IN THE CALIFORNIA SUPREME COURT

No. S206874

MARIA AYALA, et al.,

Plaintiffs and Appellants,

v.

ANTELOPE VALLEY NEWSPAPERS, INC.,

Defendant and Respondent.

After a Decision by the California Court of Appeal,
Second Appellate District, Division Four
Case No. B235484

Appeal from the California Superior Court, Los Angeles County
Case No. BC403405 (Judge Carl J. West)

DECLARATION OF MICHAEL J. WRIGHT IN SUPPORT OF MOTION FOR JUDICIAL NOTICE VOL. I OF II EXHIBITS 1 -4

CALLAHAN & BLAINE, APLC
Daniel J. Callahan (State Bar No. 91490)
Michael J. Sachs (Bar No. 134468)
Kathleen L. Dunham (Bar No. 98653)
Michael J. Wright (Bar No. 231789)
3 Hutton Centre Drive, Ninth Floor
Santa Ana, California 92707
(714) 241-4444; Fax (714) 241-4445
kdunham@callahan-law.com; mwright@callahan-law.com
Counsel for Appellants,

MARIA AYALA, ROSA DURAN, and OSMAN NUÑEZ,
on their own behalf and on behalf of all others similarly situated

IN THE CALIFORNIA SUPREME COURT

No. S206874

MARIA AYALA, et al.,

Plaintiffs and Appellants,

v.

ANTELOPE VALLEY NEWSPAPERS, INC.,

Defendant and Respondent.

After a Decision by the California Court of Appeal,
Second Appellate District, Division Four
Case No. B235484

Appeal from the California Superior Court, Los Angeles County
Case No. BC403405 (Judge Carl J. West)

DECLARATION OF MICHAEL J. WRIGHT IN SUPPORT OF MOTION FOR JUDICIAL NOTICE VOL. I OF II EXHIBITS 1 -4

CALLAHAN & BLAINE, APLC
Daniel J. Callahan (State Bar No. 91490)
Michael J. Sachs (Bar No. 134468)
Kathleen L. Dunham (Bar No. 98653)
Michael J. Wright (Bar No. 231789)
3 Hutton Centre Drive, Ninth Floor
Santa Ana, California 92707
(714) 241-4444; Fax (714) 241-4445
kdunham@callahan-law.com; mwright@callahan-law.com
Counsel for Appellants,

MARIA AYALA, ROSA DURAN, and OSMAN NUÑEZ,
on their own behalf and on behalf of all others similarly situated

DECLARATION OF MICHAEL J. WRIGHT

1. I am an attorney duly admitted to practice law before the Courts of this state, and am an attorney at Callahan and Blaine, attorneys of record for Plaintiffs and Appellants. I have personal knowledge of the facts set forth in this declaration and, if called as a witness, would competently testify to their truth.

2. Attached hereto as Exhibit 1 is a true and correct copy of Notice of Motion and Motion to Decertify the Class; Memorandum of Points and Authorities in Support filed in San Diego Superior Court case *Espejo et al., v. The Copley Press, et al* SDSC case number 37-2009-00082322_CU-OE0CTL on December 6, 2012.

3. Attached hereto as Exhibit 2 is a certified copy of Memorandum of Points and Authorities in Support of Defendants The McClatchy Company and McClatchy Newspapers, Inc.'s Motion for Decertification filed in Sacramento Superior Court case *Sawin, et al., v. The McClatchy Company, et al.,* SCSC case number 34-2009-00033950-CU-OE-GDS on January 7, 2013.

4. Attached hereto as Exhibit 3 is a true and correct copy of *Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs*, (February 2000) Planmatics, Inc.'s report for the US

Department of Labor, which I personally downloaded and printed from the Department of Labor, Employment and Training Administration website: www.doleta.gov.

5. Attached hereto as Exhibit 4 is a true and correct copy of U.S. Government Accountability Office Report to the Ranking Minority Member, Committee on Health, Education, Labor, and Pensions, U.S. Senate (July 2006) *Employee Misclassification: Improved Outreach Could Help Ensure Proper Worker Classification*, GAO-09-717, which I personally downloaded and printed from U.S. Government Accountability Office website: www.gao.gov.

6. Attached hereto as Exhibit 5 is a true and correct copy of U.S. Government Accountability Office Report to Congressional Requesters (August 2009) *Employee Misclassification: Improved Coordination, Outreach, and Targeting Could Better Ensure Detection and Prevention,* GAO-09-717, which I personally downloaded and printed from the U.S. Government Accountability Office website: www.gao.gov.

7. *Attached hereto as* Exhibit 6 is a true and correct copy of Annual Report of the White House Task Force on the Middle Class (February 2010), which I personally downloaded and printed from The White House website: www.whitehouse.gov.

8. Attached hereto as Exhibit 7 is a true and correct copy of California Employment Development Department Annual Report *Fraud Deterrence and Detection Activities* (June 2007), which I personally downloaded and printed from the California Employment Development Department website: www.edd.ca.gov.

9. Attached hereto as Exhibit 8 is a true and correct copy of California Employment Development Department Annual Report *Fraud Deterrence and Detection Activities* (June 2011), which I personally downloaded and printed from the California Employment Development Department website: www.edd.ca.gov.

10. Attached hereto as Exhibit 9 is a true and correct copy of the transcript of radio broadcast *Texas Contractors Say Playing By The Rules Doesn't Pay* by Wade Goodwyn, first broadcast on NPR on April 11, 2013, which I personally downloaded and printed from the National Public Radio website: www.npr.org.

11. Attached hereto as Exhibit 10 is a true and correct copy of the California Employment Development Department ("EDD") website regarding Underground Economy Operations (2010) which I personally downloaded and printed from the EDD's website: www.edd.ca.gov.

12. Attached hereto as Exhibit 11 is a true and correct copy of the EDD's *Information Sheet* regarding Employment Enforcement Task Force (November 2009) which I personally downloaded and printed from the EDD's website: www.edd.ca.gov.

13. Attached hereto as Exhibit 12 is a true and correct copy of a February 9, 2012 News Release Number 12-0257-SAN from the U.S. Department of Labor's Wage and Hour Division and a true and correct copy of the Memorandum of Understanding to which it refers, both of which I personally downloaded and printed from the website: www.dol.gov/whd.

14. Attached hereto as Exhibit 13 is a true and correct copy of Defendants' Memorandum of Points and Authorities in Support of Motion to Strike Class Allegations filed in Sacramento Superior Court case *Sawin, et al., v. The McClatchy Company, et al.,* SCSC case number 34-2009-00033950-CU-OE-GDS on February 15, 2011.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Executed this 29th day of April, 2013, at Santa Ana, California.

MICHAEL J. WRIGHT

ORIGINAL

FILED
Clerk of the Superior Court
DEC 6 2012
By J. Kingsbury, Deputy
DEC 6 '12 PM 4:35

FAX COPY

SEYFARTH SHAW LLP
Camille A. Olson (SBN 111919)
David D. Kadue (SBN 113578)
Richard B. Lapp (SBN 271052)
Dean A. Martoccia (SBN 193185)
Erik B. von Zeipel (SBN 223956)
2029 Century Park East, Suite 3500
Los Angeles, California 90067
Telephone: (310) 277-7200
Facsimile: (310) 201-5219

Attorneys for Defendants
THE SAN DIEGO UNION-TRIBUNE, LLC,
THE COPLEY PRESS INC., PLATINUM EQUITY, LLC, and
PROJECT JEWEL HOLDINGS, LLC

SUPERIOR COURT OF THE STATE OF CALIFORNIA

FOR THE COUNTY OF SAN DIEGO

LILIANA ESPEJO, an individual; ARTURO VALDERRAMA, an individual; GENARO VALDERRAMA, an individual; VIVIANA ZARSOZA MERCADO, an individual; JUAN CASILLAS, an individual; FELIPE GUZMAN GARCIA, an individual; ADRIANA VASQUEZ, an individual; on their own behalf and on behalf of all others similarly situated,

Plaintiffs,

v.

THE COPLEY PRESS INC., a Corporation d/b/a The San Diego Union-Tribune; PLATINUM EQUITY, LLC; THE SAN DIEGO UNION-TRIBUNE, LLC; PROJECT JEWEL HOLDINGS, LLC; BREAK OF DAWN DELIVERY SERVICES, INC., a California Corporation; HADA ENTERPRISES, INC., a California Corporation; TROY PELKY & ASSOCIATES DISTRIBUTION, INC., a California Corporation; and DOES 1 through 50, inclusive,

Defendants.

