor meets statutory or common-law definitions of "employer" of the labor broker's workers. In our experience, law enforcement agencies infrequently use joint-employer or conspiracy doctrines to extend accountability to subcontractors or further up the contract layers. Because labor brokers easily change identities or can be replaced,<sup>4</sup> the failure of accountability for the upper-tier contractors has given oxygen to the growing adoption of the labor-broker model.

A more-complex fraud scheme was developed in the Florida construction market, but it is not just in Florida. Variations have been found, for instance, in New Jersey and

New York.<sup>5</sup> The Florida fraud model adds yet another layer that protects labor brokers while facilitating money laundering, other financial crimes and workers' compensation premium fraud.

A labor broker who needs a certificate of insurance (COI) for specialty subcontractors contacts a "facilitator." The facilitator is associated with a money-service business or check-cashing store. The facilitator rents to the labor broker, for a fee, a corporate or limited liability company (LLC) identity registered with the secretary of state. It is a shell company. Labor brokers are not on paper the principals of the company or LLC. The facilitator introduces the labor broker to an insurance broker who may know of the scheme. An application for workers' compensation insurance is completed with a minimal payroll number. The application goes to the insurer and, once approved, the insurance broker issues COIs in the name of the shell company.

The shell company and COI can then be "rented" to other labor brokers who are completely unrelated to the first labor broker. Insurers enable the fraud scheme by not tracking the number of COIs issued by insurance brokers. In Florida, this is how a shell company called E South Construction, which claimed only four employees with \$43,200 of payroll, acquired 450 COIs.<sup>6</sup> E South's income was over \$11 million.<sup>7</sup>

The labor broker can now give the specialty subcontractor the COI and begin providing labor. The labor broker bills the wages and other costs to the specialty subcontractor weekly. The specialty subcontractor pays the labor broker by check made out to the shell company. The labor broker brings the check to the money service business associated with the facilitator. Because the labor broker is not a principal of the shell company (because the broker is renting the name), the endorsement on the check is forged or the money service business has a rubber stamp with a shell company principal's signature to endorse the check.<sup>8</sup>

In a variation, an appointment is made for a shell company principal to be in the money service business to endorse the check or checks. If the check is \$10,000 or more, a currency transaction report ("CTR") must be completed. In the former instance where a principal is not at the money service business, the CTR falsely claims the principal negotiated the check.<sup>9</sup> With cash in hand the labor broker then pays the employees in unreported cash, with a deduction for charges the labor broker pays to the facilitator, money service business or other co-conspirators.

In a more-sophisticated operation, the labor broker changes its shell company identity before the close of the workers' compensation policy period. Because the labor broker's name does not appear on articles of incorporation, check endorsements, or insurance applications, the primary threat of law enforcement detection and prosecution rests with the shell company principals, not the labor broker or specialty subcontractor.

This is organized crime. Indeed, the money service businesses involved in these conspiracies may be laundering money for organized crime and drug cartels.<sup>10</sup> It is important to emphasize that the tendency for law enforcement to solely focus on the wrongdoers at the lowest level, reinforces and brings legitimacy to the structuring of the fraud schemes. Accordingly, for the specialty subcontractor, the goal is met of attaining labor at a low cost with remote accountability.

### **Imposing high costs on workers, taxpayers, insurers**

A frequent misconception is that fraud in the construction industry rests largely in the single-family residential construction market. Nothing is further from the truth. The UBC and its affiliates have uncovered, and shared with law enforcement, fraud schemes on military bases,<sup>11</sup> large industrial facilities, hospitals, universities, luxury vertical residential and commercial towers, and even state-legislative office buildings. Many projects are overseen by construction managers, general contractors and specialty subcontractors that are the biggest names in the industry.

A single case in Florida cost taxpayers and workers' compensation insurers millions of dollars. The U.S. Attorney's Office for the Middle District of Florida recently obtained guilty pleas from Gregorio Jose Fuentes-Zelaya and Dennis Alexander Barahona for conspiracy to commit wire fraud and tax fraud.<sup>12</sup> The U.S. Attorney's Office wrote in its press release:

According to court documents, Fuentes-Zelaya and Barahona established shell companies that purported to be involved in the construction industry. They obtained workers' compensation insurance policies in the name of the shell companies to cover a minimal payroll for a few purported employees. They then "rented" the workers' compensation insurance to work crews who had obtained subcontracts with construction contractors on projects in various Florida counties. Fuentes-Zelaya and Barahona sent the contractors a certificate as "proof" that the work crews had workers'



compensation insurance, as required by Florida law. By sending the certificate, the defendants falsely represented that the work crews worked for their companies. Over the course of the scheme, Fuentes-Zelaya and Barahona “rented” the certificates to hundreds of work crews.<sup>13</sup>