Case No. 37-2009-00082322-CU-OE-CTL
[Consolidated with Case No. 37-2010-00085012-CU-OE-CTL]

Assigned to Hon. John S. Meyer

NOTICE OF MOTION AND MOTION TO DECERTIFY THE CLASS; MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT

[CRC 3.764(a)(4)]

DATE: February 1, 2013
TIME: 10:30 a.m.
DEP'T: C-61

Complaint Filed: January 29, 2009

Trial Date: April 5, 2013

TABLE OF CONTENTS

Page(s)

INTRODUCTION 1

SUMMARY OF ARGUMENT 2

FACTS RELEVANT TO DECERTIFICATION 2

I. Background 2

II. The Distribution Agreements 3

III. Contractors varied in how they fulfilled their obligations under the distribution agreement 3

A. Variations in Contractor Practices 3

B. Variations in Contractor Experiences Related to Items That Plaintiffs Claim as Reimbursable Expenses 4

ARGUMENT 7

I. This Court can decertify when law and facts show certification is no longer proper. 7

A. A defendant can move for decertification when certification is no longer appropriate. 7

B. Changes in class action law should affect this case 7

C. As Narayan holds, a class action is improper where evidence on IC factors varies. 9

II. IC Analysis Creates Questions That Here Will Not Yield A Common Set Of Answers. 9

A. IC determinations depend on combinations of factors, not factors in isolation. 9

B. IC determinations are incompatible with class treatment where different class members present different combinations of factors. 9

C. Evidence under the factors varies from class member to class member. 10

D. Plaintiffs' purported "common evidence" concerns only one factor and does not allow a classwide IC determination. 15

E. Differing combinations of IC factors for different class members prevent a classwide determination on the threshold issue of employee status. 16

III. Expense Reimbursement Claims Raise Numerous Individualized Inquiries. 19

A. Auto expenses 19
B. Non-auto expenses 20
IV. The UT's Gattuso defense also would require substantial individual issues. 24
CONCLUSION 25

TABLE OF AUTHORITIES

Page(s)

FEDERAL CASES

Cruz v. Dollar Tree Stores, Inc.
2011 WL 2682967 (N.D. Cal. July 8, 2011) 8

Doe I v. Wal-Mart Stores
572 F.3d 677 (9th Cir. 2009) 15

Narayan v. EGL, Inc.
No. C-05-04181-RMW, 2012 WL 4004621 (N.D. Cal. Sept. 7, 2012), at *7 ..... 9, 10, 11, 19

Ruiz v. Affinity Logistics Corp.
No. 05-CV-2125-JLS, 2012 WL 3672561 (S.D. Cal. 2012) 11, 12

Ruiz v. Affinity Logistics Corp.
2009 U.S. Dist. LEXIS 130728 (S.D. Cal. Jan. 29, 2009) 19

Spencer v. Beavex, Inc.
No. 05-CV-1501 WQH, 2006 WL 6500597 (S.D. Cal. Dec. 15, 2006) 11

Wal-Mart Stores, Inc. v. Dukes
131 S. Ct. 2541 (2011) ..... passim

CALIFORNIA CASES

Air Couriers Int'l v. Emp't Dev. Dep't.
150 Cal. App. 4th 923 (2007) 11

Ali v. U.S.A. Cab, Ltd.
176 Cal. App. 4th 1333 (2009) 19, 20

Angelotti v. Walt Disney Co.
192 Cal. App. 4th 1394 (2011) 12

Antelope Valley Press v. Poizner
162 Cal. App. 4th 839 (2008) 10, 11

Arnold v. Mutual of Omaha Ins. Co.
202 Cal. App. 4th 580 (2011) 11

Arzate v. Bridge Term. Transp. Inc.
192 Cal. App. 4th 419 (2011) 9, 15, 16, 18

Ayala v. Antelope Valley Newspapers, Inc.
210 Cal. App. 4th 77 (2012) 18, 19

Block v. Major League Baseball
65 Cal. App. 4th 538 (1998) 4

Borello, 48 Cal. 3d at 350-51 9

Brinker Rest. Corp. v. Superior Court
53 Cal. 4th 1004, 1023-24 (2012) 8

Brose v. Union-Tribune Publ'n Co.
183 Cal. App. 3d 1079 (1986) 9

Caro v. Procter & Gamble Co.
18 Cal. App. 4th 644 (1993) 19

Evans v. Lasco Bathware, Inc.
178 Cal. App. 4th 1417 (2009) 19

Gattuso v. Harte-Hanks Shoppers, Inc.
42 Cal. 4th 554 (2007) 1, 2, 23, 25

Keller v. Tuesday Morning, Inc.
179 Cal. App. 4th 1389 (2009) 7

Lara v. Workers' Comp. Appeals Bd.
182 Cal. App. 4th 393 (2010) 11

Pineda v. Bank of America
50 Cal. 4th 1389 (2010) 1

Safaie v. Jacuzzi Whirlpool Bath, Inc.
192 Cal. App. 4th 1160 (2011) 7

Sotelo v. Medianews Group, Inc.
207 Cal. App. 4th 639 (2012) ..... passim

Wackenhut Wage & Hour Cases, Judicial Council Coordination Proceeding No. 4545, 2012 WL 3218518 (L.A. Sup. Ct. Aug. 1, 2012) 8

Walsh v. IKON Office Solutions
148 Cal. App. 4th 1440 (2007) 7

Williams v. Allstate Ins. Co.
No. BC382577, 2012 WL 5354707 (L.A. Sup. Ct. July 24, 2012) 8, 24

Yellow Cab Coop., Inc. v. Worker's Comp. Appeals Bd.
226 Cal. App. 3d 1288 (1991) 12

FEDERAL STATUTES

Fair Labor Standards Act 3

CALIFORNIA STATUTES

22 Cal. Code Regs § 4304-6(c)(1) 10

Labor Code § 224 22

Labor Code § 2802 ..... passim

OTHER AUTHORITIES

Cal. R. Ct. 3.764(a)(4) 7

PLEASE TAKE NOTICE that on February 1, 2013, at 10:30 a.m., or as soon thereafter as the parties may be heard, in Department C-61 of the San Diego Superior Court, Hall of Justice, located at 330 West Broadway, San Diego, California 92101, Defendants The San Diego Union-Tribune, LLC, The Copley Press Inc., Platinum Equity, LLC, and Project Jewel Holdings, LLC (collectively "Defendants") will move and hereby do move to decertify the class that the Court certified in its Order of September 21, 2011. Continuing certification would be improper in light of these points:

1. Under the developing case law, the lack of a common profile or experience among class members precludes a classwide determination on the threshold issue in this case of independent contractor versus employee status. The varying combinations of relevant factors present among the class would necessitate a case-by-case analysis contrary to the propriety of a class proceeding.

2. Even if a classwide determination of employment status were possible, it would not itself establish any liability owed to any plaintiff. Further elements of liability for expense reimbursement would also be subject to the need for individualized proof. The developing case law now makes clear that Plaintiffs cannot circumvent the need for that proof by resorting to a "trial by formula."

3. These elements of liability are particularly problematic for Plaintiffs with respect to claims for reimbursement for non-auto expenses, which this Court's Order did not certify (but which Plaintiffs nonetheless believe have been certified).

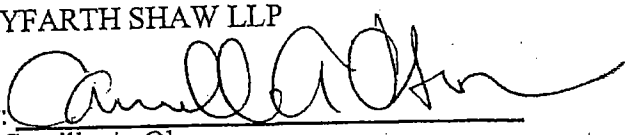
4. Still further individualized inquiries are necessitated as a result of the *Gattuso* defense, which applies in this case and which this Court has recognized, post-certification, as raising triable issues.

These points considered, the class should now be decertified, with the Plaintiffs directed to pursue their claims individually.

The accompanying memorandum is within the 25 pages of briefing that the Court allowed at the case management conference of October 26, 2012.

DATED: December 6, 2012

SEYFARTH SHAW LLP

By: 

Camille A. Olson
David D. Kadue
Attorneys for Defendants THE SAN DIEGO UNION-TRIBUNE, LLC, THE COPLEY PRESS INC., PLATINUM EQUITY, LLC, and PROJECT JEWEL HOLDINGS, LLC

INTRODUCTION

This Court's order of September 21, 2011 (the "Order") denied certification of the class that the Plaintiffs had proposed,[1] while certifying a much narrower class: the roughly 1,200 newspaper carriers who, since January 29, 2005 and before July 2007, signed distribution agreements as independent contractors ("ICs") with The San Diego Union-Tribune (the "UT") to handle newspaper delivery to home and business subscribers. The only significant claim the Order certified for class treatment was for reimbursement of certain employee expenses under Labor Code section 2802.[2]

The parties dispute the scope of the certified Section 2802 claim. When the Court expressed reservations about class certification at the August 2011 hearing, the Plaintiffs (mistakenly) assured the Court that the auto-expense claim would simply involve multiplying route miles by IRS mileage allowance rates, and argued for certification of the Section 2802 claim on that basis. Although the ensuing Order did not explicitly limit certification to auto expenses, that limitation was clear from the context of oral argument and from the Order's own language, which defined the Fourth Cause of Action as "failure to pay reimbursement for auto expenses."[3] Yet Plaintiffs now say their Section 2802 claim covers additional purported expenses, some of which are not expenses at all and are not even mentioned in the Second Amended Complaint.

In any event, ongoing class treatment would be untenable for various reasons that would only multiply and compound if class certification here were deemed to encompass non-automobile-related categories of allegedly unreimbursed expenses. Decertification is appropriate now because legal developments and discovery have revealed the absence of common sources of classwide proof on both liability and damages. The Supreme Court's decision in *Dukes*, now applied to California class actions, requires that plaintiffs be able to generate "common answers" to the questions they raise. Here, however,

---

1 The Court declined to certify a proposed class of carriers who contracted with third-party newspaper distributors, because "individual factual determinations make class adjudication impracticable and inappropriate." Sept. 21, 2011, Order at 6 (App. Tab 1).

2 The other certified claims are not significant: the Sixth and Seventh Causes of Action (failure to provide itemized wage statements failure to keep accurate payroll records) are time-barred, *Pineda v. Bank of Am.*, 50 Cal. 4th 1389, 1395 (2010) (limitations period for penalty claim is one year), and the Eighth Cause of Action (unfair business practices) is simply derivative.

3 Order at 10-11 (referring to Fourth Cause of Action as "failure to pay reimbursement for auto expenses"). The expense-reimbursement claim is the Fourth Cause of Action. 2d Am. Complt. ¶¶ 54-57.

determinative common answers are absent. The threshold issue of employment status depends on a multi-factor IC test that, in this case, would not yield a common combination of answers. Moreover, the additional elements of liability require further individualized proofs. Finally, all the expense claims are vulnerable to defenses (such as the *Gattuso* defense) that mandate individualized inquiries. Because individual issues would predominate over common questions and classwide answers, class treatment would be impracticable and inappropriate.

SUMMARY OF ARGUMENT

The class should be decertified for three independent reasons:

There is no reliable way to adjudicate IC status on a classwide basis. Recent judicial decisions recognize that common questions are not sufficient; class plaintiffs must be able to generate "common answers apt to drive the resolution of the litigation." The Plaintiffs cannot do so here, as IC analysis requires that the various intertwining factors be weighed together in combination, and because the evidence on the relevant factors varies from class member to class member, resulting in no common combination that would permit a classwide finding that all class members were de facto employees.

Individualized proof is needed to prove liability for expenses. Establishing employee status alone would not establish liability, because Section 2802 also requires proof that items of claimed reimbursement are for expenses or losses that were reasonable and that were a necessary consequence of job duties.

Defenses require individualized inquiries. Recent cases affirm that, under *Dukes*, due process entitles class-action defendants to litigate defenses to each individual claim. As this Court confirmed in its April 2012 denial of Plaintiffs' summary adjudication motion, the UT has triable affirmative defenses based on *Gattuso*, defenses that require individualized inquiries into the extent to which the UT's payments to class members already compensated them for the expenses being claimed.

FACTS RELEVANT TO DECERTIFICATION

I. BACKGROUND

Plaintiffs' claims all rest on the same core notion—that they were de facto employees misclassified as independent contractors. The IC status of newspaper carriers is part of a longstanding, nearly universal industry practice, recognized by specific regulations of the California Employment

Development Department (the "EDD") and many years of American jurisprudence in various forums. The flexibility associated with IC operations has allowed widely varying approaches to newspaper distribution—from (a) one carrier contracting for a single route to generate supplemental income during a few hours a week to (b) other carriers contracting for several delivery areas and operating as a family business to (c) an entrepreneur handling multiple delivery areas by engaging her own subcontractors and employees to (d) various combinations of all those approaches. Specific exemptions in the Fair Labor Standards Act and the Internal Revenue Code recognize the validity of this industry norm. Although most states have analogous exemptions, California has no specific statutory non-employee provision for newspaper carriers. While the result under applicable legal standards should ultimately be the same, the lack of a specific Labor Code exemption for newspaper carriers has opened the door to this particular version of the now ubiquitous California wage and hour class action.

II. THE DISTRIBUTION AGREEMENTS

Each class member and the UT entered into newspaper distribution agreements stating that the carrier was an independent contractor, free to "exercise sole and exclusive control over the manner and means employed in operating business and perform all obligations under [the] contract without direct supervision." Decl. of P. Savoie, dated July 22, 2011, ¶¶ 3-6, 16 (Defs.' Appendix of Declarations and Exhibits in Support of Motion to Decertify the Class (cited herein as "App.") Tab 18).[4]

III. CONTRACTORS VARIED IN HOW THEY PERFORMED UNDER DISTRIBUTION AGREEMENTS.

A. Variations in Contractor Practices

Contractor practices varied significantly as to many matters not determined by the terms of the distribution agreements. Specifically, practices varied as to

- whether, and how frequently, carriers contracted out the work to others (see Declaration of D. Kadue ¶ 2, App. Tab 15),
- whether contractors sub-contracted the work, or used substitutes and helpers in connection with performing delivery services (see Kadue Decl. ¶ 8),
- whether contractors entered into agreements with other companies, including UT competitors, to provide similar results (see Kadue Decl. ¶ 9),

[4] Defendants concurrently are filing an separate Appendix of Declarations and Exhibits in Support of Motion to Decertify the Class, containing all declarations and other record materials cited herein.

- whether contractors interacted with UT managers and performed work on the UT's premises (see Kadue Decl. ¶ 10),
- whether contractors received what they perceived to be instructions from UT managers or instead had little or no daily interaction with UT personnel (see Kadue Decl. ¶ 11),
- whether contractors (instead of the UT) supplied the instrumentalities, tools and place of work in connection performing their contractual obligations (see Kadue Decl. ¶ 12),
- how long contractors contracted with the UT (see Kadue Decl. ¶ 13),
- whether contractors believed they created an employment relationship with the UT (see Kadue Decl. ¶ 14),
- whether contractors made business investments in connection with performance of their contractual obligations (see Kadue Decl. ¶ 9),
- whether contractors used managerial skill to increase their profits (see Kadue Decl. ¶ 10), and
- whether contractors negotiated the terms of their distribution agreements, or otherwise knew that the terms were subject to negotiation (see Kadue Decl. ¶ 11).

B. Variations in Contractor Experiences Related to Expenses

Automobile Expenses. Not every class member actually performed services under the distribution agreement he or she signed. And those who did personally perform services frequently engaged the assistance of others. (Decl. of A. Smith ¶ ¶ 6-7 (relied on helper; served as substitute) (App. Tab. 10) For any particular day, there would be no way to know whether class members incurred auto expenses themselves or had someone else do so (in which case the class member would not be entitled to recovery). Nor are there records to show whether a carrier actually drove a route for delivery, walked the route, used a bicycle, or used some combination of those modes of transport. For carriers that delivered products for other companies, there is no way to allocate miles driven in connection with performance under one contract or another. Moreover, any determination of actual daily mileage would be impossible, as routes changed continuously, subscribers didn't get the paper every day of the week, and subscribers often ordered temporary delivery stops. Finally, although IRS mileage rates are presumptively reasonable, factual variations would arise because the UT can defend itself on the basis that actual expenses amounted to less than the IRS allowance, and that particular forms of expense (e.g., the vehicle used, the auto insurance purchased) were unreasonable.

Supplies. Contractors decided what supplies to use in their delivery business and where to obtain them. (Decl. of P. Savoie, dated Dec. 6, 2012, ¶ 26 (App. Tab. 21).) Many contactors used polybags, especially in bad weather, to protect the product they delivered. Contractors bought some of their

supplies, such as bags, rubber bands, and envelopes, from the UT, although they also could and did buy these items elsewhere. (*Id.*) Some Plaintiffs contend that UT managers made them buy UT supplies. Contractors varied widely in their UT purchases, with some buying hundreds of dollars in supplies from the UT, while others purchased next to nothing. (*Id.* ¶ 27.) Whether these purchases reflected contractual freedom or the result of coercion, whether the supplies were exclusively for delivering UT products or other products, and whether the cost of supplies was reasonable and a necessary consequence of contractor duties all are matters requiring individualized proof.

24-Hour Accident Insurance. Contractors were required to have on-route insurance and could source that insurance on their own or purchase it from a third-party provider arranged by the UT. Contractors had an option to purchase additional insurance, known as 24-hour insurance, that would cover accidents while they were off route as well. (July 22, 2011 Savoie Decl. ¶ 67 (App. Tab 18).) Plaintiffs allege that some UT managers required some contractors to purchase 24-hour insurance. (Kadue Decl. ¶ 14 (App. Tab 15).) In connection with the UT contract, some contractors bought 24-hour insurance, some bought only on-route insurance, and some bought no insurance at all.

Insert charges. Newspaper delivery requires inserting (enclosing advertising supplements or Sunday sections) to create a fully assembled newspaper product. During most of the class period, contractors could choose to (a) handle inserting themselves, (b) contract the work out to others, or (c) have the UT contract out the work. (Decl. of P. Savoie, dated Aug. 9, 2012 ¶ ¶ 6-8 (App. Tab. 20).)Under the last option, the carrier would, of course, not earn any inserting fees, and "insert charges" would appear on carrier statements, to offset the "insert credits" that the contractor automatically received on those statements. (*Id.* ¶ 9.)