The estimated wages that Fuentes-Zelaya and Barahona failed to report totaled \$22,793,748, making the unpaid Medicare, Social Security and FUTA taxes \$5,766,286.<sup>14</sup> Fuentes-Zelaya and Barahona told their workers’ compensation carriers that their payroll ranged from \$80,000 to \$100,800. As a result, their premiums were far less than the estimated \$3,600,000 that should have been paid.<sup>15</sup>

In addition to the individual cases, research by economists and sociologists have demonstrated the severity of fraud in the construction industry. A recently completed study of construction-employer fraud nationally disclosed that up to 20.5 percent of construction workers who should be treated as employees are not.<sup>16</sup> Federal income tax losses amount to \$1.8 billion annually and state income tax losses are about \$730 million.<sup>17</sup> Construction workers lose close to \$1 billion of overtime and other premium pay annually.<sup>18</sup> Social Security and Medicare losses are \$5.08 billion annually and approximately \$717 million of unemployment contributions are not made.<sup>19</sup> Workers’ compensation carriers lose \$2.03 billion in premiums.

The scope of the national losses is reflected in state specific studies as well. A 2010 report on the Tennessee construction industry found that 21 percent of the workforce was misclassified or paid off-the-books resulting in losses of \$14 million to the state unemployment trust fund and \$115.4 million in federal employment and income taxes.<sup>20</sup> In 2019, the Tennessee Bureau of Workers’ Compensation estimated that premium losses had skyrocketed by 223 percent to \$296.1 million a year.<sup>21</sup> Moreover, that resulted in a \$13 million dollar operating loss to the Bureau caused by accompanying unpaid assessments on premiums.<sup>22</sup> Researchers in California estimated the yearly losses from fraud in the construction industry to Social Security is \$235 million, Medicare \$55 million, federal unemployment \$12 million, state unemployment \$62 million and \$264 million in workers’ compensation premiums.<sup>23</sup> Although not specific to the construction industry, in testimony before a state legislative committee in 2008 on a bill addressing fraud in construction, Pennsylvania officials estimated that there were 580,000 workers in the state that should have been, but were not, reported as employees, costing the state \$200 million in lost revenue to the unemployment trust fund and \$81 million in lost workers’ compensation premiums

for insurers.<sup>24</sup> Clearly, there is a severe and pervasive problem.

Law abiding construction employers are not pleased with these circumstances. Because they follow the law, they and their employees are punished by losing work. Matthew Townsend, a president of the Signatory Wall and Ceiling Contractors Alliance, testified in 2019 before the Workforce Protections Subcommittee of the House Education and Labor Committee:

In my industry, misclassification is not about making tough calls applying complicated laws to ambiguous facts. Rather, it is a choice simply to disregard wage and hour laws, workers' compensation laws, unemployment insurance regulations, and other basic responsibilities of being an employer. This is done for the purpose of gaining an advantage against law-abiding competitors, realizing tremendous profits, and avoiding the financial risks that honest entrepreneurs must accept. Business owners using the misclassification model do not bear the risks of unanticipated overtime, bad planning, or poor execution. Instead, this racket transfers these risks onto workers and taxpayers.<sup>25</sup>

### **\$28 Billion taxpayer subsidy of abuse in the Construction Industry**

The University of California Berkeley Labor Center issued a report in January 2022 on the number of construction worker families in the U.S. enrolled in safety net programs — adult Medicaid, children's Medicaid, the earned income tax credit, Temporary Assistance for Needy Families and the Supplemental Nutrition Assistance Program.<sup>26</sup>

Shockingly, 39 percent of construction worker families are enrolled in at least one safety-net program, costing state and federal taxpayers \$28 billion a year.<sup>27</sup> That compares to 31 percent of all working families.<sup>28</sup> Additionally, 31 percent of construction workers do not have health insurance compared to 10 percent of all workers.<sup>29</sup> The authors of the report attributed the high degree of reliance on public assistance to a number of factors. Chief among them were low pay, wage theft, misclassification as independent contractors, off-the-books payments and "payroll fraud."<sup>30</sup>

Those findings are disturbing for an industry that is a significant economic engine of our national economy. From the UC Berkeley report:

Construction is one of the largest industries in the United States. There are

approximately 10 million people employed in the construction industry, about 1 in 16 workers nationally. Just prior to the COVI-19 pandemic, in 2019, it contributed \$903.6 billion, or 4.2%, of U.S. GDP. It accounted for \$812 billion in personal income, or \$1 out of every \$23 in total national earnings in 2019.<sup>31</sup>

## **Reforms urgently needed**

The scofflaws are well-informed, and are thoroughly practiced in taking advantage of the openings given to them by the insurance industry. Chief among these are the certificates of insurance and the issuance of COIs by insurance brokers.