Although UT policy had the contractor choose who did the inserting, Plaintiffs allege that some UT managers created an arrangement whereby the UT unilaterally selected a separate inserting contractor, and that the "insert charge" could exceed the automatic credit. (Kadue Decl. ¶ 15 (App. Tab 15).) These allegations create a need for individualized proofs, because class members would not have any claim for reimbursement of inserting charges if they performed inserting themselves (as many did) or opted out of inserting, as is documented by the distribution agreement. (Decl. of P. Savoie, dated Aug. 9, 2012, ¶ 7 (App. Tab 20).

Carrier-collect charges. The UT permitted some veteran subscribers to pay their subscription fees directly to the contractor, as opposed to mailing payments to the UT. This arrangement could involve more and earlier payments to the carrier, a higher likelihood of tips, and payment of a collection commission to the carrier by the UT. To accommodate this arrangement, the UT put "carrier-collect charges" on carrier statements, to reflect that the contractor had already received money directly from the subscribers. (Decl. of P. Savoie, dated Aug. 9, 2012, ¶ 10 (App. Tab 20).) Plaintiffs claim that some carrier-collect subscribers failed to pay them, and that the UT, although informed of the non-payment, failed to make good the loss. (Kadue Decl. ¶ 16 (App. Tab 15).) The UT's carrier-collect subscriber declarants, meanwhile, testify that they actually paid the contractors the subscription fees owed to them. As a population, carrier collect subscribers would have been paying subscribers for many years prior to the start of the class period, and would be among the most loyal customers and have an extraordinarily low rate of non-payment. Additionally, UT policy was to reimburse carriers for carrier-collect losses on a case-by-case basis if the carrier requested a refund and had used reasonable efforts to bill the subscriber and collect the amount owed. (Decl. of P. Savoie, dated Dec. 6, 2012 ¶ 15 (App Tab 21); Decl. of D. Sonsteng ¶ 26 (App Tab 22).). Only individualized proof would determine whether any particular contractor suffered any loss on carrier-collect subscriptions where the carrier reported non-payment to the UT and the UT failed to make reimbursement, and whether any loss was reasonably and necessarily incurred.

C. Varying Experiences Related to Enhanced Compensation for Expenses

In proposing and negotiating delivery fees, UT managers considered projected expenses associated with performance under distribution agreements. This method helped ensure that fees would would yield sufficient profit to make the UT competitive with respect to a distributor's other economic opportunities, and to prevent high turnover if rates were too low. UT managers used varying methodologies for forecasting contractor expenses while coming up with appropriate fees. These practices ranged from gut feel based on experience to the use of extensive spreadsheets with data points to figure out what piece rate would yield a minimum of $9 to $11 per hour of profit (excluding various other sources of revenue that would make that yield even higher). The spreadsheet approach factored in mileage expense at the IRS reimbursement rate as well as what the contractor's projected costs would be

for supplies, insurance, warehouse, and bond premium, as well as every other recurring ordinary expense for which the Plaintiffs now seek further reimbursement. Practices varied as to the manner in which projected expenses and calculation of piece rates were communicated to and discussed with carriers. Some carriers challenged the expense assumptions of managers in an effort to negotiate higher fees and rates, and others were perhaps never told nor aware of how rates and fees were calculated and the amount by which they were increased to account for projected expenses.

ARGUMENT

I. THIS COURT CAN DECERTIFY WHENEVER THE LAW AND FACTS SO WARRANT.

A. Defendants can move for decertification at any time.

A party may move to decertify a class, Cal. R. Ct. 3.764(a)(4), and courts act to ensure that compliance with class prerequisites continues. *See, e.g., Safaie v. Jacuzzi Whirlpool Bath, Inc.*, 192 Cal. App. 4th 1160, 1171-72 & n.5 (2011). Courts considering decertification consider legal developments indicating that common questions no longer predominate. *See Walsh v. IKON Office Solutions,* 148 Cal. App. 4th 1440, 1451, 1453-56 (2007); *accord Safaie*, 192 Cal. App. 4th at 1172 (affirming trial court's decertification order where individual issues of fact predominated); *Keller v. Tuesday Morning, Inc.*, 179 Cal. App. 4th 1389, 1397, 1399 (2010) (upholding trial court's decertification of class where individual inquiries of liability and damages predominated).

B. Changes in class-action law should affect this case.

1. *Dukes* has affected California wage and hour cases.

The Supreme Court has proclaimed that "[w]hat matters to class certification ... is not the raising of common questions—even in droves—but rather the capacity of a classwide proceeding to generate common *answers* apt to drive the resolution of the litigation." *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541, 2551 (2011). The plaintiffs' "common contention" thus must be capable of classwide resolution, so that its "truth or falsity will resolve an issue that is central to the validity of each one of the claims in one stroke." *Id.* And because defendants can present defenses to individual claims, plaintiffs cannot evade difficulties with common proof by resorting to a Trial by Formula approach. *Id.* at 2561.

Although *Dukes* addressed employment discrimination, its lessons apply in wage and hour cases. The California Supreme Court cited *Dukes* in *Brinker Rest. Corp. v. Superior* Court, 53 Cal. 4th 1004,

1023-24 (2012). In *Cruz v. Dollar Tree Stores, Inc.*, 2011 WL 2682967 (N.D. Cal. July 8, 2011), where California store managers sought pay for overtime work and missed breaks on a claim that Dollar Tree had misclassified as exempt employees, the trial court decertified a class it originally had certified, because the court concluded, under the new *Dukes* rubric, that the plaintiffs could not produce class-wide proof of liability and could not use a Trial by Formula method of proof. *Id.* at *5-6.

2. State courts have recognized that *Dukes* affects California class-action law.

The Supreme Court's interpretation of Rule 23 has implications for California class actions.[5] Two Superior Court Judges—in *Williams v. Allstate Ins. Co.*, 2012 WL 5354707 (L.A. Sup. Ct. July 24, 2012) and *Wackenhut Wage & Hour Cases*, 2012 WL 3218518 (L.A. Sup. Ct. Aug. 1, 2012)—recently decertified class actions in light of *Dukes*.[6] The *Williams* court, recognizing that "*Dukes* has changed the law" governing class actions, held that "[u]nder the changed law, the class action procedure is no longer appropriate" when defenses are raised as to each individual class member. 2012 WL 5354707, at *2 (citation omitted). The court thus decertified a class of auto field adjusters claiming pay for off-the-clock work:

> After *Dukes*, Allstate is entitled to litigate its defenses to the claims of each individual class member. For example, the court must permit Allstate to attempt to prove a particular class member did not work off the clock. ... *Dukes* gives Allstate the right to demonstrate certain class members did not work off the clock on certain dates.

Id. Because 230 field adjusters worked for the company, the court concluded that allowing a trial with evidence presented regarding each class member would be unmanageable. *Id.* at *2-3.

Similarly, the *Wackenhut* court saw *Dukes* as "significant new case law" representing "changed circumstances." 2012 WL 3218518 at *3. The trial court thus decertified classes of security officers claiming pay for missed meal breaks, because Wackenhut's "right to defend itself" under *Dukes* would lead to "numerous, unmanageable individualized inquires." *Id.* at *7.

---

[5] Plaintiffs concede that California courts follow federal Rule 23 decisions. Pls.' Mem. Supp. of Class Certification at 32 n.16 (June 24, 2011) (citing *Vasquez v. Superior Court*, 4 Cal. 3d 800, 821 (1971)).

[6] This Court, per Judge Foster, has considered unpublished California trial court opinions as a potential source of wisdom. (Aug. 21, 2011 Hrg. at 6:12-26 (App. Tab 2).)

C. As *Narayan* holds, a class action is improper where evidence on IC factors varies.

A federal district court recently decided that class certification would be improper where the evidence varied among class members as to even a single IC factor. *Narayan v. EGL, Inc.*, 2012 WL 4004621 (N.D. Cal. Sept. 7, 2012), at *7.

II. IC ANALYSIS HERE CREATES QUESTIONS THAT WILL NOT YIELD COMMON ANSWERS.

A. IC determinations depend on combinations of factors, not factors in isolation.

As the Court of Appeal recently explained in *Sotelo v. Medianews Group, Inc.*, 207 Cal. App. 4th 639 (2012), the many IC factors do not apply "mechanically as separate tests; they are intertwined and their weight depends often on particular combinations." *Id.* at 656-57 (citing *Borello*, 48 Cal. 3d at 350-51). In any given case, some IC factors will indicate employment, while others indicate independence. "[E]ach case must turn on its own particular facts and circumstances." *Brose v. Union-Tribune Publ'n Co.*, 183 Cal. App. 3d 1079, 1085 (1986). Moreover, courts must consider *all* relevant factors in determining IC status, as a failure to do so is reversible error. *See Arzate v. Bridge Term. Transp. Inc.*, 192 Cal. App. 4th 419, 427 (2011) (reversing summary judgment because trial court determining IC status must consider all relevant factors and failed to consider certain factors).

B. IC determinations are incompatible with class treatment where different class members present different combinations of factors.

The foregoing nature of IC law does not hinder class treatment if each class member's experience presents the same combination of factors. By the same token, class treatment is improper if class-member experiences present varying combinations of factors. Recently illustrating this point was *Sotelo*, 207 Cal. App. 4th 639, where, as here, newspaper carriers sought Labor Code recoveries on the theory that the newspaper had misclassified them as independent contractors. The Court of Appeal upheld the denial of certification even though the evidence varied only as to a "few" IC factors. *Id.* at 660. The court explained that variability as to even some factors precluded class certification: "even if other factors were able to be determined on a class-wide basis, those factors would still need to be weighed individually, along with the factors for which individual testimony would be required." *Id.*

Similarly, in *Narayan v. EGL, Inc.*, 2012 WL 4004621 (N.D. Cal. Sept. 7, 2012), a federal district court recently denied class certification to a group of delivery drivers because of intra-class

factual variances on the IC factor of whether the class members engaged in a distinct business. The court concluded that the variance on this one factor alone meant that a "class action could not possibly yield an answer to the ultimate question of whether the class members are employees," because inability to resolve that issue on a uniform basis would leave unresolved the issue of how that factor "is weighed in combination with" all of the other IC factors. *Id.* at *7.

The foregoing authorities, all issued since the Order here, show that where the evidence varies among the class members on IC factors, a classwide determination would be unmanageable.

C. Evidence under the factors varies from class member to class member.

Among the IC factors enumerated in *Sotelo*, the following are of particular relevance here:

(2) whether the one performing services is engaged in a distinct occupation or business;

(3) the kind of occupation, with reference to whether, in the locality, the work is usually done under the direction of the principal or by a specialist without supervision;

(5) whether the principal or the worker supplies the instrumentalities, tools, and the place of work for the person doing the work;

(6) the length of time for which the services are to be performed;

(9) whether the parties believe they are creating an employer-employee relationship;

(11) the hiree's degree of investment other than personal service in his or her own business and whether the hiree holds himself or herself out to be in business;

(12) whether the hiree has employees;

(13) the hiree's opportunity for profit or loss depending on his or her managerial skill.

See 207 Cal. App. 4th at 656-57 (citing *JKH Enter., Inc. v. Dep't of Indus. Relations*, 142 Cal. App. 4th 1046, 1064 n.14 (2006)).[7] An additional relevant factor is whether the written agreement between the parties was subject to negotiation.[8] For each factor, the evidence here fails to yield an answer that would

[7] The court in *Sotelo* identified fourteen numbered factors, after first identifying the factor that concerns whether the putative employer exercised "control of work details." *Id.* at 656-57.

[8] *See* 22 Cal. Code Regs § 4304-6(c)(1) ("A written agreement to the extent it provides for negotiation of terms, including fees, expense adjustments and other items for compensation to the carrier, shall tend to indicate the existence of an independent contractor relationship."); *Antelope Valley Press v. Poizner*, 162 Cal. App. 4th 839, 848, 855 (2008) (analyzing evidence of negotiation or non-negotiation in determining independent contractor or employee status).

be true for each class member. On the contrary, because the UT contractors had different practices and experiences, the evidence points to different answers for different class members.[9]

Varying evidence on factor (2): the "distinct occupation or business" factor. Courts addressing this factor have asked (a) whether the person hired sub-contractors or used substitutes or helpers, (b) whether the person was engaged in similar work for other companies, (c) whether the person developed a business structure, held himself out as engaged in a separate business, or had business cards, and (d) whether the person made investment in equipment or tools.[10] The facts yielded by these inquiries in this case would vary from class member to class member. Some contractors, including four Plaintiffs, regularly used substitutes and helpers, while other contractors, including one Plaintiff, did not;[11] some contractors engaged in similar work for other companies, while others did not;[12] some

---

[9] This variation also arises because carriers contracted out of different distribution centers with varying practices as to negotiation of rates, enforcement of complaint charges, spot-checking delivery results, and employee presence at the distribution center during assembly of newspapers.

[10] *See Narayan*, 2012 WL 4004621 at *6 ("distinct business" inquiry includes consideration of whether class members hired subcontractors, whether contractors developed business structures, such as developing "an owner role" after hiring sub-drivers, whether class members "contracted with other companies," and whether contractors advertised); *Spencer v. Beavex, Inc.*, No. 05-CV-1501 WQH, 2006 WL 6500597, at *16 (S.D. Cal. Dec. 15, 2006) (contractors' use of "back-ups and subs" implicated distinct occupation factor and created individualized proof justifying denial of class certification); *Sotelo v. Medianews Group, Inc.*, 207 Cal. App. 4th 639, 658 (2012) (evidence varied as to "distinct business" factor where some class members "carry products only offered by a single distributor, and others (covertly or openly) carry products from different distributors" and "some carriers utilized business cards holding themselves out as a distinct delivery service"); *Ruiz v. Affinity Logistics Corp.*, No. 05-CV-2125-JLS, 2012 WL 3672561, at *9 (S.D. Cal. 2012) (utilizing managerial skills to increase profit is relevant factor in distinct business inquiry); *Lara v. Workers' Comp. Appeals Bd.*, 182 Cal. App. 4th 393, 400, 407 (2010) (as to distinct occupation factor, relevant inquiries include whether plaintiff had IC experience with other companies, whether contractor developed business structure, such as having a business name or office, and whether contractor advertised); *Air Couriers Int'l v. Emp't Dev. Dep't.*, 150 Cal. App. 4th 923, 938 (2007) (whether contractors invested in equipment or materials pertains to distinct occupation factor); *Arnold v. Mutual of Omaha Ins. Co.*, 202 Cal. App. 4th 580, 589 (2011) (relevant inquiries into distinct occupation factor include whether contractor was responsible for providing own instrumentalities or tools); *Antelope Valley Press v. Poizner*, 162 Cal. App. 4th 839, 854-855 (2008) (analysis of distinct occupation factor included whether contractors made substantial investments to fulfill contractual duties).

[11] *Compare* J. Casillas Dep. 181:13-21, 346:12-350:2 (girlfriend delivered entire route two days a week without compensation; contractor used four other helpers to prepare papers) *and* L. Espejo Dep. 117:16-119:3 (only delivered four days a week; husband delivered other days and helped her on the days she delivered) (App. Tab. 37, 38) *and* F. Garcia 71:10-75:21 (substituted for another contractor for one month, and was paid by that contractor) (App. Tab 39) *and* G. Rivera Decl. ¶5 (used substitutes and helpers as she saw fit, to accommodate her weekday job) (App. Tab 9) *and* A. Vasquez Dep. 312:1-313:22 (husband tried to help all the time so that Plaintiff Vasquez could finish her route early) (App. Tab 42), *and* N. Williams Decl. ¶ 11 (hires substitutes when he feels he needs a day off) *with* A. Valderrama Dep. 357:5-9, 348:2-349:5 (never used a substitute, but relied on his brother and friend Ana as helpers; did not pay his brother but paid Ana $200 every cycle) (App. Tab 40) *and* G. Valderrama

contractors developed a business structure and held themselves out as engaged in a separate business; and some contractors invested in equipment or tools.[13]

Varying evidence on factor (3): whether the work was done under direction of principal. This factor entails a number of sub-inquiries into contractor practices, including (a) whether the contractors had any interaction with the UT, (b) whether the contractors performed work on the UT's premises, (c) whether the contractors received what they perceived to be instructions or directions from the UT or its managers.[14] The evidence demonstrates that the relevant facts under these inquiries vary from class member to class member, as some contractors had regular interactions with UT managers,

---

Spec. Rogs. 101-103 (only used a substitute once, for four days) (App. Tab 45). *See also* Decl. of N. Tetrault, dated Dec. 5, 2012, ¶ 22 (UT manager recalled specific contractors who did not use substitutes) (App. Tab. 24).

[12] *Compare* Decl. of R. Basurto ¶¶ 2-3 (delivered papers for 13 years with his grandfather and two uncles, including the *LA Times, North County Times, Navy Compass and Flight Jacket* (weekly military papers), and various Mexican community newspapers while he simultaneously contracted to deliver the *Union Tribune*) (App. Tab 6) *and* Decl. of E. Pietrowski ¶ 4 (delivered the *North County Times* as well as the *Union Tribune*) (App. Tab 8), *and* Dep. of A. Valderrama 135:22-137:18 (previously delivered copies of *Auto Trader* as an employee) (App. Tab 40) *with* L. Espejo Dep 122:4-8 (did not deliver any other publications besides the *UT*) (App. Tab 38). *See* Decl. of N. Tetrault, dated Dec. 5, 2012, ¶ 21 (contractor concurrently distributed *The Daily Californian*) (App. Tab. 24).