A COI for a high-steel contractor with a million dollars in payroll looks the same as one for a construction-site cleaning firm with a \$250,000 payroll. COI's are not specific on the work performed, nor do they disclose estimated payroll. Additionally, COI's are simply sheets of paper with information that can be easily forged or modified. Remembering the labor-broker scheme, COI's allow specialty contractors to claim that they had no idea that the labor broker was a cheat.

**QR codes.** If the insurance industry is going to stick to paper COIs, it would be well-counseling to include a QR code that can be scanned to see the true COI of record. Another idea is using block-chain technology. Additionally, having information on the specific work claimed and estimated payroll peels away an excuse, thus giving subcontractors an indication that fraud is being committed.

**Track insurance certificates.** Moreover, insurers need to track the number of COIs being issued. There is little excuse for insurers remaining blind to brokers issuing hundreds of COIs to "small" construction businesses. Tracking the COIs issued will allow insurers to "red flag" for audit contractors whose COI requests are out of whack with their payroll.

Some in the insurance industry may be content with keeping things as they are and simply continue to pass along the \$2 billion a year in premium fraud losses to their insureds who are not crooks. This is an attractive stance, especially given the lucrativeness of the market. But this is a death spiral to law-abiding employers who face the triple indignity of losing jobs to cheaters and seeing their insurance rates rise, thus making them less competitive against the scofflaws. It is difficult to imagine how this in the long run will benefit insurers. Things must change.





**About the author:** Matthew F. Capece is a Representative of the General President of the United Brotherhood of Carpenters & Joiners of America. He graduated from the University of Connecticut School of Law with a JD and an award in labor-law studies. He has been a specialist in matters involving employment tax fraud, workers' compensation insurance premium fraud and wage theft in the construction industry since 1989. His duties include tracking state and federal legislation and law-enforcement cases. Much of his time is spent meeting with policy makers, workers' compensation carriers and law enforcement agencies as well as construction workers and employers who have been victimized by fraudulent business practices. He was a member of the Tennessee Bureau of Workers' Compensation Employee Misclassification Advisory Committee. In 2013 he received the Kim Presbrey Award from the Workers' Injury Law & Advocacy Group, and in 2018 he received the Samuel Gompers Award from the International Association of Industrial Accident Boards & Commissions. He is a member of Carpenters Local 326, the Tennessee Employment Relations Research Association, the Labor Employment Relations Association and is licensed to practice law in Connecticut and the District of Columbia.

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## Endnotes

1. Karl Racine, Attorney General for the District of Columbia, *Illegal Worker Misclassification: Payroll Fraud in the District's Construction Industry*, economic analysis by Dale Belman and Aaron Sojourner, 1, 2 and 15 (May 22, 2019), available

at <https://oag.dc.gov/sites/default/files/2019-09/OAG-Illegal-Worker-Misclassification-Report.pdf>.

2. Interior systems specialty subcontractors install, for instance, metal studs, drywall (also called sheetrock), and acoustical ceilings.
3. See, e.g., *State of Minnesota v. Mehr*, criminal complaint, Prosecutor Case No. 19A00991(4<sup>th</sup> J.D. 2020). The defendants created company identities for employees, had them obtain a minimum workers' compensation insurance policy and submit hourly billing statements.
4. Four companies operated by labor broker Carmelo Lugo and J. Carmen Lugo, have been penalized at least five times by the Tennessee Bureau of Workers' Compensation for either not having workers' compensation insurance or for under-reporting payroll. Tennessee Bureau of Workers' Compensation settlement agreements on file with author Matthew F. Capece.
5. Phaedra Trethan, *Authorities: \$100M Money Laundering Scheme Busted*, Courier-Post, August 28, 2017, available at, <https://www.courierpostonline.com/story/news/2017/08/28/cash-cars-watches-seized-cinnaminson-money-laundering-arrests/608758001>; and Kim Slowey, *Manhattan DA Busts Labor Broker for Workers' Comp Fraud*, Construction Dive, Sept. 9, 2019, available at, <https://www.constructiondive.com/news/manhattan-da-busts-labor-broker-for-workers-comp-fraud/562542/>.
6. Florida Division of Insurance Fraud, Case No. 11-460, *Probable Cause Affidavit, Request for Arrest Warrant*, Defendants Hugo Otoniel Rodriguez, et. al., 12 (July 23, 2012).
7. *Id.*
8. See, *Legislature Sends Check-Cashing Bill to Governor Without Database*, WorkCompCentral, March 13, 2012.
9. Press Release, Dept. of Justice, U.S. Attorney's Office, Southern District of Florida, *Principals of La Bamba Check Cashing Business Sentenced in Connection with \$132,000 in False CTRs*, Sept. 15, 2009, available at, [https://www.justice.gov/archive/tax/usaopress/2009/txdv09\\_090915-04.pdf](https://www.justice.gov/archive/tax/usaopress/2009/txdv09_090915-04.pdf); and Eighteenth Statewide Grand Jury, *supra* note 7 at 12.