[13] *See* A. Valderrama RFA 26-27 (submitted to his tax preparer receipts for costs of gas, rubber bands, plastic bags, car repairs, shoes, and a raincoat to include as business expenses in his tax filings) (App. Tab 44); F. Garcia Dep. 607:4-608:10 (asked his accountant what being an independent contractor meant, filed his taxes as an independent contractor) (App. Tab 39).

[14] *See Ruiz*, 2012 WL 3672561 at *9 (supervision and interaction with principal in course of performing contractual duties is relevant inquiry in determining whether work was done under direction of principal); *Angelotti v. Walt Disney Co.*, 192 Cal. App. 4th 1394, 1405 (2011) (whether contractor received instructions from principal while performing contractual obligations and whether employer provided place of work is relevant to whether work was done under principal's direction); *Yellow Cab Coop., Inc. v. Worker's Comp. Appeals Bd.*, 226 Cal. App. 3d 1288, 1297 (1991) (contractors' belief they had to follow principal's directions pertains to whether work was done at principal's direction).

while others did not;[15] and some contractors received what they perceived to be directions or instructions from the UT or its managers, while others did not.[16]

Varying evidence on factor (5): who supplies instrumentalities, tools, and place of work. The evidence on whether the principal or the worker supplied the instrumentalities, tools, and place of work also would vary from class member to class member. Some contractors would testify that they were responsible for and paid all costs related to their instrumentalities and tools and that they did not work on UT premises, while other contractors might testify that they were given instrumentalities and tools, and that they performed a portion of their work at the UT's distribution centers.[17]

Varying evidence on factor (6): length of time for which services are to be performed. The evidence under this factor varies among the class members, as some direct contractors contracted with the UT for very short time periods, while other contractors had contractual relationships of significant duration with the UT.[18]

---

[15] *Compare* J. Casillas Dep 165:4-166:12 (UT manager would come by his house if he was late, and follow him on his route) (App. Tab 37) *and* L. Espejo Decl. ¶ 5 (every morning from January to April 2005 managers would order contractors in line to receive papers) (App. Tab 28), *and* F. Garcia ¶ 10 (UT managers wrote down the times that he arrived and left the warehouse) (App. Tab 29), *and* A. Vasquez Decl. ¶ 15 (UT managers instructed contractors in the warehouse, and gave them instructions on how to deliver papers) (App. Tab 35) *and* 10/10/12 A. Valderrama Decl. ¶ 3 (UT managers "always seemed to be in the warehouse when I was") (App. Tab 32) *with* A. Valderrama Dep 40:2-42:9 (did not remember how often he saw the UT manager at his distribution center, because his manager was often in an office on another floor) (App. Tab 40) *and* G. Valderrama (did not have regular meetings with managers when delivering the *UT*) (App. Tab 34).

[16] *Compare* J. Casillas Decl ¶ 38 (got verbal reprimand when he contacted subscribers with regard to papers being stolen on his route) (App. Tab 27), *and* F. Sorgenfrey Decl. ¶ 5 (manager rode with him for the first week on the route) (App. Tab 11) *and* A. Vasquez Dep. 31:20-33:5 (UT managers supervised and enforced unwritten rules regarding preparation and delivery of newspapers) (App. Tab 42) *with* J. Casillas Dep. 101:6-12 (contractor surrendering route was responsible for showing route to next contractor) (App. Tab 37) *and* G. Rivera Decl. ¶ 11 (always decided the order in which to deliver papers on her route, and was never required to report to anyone her order of delivery) (App. Tab 9) *and* G. Valderrama Dep. 300:5-7, 322:10-19 (did not receive any instruction on how to prepare newspapers, and when district managers told him that he should consider bagging his papers and using rubber bands, he considered it a suggestion) (App. Tab 41).

[17] *Compare* G. Rivera Decl. ¶¶ 7-8 (no one from the UT approved, inspected, or maintained contractor's vehicles; contractor was responsible for her expenses and what she chooses to pay her helpers) (App. Tab 9) *and* N. Williams Decl. ¶¶ 7, 14 (understood that as an independent contractor, he was responsible for purchasing his own supplies and that his contractual pay was meant to cover all of his expenses) (App. Tab 12) *with* F. Sorgenfrey ¶ 6 (at one time while under contract with the UT, was not charged for supplies, including rubber bands and plastic bags) (App. Tab 11) *and* L. Espejo Dep. 179:1-180:11 (was told by a manager that she was required to prepare the papers in the distribution center) (App. Tab 38).

[18] Contractors varied widely in the durations of their contractual arrangements. *Compare* Garcia Dep. 95:21-965, 285:17-25, 350:20-25 (carrier under UT contract for years) (App. Tab 39) *and* A.

Varying evidence on factor (9): contractors' belief as to employer-employee relationship. The evidence under this factor varies considerably among the class members. The distribution agreements explicitly state that the contractors were independent contractors. Most contractors understood when they contracted with the UT that they were entering into an independent contractor relationship, whereas some believed they were creating an employer-employee relationship.[19]

Varying evidence on factor (11): degree of investment in business. The evidence under this factor varies, as some contractors made some investment in connection with their work under the distribution contract, while other contractors may not have made any significant investment related to this work.[20]

Varying evidence on factor (12): whether the hiree has employees. The evidence under this factor varies, since (as noted *supra* at footnote 11) some contractors regularly relied upon sub-contractors, substitutes, or helpers to achieve contractual results, while other contractors may never have engaged such persons.

Varying evidence on factor (13): opportunity for profit depending on managerial skill. The evidence under this factor varies among the class members, as some contractors used managerial skill to increase their profit, including by engaging others to assist in achieving contractual results or performing the work in a more efficient manner that would lead to greater profits.[21] The extent to which contractors

---

Valderrama Dep. 27:21-24 (carrier under UT contract for three years) (App. Tab 40) *with* Espejo Dep. 169:2-20, 319:7-16 (carrier under UT contract for only five months) (App. Tab 38).

[19] *Compare* G. Rivera Decl. ¶ 4 (shadowed friend who was already a contractor before contracting a route with the UT; both the UT and her friend explained that under the contract she would be an independent contractor) (App. Tab. 9) *and* F. Sorgenfrey Decl. ¶ 16 (understood that as an independent contractor, the UT would not withhold taxes from him) (App. Tab. 11) *and* N. Williams Decl. ¶ 5 (was told he was an independent contractor when he first contracted directly with the UT) (App. Tab. 12) *with* A. Valderrama Dep. 197:18-20, Spec. Rog. 18 (believed he was an employee when he signed contract with UT) (App. Tab. 40, 46); A. Vasquez Dep. 151:9-19 (believed her contract made her an employee of the UT, and did not seek further information beyond that understanding) (App. Tab. 42).

[20] *See* G. Rivera Decl. ¶ 7 (used two vehicles on Sundays in order to load papers more quickly and deliver them faster) (App. Tab. 9); G. Valderrama Dep. 425:17-24 (modified vehicle by removing part of seat to make it easier to deliver papers) (App. Tab. 41); A. Valderrama Dep. 221:22-222:3, 345:15-17 (purchased insurance for his helper, used same vehicles for business and personal use) (App. Tab. 42).

[21] *See* G. Rivera Decl. ¶ 13 (communicated directly with subscribers and provided them with her telephone number in order to develop good relationships with subscribers, to minimize complaints, and to allow direct contact for resolution of delivery issues), Dep. of F. Garcia 274:15-21 (delivered sample newspapers to receive enhanced compensation) (App. Tab. 9); N. Williams Decl. ¶ 9 (changed delivery order and threw papers on both sides of the street to deliver more efficiently) (App. Tab. 12); F.

had the opportunity to obtain a greater profit based on their managerial skill thus would vary among the class members.

Varying evidence on the factor that concerns whether the contract is subject to negotiation. The evidence under this factor also varies considerably among the class members, as some contractors knew that the contract was subject to negotiation and negotiated various terms with the UT, including fees and route selection, while other contractors either did not know that the contract was subject to negotiation or did not attempt to negotiate any contractual terms.[22]

D. Plaintiffs' purported "common evidence" concerns only one factor and does not allow a classwide IC determination.

The Order, at 7-8, identified ten pieces of "common evidence" to assist the trier of fact "to determine whether the carrier or the UT controlled the 'manner and means of delivery.'" But this evidence does not meet the *Dukes* test of providing an answer that in "one stroke" materially advances the litigation. First, the evidence cited goes to the principal's control of contractual results, not to control over the manner and means of contractor performance. Moreover, all this evidence goes to but a single factor, which would not itself allow a fact finder to reach a determination on IC status.[23] As *Arzate* makes clear, determining IC status entails a look of *all* relevant factors, and it is reversible legal error to disregard any of them. 192 Cal. App. 4th at 427. As *Sotelo* instructs, no single factor applies as a

---

Sorgenfrey Decl. ¶¶ 8-9 (used rubber bands as much as possible because they were less expensive than bags; organized group of contractors to place bulk orders of supplies from supplier, thus decreasing operating costs) (App. Tab. 11); A. Vasquez Dep. 312:1-313:22 (relied on husband's help when possible so that she could finish route early) (App. Tab. 42).

[22] *Compare* A. Valderrama Dep. 248:3-249:22 (contractor knew he had discretion in selecting and negotiating delivery areas) (App. Tab 40) *with* G. Valderrama Dep. 400:23-402:12 (contractor did not know he could negotiate terms of the contracts) (App. Tab 41). *See also* Decl. of N. Tetrault, dated Dec. 5, 2012, ¶ 8 (Zone Leader at El Cajon distribution center negotiated with contractors regarding various contractual terms, such as delivery fee per copy, carrier collect fee, insert fee, alternate publication delivery fee, third party sales fee, Sunday inserting fee, carrier accident insurance, complaint charges, special products fee, redelivery fees, CPT (Complaint per Thousand) rates, distribution center rent, delivery times, and contract duration) (App. Tab 24).

[23] Defendants do not concede this evidence establishes that they controlled the contractors' "manner and means" of performance. On the contrary, Defendants' position is that this evidence merely reflects a principal's right to pursue and enforce contractual results. The right to enforce specified final results under a contract is not the same as the right to control the contractors' manner and means of performance. *See Doe I v. Wal-Mart Stores*, 572 F.3d 677, 682 (9th Cir. 2009) (holding that plaintiffs could not establish that Wal-Mart controlled the "manner or means" of accomplishing desired results through its supplier contracts, deadlines, quality standards, nor could plaintiffs show that Wal-Mart exercised control through its monitoring of "contractual obligations").

separate test; rather, all factors must be considered together, since they are intertwined" and their weight depends on "particular combinations." 207 Cal. App. 4th at 656-57.

E. Differing combinations of IC factors among class members prevent a classwide determination on the threshold issue of employee status.

Because the evidence here does not present the same combination of IC factors across the class, the Court potentially might find one contractor to be an employee even if class members generally are independent contractors. Consider two hypothetical class members, whose profiles comport with the composite factors that various class members would present. The Plaintiffs' best case would be **Carrier A**, an individual lacking business experience who entered into the UT distribution contract with the understanding that he was an employee, and who was told by a rogue UT manager that he must follow the manager's specific work instructions. **Carrier A** perceived carrier mail and delivery lists as directions for the manner or means of his job performance. For **Carrier A**, various factors could point toward a finding of employment. The Court could, under these and other circumstances pointing to employment, find that **Carrier A** was the UT's employee.

Now consider **Carrier B**. She incorporated her business, contracted out work to substitutes, and employed helpers. She used her own premises, equipment, and tools to deliver newspapers. She believed she was an independent contractor, not required to follow UT suggestions, and was obliged only to accomplish contractually specified results. For **Carrier B**, carrier mail and delivery lists were merely informational items used to identify contractual results. The Court likely would find that **Carrier B** was properly classified as an independent contractor.

Thus, two different contractors could present differing combinations of IC factors, justifying different outcomes on the threshold issue of employee status. The chart below further illustrates the impropriety of any one-size-fits-all determination on the issue of IC status, by providing more examples of the ways in which two theoretical class members could differ dramatically in terms of their traits, characteristics, and circumstances.

Differences in aspects of distributor operations	
Carrier A (employee?)	**Carrier B (clearly an IC)**
Signed distribution agreement "as is" after UT	Negotiated various contractual provisions,

manager said it was nonnegotiable	including fees and service incentives
Did not select route contracted for	Bargained for multiple routes near existing carrier operations
Contracted as an individual and did not fully appreciate nature of IC relationship	Contracted as business entity and intended to be an IC
Contracted for long periods and continually renewed contracts	Contracted for only brief periods of time
Had to go on ride-along with UT manager to learn route and how to deliver	Had no UT orientation; used own industry experience and other background and skills
Followed sequence of delivery list available from UT, without deviation	Constructed own delivery lists and reconfigured routes to maximize efficiencies
Contracted only with UT and did not deliver for other companies	Entered delivery contracts with other companies, including UT competitors
Never used a substitute or helper for assistance in delivering route	Engaged subcontractors and hired helpers on ongoing basis to handle deliveries
Used existing personal vehicle to drive route	Selected vehicles and customized them to optimize capacity and fuel efficiency
Purchased supplies only from UT	Sourced own supplies on own, acting in concert with other distributors to achieve volume efficiencies
Prepared newspapers for delivery on UT premises, with UT personnel present	Prepared newspapers elsewhere, with little to no regular interaction with UT
Performed services as an individual	Performed services a business proprietor or owner of a business entity
Rarely interacted with subscribers on the route and did not respond to complaints	Shared contact information with subscribers and fielded customer complaints and inquiries to achieve service incentives
Had the UT redeliver missed deliveries or lost or stolen papers	Handled all of his or her own redeliveries
Never solicited new subscriptions from households on route	Actively solicited new subscribers, such as through sampling, to collect more delivery fees and also commissions for new subscribers
Sole source of revenue was delivery piece rate paid by UT	Provided services (such as inserting) or sold supplies to other carriers to increase revenue
Filed tax returns as an employee	Filed tax returns as an independent contractor and claimed business expense deductions

(*See* Kadue Decl. ¶¶ 8-18 (App. Tab 15).)

These divergent profiles cannot provide a sound basis for a sound answer to the question, "Are Carriers A and B employees"? **Carrier B** operates as an independent contractor under any legal test, while **Carrier A** presents a closer question. Yet the evidence in this case is consistent with these extreme profiles among class members, as well as any number of combinations in between. One simply cannot extrapolate the experience of a few class members here to the experience of the class as a whole.

This lack of an all-or-nothing outcome distinguishes this case from *Ayala v. Antelope Valley Newspapers, Inc.*, 210 Cal. App, 4th 77 (2012), where the Court of Appeal favored certification on the IC issue after noting that the defendant assumed a classwide IC determination could be proper. *Id.* at 85 n.1. That is not the position the UT takes here. Moreover, *Ayala* expressly held that the class in that case, on remand, might face certification problems not then before the court (problems that the UT presents here). *Id.* at 94.

Ayala is not only distinguishable, but wrongly decided. First, *Ayala* misanalyzed the issue of the right to control the manner and means of performance: the court conflated common proof of the newspaper's control over contractual results (e.g., satisfactory delivery of the newspaper product) with common proof of control over the manner and means of achieving those results. Second, *Ayala* erred in disregarding the need to consider all relevant factors, as established in *Arzate v. Bridge Term. Transp. Inc.*, 192 Cal. App. 4th 419, 427 (2011), which holds that an IC analysis is erroneous unless it considers all relevant factors. The *Ayala* court had no sound answer to the point that on many factors the proof varied; the court said only that the "focus" of the secondary factors is "mostly" on the job itself, 210 Cal. App. 4th at 92, but the law does not permit a court to simply disregard certain factors. *Sotelo,* by contrast, used the correct approach, evaluating evidence under all the factors and concluding that variability on those factors precluded class certification. 207 Cal. App. 4th at 660. Third, *Ayala* erred in ignoring the critical factor of whether the carrier has an independent business that used subcontractors. *Ayala* is devoid of analysis as to this factor, which proved crucial in the recent decertification decision in *Narayan*, 2012 WL 4004621, at *5-8. Finally, *Ayala* had no rationale for deviating from *Sotelo*'s sound analysis, but instead simply stated that *Sotelo* involved "facts and positions unique to the parties," even though both cases involve groups of newspaper carriers making identical Labor Code claims. 210 Cal. App. 4th at 91 n.9. *Ayala* also failed to follow *Ali v. U.S.A. Cab, Ltd.*, 176 Cal. App. 4th 1333 (2009),

another case that declined to certify a class of drivers who alleged they were de facto employees misclassified as independent contractors, after concluding that variation on secondary factors was critical to the analysis and weighed against certification. *Id.* at 1349-52.

III. EXPENSE REIMBURSEMENT CLAIMS RAISE NUMEROUS INDIVIDUALIZED INQUIRIES.

The expense-reimbursement claims arise under Labor Code section 2802, which raise, beyond the threshold element of employee status, numerous elements of liability, as well as issues regarding defenses and damages. The elements of liability are (1) the item for which reimbursement is sought must be an actual expense or loss, (2) the expense or loss must be reasonable, and (3) the expense or loss must be a necessary consequence of job duties. *See Ruiz v. Affinity Logistics Corp.*, 2009 U.S. Dist. LEXIS 130728, at *7 (S.D. Cal. Jan. 29, 2009) (issues require "fact-intensive inquiry") (quoting *Grissom v. Vons Cos. Inc.*, 1 Cal. App. 4th 52, 58 (1991)).