10. David Borum & Geoffrey Branch, *How Construction Cons Steal Workers' Comp Premiums: It's a Shell Game*, Journal of Insurance Fraud in America, April 25, 2017, reprinted by Property Casualty 360, available at, <https://www.propertycasualty360.com/2017/04/25/how-construction-cons-steal-workers-comp-premiums>
11. Information on cases at Fort Knox and Red Stone Arsenal are in the possession of the author.
12. *Two Men Plead Guilty*, supra note 7. Regrettably, there is no mention of any liability for the contractors that used the construction labor provided through this shell company, labor brokering scheme.
13. *Id.*
14. *Id.*
15. *Id.* Notably, missing from the press release is any mention of any accountability for the contractors that used Fuentes-Zelaya and Barahona.
16. Russell Ormiston, Dale Belman and Mark Erlich, *An Empirical Methodology to Estimate the Incidence and Costs of Payroll Fraud in the Construction Industry*, 3 (2020), available at <https://stoptaxfraud.net/wp-content/uploads/2020/03/National-Carpenters-Study-Methodology-for-Wage-and-Tax-Fraud-Report-FINAL.pdf>.
17. *Id.*
18. *Id.* at 5.
19. *Id.* using mid-range numbers.
20. William Canak and Randal Adams, *Misclassified Construction Employees in Tennessee*, Dr. William Canak and Dr. Randal Adams, iv, v and vi (January 15, 2010), available at <https://stoptaxfraud.net/wp-content/uploads/2018/11/TN-payroll-fraud-study-1-15-10.pdf>.
21. Tennessee Bureau of Workers' Compensation, *Annual Report on Employer Coverage Compliance*, 6 (February 1, 2019), available at,

<https://www.tn.gov/content/dam/tn/workforce/documents/injuries/2019ComplianceAnnualReport.pdf> .

22. See, Tenn. Code §50-6-401(b)(1) and (2).

23. Yvonne Yen Liu, Daniel Flaming and Patrick Burns, *Sinking Underground; The Growing Informal Economy in California Construction*, Economic Roundtable, 31 (2014), available at, <https://economicrt.org/publication/sinking-underground>.

24. Testimony of Patrick T. Beaty, Deputy Secretary for Unemployment Compensation Programs, Pennsylvania Department of Labor and Industry, before the House of Representatives Commonwealth of Pennsylvania, Labor Relations Committee on HB 2400, The Employee Misclassification Prevention Act, 3 (April 23, 2008).

25. *Hearing on Misclassification of Employees: Examining the Costs to Workers, Businesses, and the Economy: Before the Workforce Protections Subcommittee, House Education and Labor Committee, 116th Congress* (2019) (Statement of Matt Townsend, President of the Signatory Wall and Ceiling Contractors Alliance), 1, available at, <https://edlabor.house.gov/imo/media/doc/TownsendTestimony092619.pdf>. See also, Doug Burton, op-ed, *To help NC businesses, end the misclassification fraud*, The News & Observer, June 3, 2015 (“This fraud is a growing problem that harms workers, puts a strain on government resources and provides an unfair advantage when these unscrupulous employers compete with law-abiding businesses.”), available at <https://www.newsobserver.com/opinion/op-ed/article23037534.html>, last visited April 28, 2021.

26. Ken Jacobs, Kuichih Huang, Jenifer MacGillvary and Enrique Lopezlira, *The Public Cost of Low-Wage Jobs in the US Construction Industry*, UC Berkeley Labor Center (January 2022), available at, <https://laborcenter.berkeley.edu/the-public-cost-of-low-wage-jobs-in-the-us-construction-industry/>.

27. *Id* at 1.

28. *Id*.

29. *Id*.

30. *Id* at 1, 2-3 and 6.