A. Auto expenses

Plaintiffs would need to rely on individualized testimony to establish (i) the route each carrier chose to take, (ii) how often each carrier drove her vehicle, (iii) how far each carrier drove her vehicle, (iv) how many vehicles she used when delivering newspapers, (v) whether each carrier used helpers or substitutes (who, in turn, used their own vehicles) to deliver newspapers, (vi) whether the carrier was simultaneously delivering for another company, and (vii) whether the expenses incurred were reasonable in any particular circumstance. The Plaintiffs presumably would use mileage estimates and IRS expense allowances to compute mileage expenses, but that data would be inherently unreliable because these are estimates only and because carriers, to the extent that they used substitutes of did not themselves drive the route or walked some portion of it, would not have actually incurred auto expenses.

Although variations in evidence on damages do not themselves necessarily preclude class certification, California courts have denied certification where such variations destroy the "requisite community of interest." *See, e.g., Ali*, 176 Cal. App. 4th at 1350; *accord Evans v. Lasco Bathware, Inc.*, 178 Cal. App. 4th 1417, 1428 (2009) (class certification improper if variables make damages "not amenable to estimation"); *Caro v. Procter & Gamble Co.*, 18 Cal. App. 4th 644, 668 (1993) (class certification improper without reliable formulae to calculate damages).

B. Non-auto expenses

Although the Order discussed "auto expenses," Order at 10-11, Plaintiffs also seek to recover for items recorded as "charges" in carrier statements: (1) subscriber complaint charges, (2) the cost of supplies used to protect newspapers, (3) expenses for accident insurance, (4) insert charges, and (5) carrier-collect charges. Each expense-reimbursement claim raises a series of individual issues of liability, defenses, or damages.

1. The Court certified only the claim for auto expenses.

At the hearing on class certification, Plaintiffs argued for certification as to auto expenses in the (mistaken) belief that such a claim simply involved multiplying mileage by IRS allowance rate. Aug. 12, 2011, Hrg. at 31:4-11 (App. Tab 2).[24] The Court's Order followed suit, siding with the Plaintiffs as to the Section 2802 claim (appearing in the Fourth Cause of Action) only in the limited context of auto expenses: "[W]ith respect to the Fourth cause of action – failure to pay reimbursement for auto expenses, there is no dispute the UT did not reimburse plaintiffs for auto expenses. If the carriers are found to be employees, the UT will be required to reimburse plaintiffs for automobile-related expenses. The only question is one of damages." Sept. 11, 2011, Order at 10:18-11:3 (App. Tab 1).

Whether or not auto-expense claims raise only damages issues (and not also liability issues), the Court has since recognized that Section 2802 claims involve "separate wrongful acts" (Nov. 2, 2012 Tentative Ruling on Defendants' motion for summary adjudication, at 2 (App. Tab. 4), thereby requiring Plaintiffs to prove that these separate acts affected each individual class member.

2. Non-auto expense claims were properly not certified.

(a) Subscriber complaint charges. Contractors who received excessive subscriber complaints incurred complaint charges. Only a minority of contractors experienced these charges, because most contractors successfully fulfilled their contractual obligations. Experiences with subscriber complaint charges varied from class member to class member. An individual contractor would be entitled to recovery for unreimbursed complaint charges only by demonstrating that his conduct was "reasonable."

[24] "I'd like to suggest also that in terms of certifying a class, whether it be only the carriers that signed direct contracts or a broader class, that with regard to the cause of action ... for the reimbursement under 2802 for mileage, that represents about 80% of damages for the carriers, and that is a very clean thing to measure." Hearing Tr. at 31:4-11.

That is a fact-intensive inquiry subject to individualized proof. As a result, individualized inquiries would be required to determine whether and to what extent complaint charges resulted from grossly negligent conduct.[25] Plaintiffs' discovery responses concede that individual testimony on the issue of subscriber complaint charges would be necessary. While Plaintiffs would present "representative testimony,"[26] *Dukes* makes it clear that trial based on a "sample set" of plaintiffs is not permitted, since Defendants have the right to present individual defenses. *Dukes*, 131 S. Ct. at 2561.

(b) The cost of supplies used to deliver newspapers. The use of supplies to protect newspapers varied among class members.[27] Individualized inquiries would be needed to see if various UT managers required class members to incur those costs, and whether those costs were reasonable. Plaintiffs' discovery responses concede that individual testimony on this issue would be necessary.[28]

(c) Accident insurance premiums. While on-route insurance could be a business expense, the Labor Code authorizes insurance premium deductions for the employees' own benefit, when they are pursuant to written consent. Lab. Code § 224. The parties dispute the extent to which insurance was required. Some contractors, for example, bought only on-route insurance and not 24-hour insurance, and some contractors did not buy any insurance at all. (D. Sonsteng Decl. ¶ 17 (App. Tab 22); N. Tetrault

---

[25] *See* Aug. 9, 2012 Decl. of P. Savoie ¶ 14 (contractors incurred complaint charges if they received more than the contractually agreed upon number of complaints per delivery; many contractors performed their duties without incurring complaint charges) (App. Tab 20); Plaintiffs' Supp. Resp. to Def. SDUT's 3d Req. for Adm. 404 (admitting "it is possible" some class members did not incur complaint charges) (App. Tab 43).

[26] *See* Pls.' Supp. Resp. to Def. SDUT's 3d Req. for Admission 365 (representative class-member testimony needed to establish which complaint charges imposed during the class period did not result from class members' dishonesty, willful acts, or gross negligence) (App. Tab 43).

[27] *Compare* L. Espejo Dep. 314:12-23 (purchased bags and envelopes, but never purchased rubber bands) (App. Tab 38) *with* Sorgenfrey Decl. ¶ 8 (used rubber bands as much as possible because they were less expensive than bags, and reduced his cost for supplies) (App. Tab 11).

[28] *See* Pls.' Supp. Resp. to Def.'s 3d Req. for Admission 369, 371, 373 (representative testimony from some class members will be needed to determine what financial investments each class member, other than the named Plaintiffs, made in tools or equipment; which class members made investments in tools or equipment; and to what extent the class members made investments in tools or equipment during the class period) (App. Tab. 43); 416, 417 (representative testimony from some class members will be needed to establish the extent to which a Defendant required class members to use polybags or rubber bands, and the extent to which a Defendant required class members to purchase polybags and rubber bands from a Defendant) (App. Tab. 43).

Decl., dated Dec. 5, 2012, ¶ 24 (App. Tab 24).) Plaintiffs, meanwhile, claim that the UT required them to buy 24-hour insurance.[29] Plaintiffs concede individual testimony would be necessary on this issue.[30]

(d) Insert charges. Some carriers contractually agreed to have the UT use other contractors to pre-insert sections of the newspaper, such as advertising supplements or Sunday sections, and to have the cost of that activity reflected as "insert charges" on carrier statements. (Distribution Agreement, App'x to Agreement at 6 (App. Tab. 36).) This was a voluntary arrangement. *Id.* As a result, whether contractors incurred insert charges varies from contractor to contractor, as some agreed to have the UT use inserters, while others did their own inserting services.[31] Yet Plaintiffs allege that some UT managers required contractors to agree to use other contractors to perform inserting. (Kadue Decl. ¶ 5 (citing Plaintiffs' brief).) Here again individualized testimony would be necessary,[32] as Plaintiffs concede in discovery responses.[33]

(e) Carrier-collect charges. These debits in carrier statements reflected income the carrier had already received directly from the subscriber, and thus did not reflect any expense or loss at all. Carrier-collect subscribers have confirmed that they did pay the carriers directly. (*See* Decl. of A. Wohlgemuth ¶ 5, (App. Tab 26); Decl. of V. Labrador ¶ 5 (App. Tab 25).) At least one contractor who delivered to carrier-collect subscribers also has stated that does not recall any of these subscribers failing to pay.

---

[29] *Compare* Aug. 9, 2012 Decl. of P. Savoie ¶ 15-17 (contractors could secure insurance on their own or through Wilson Gregory, contractors were allowed to opt between on-route insurance and 24-hour accident insurance) (App. Tab. 20) *with* G. Valderrama Decl. ¶ 11 (managers told him to choose 24 hour option) (App. Tab. 41) *and* Decl. of A. Vasquez ¶ 12 (did not understand insurance agreements because they were in English) (App. Tab. 42).

[30] *See* Pls.' Supp. Resp.to Def. SDUT's 3d Req. for Adm. 362, 363 (representative testimony from some class members will be needed to establish to which extent each class member's purchase of on-route and 24-hour accident insurance during the class period was involuntary) (App. Tab. 43).

[31] *See* Decl. of D. Cramer ¶ 15 (UT manager observed that some contractors used inserting service, while others performed inserting themselves); Decl. of N. Tetrault, dated Dec. 5, 2012, ¶ 23 (recalled specific contractors who did their own inserting, and who thus earned an insert fee and did not incur insert charges) (App. Tab 13); Decl. of V. Diep ¶ 7 (some contractors used inserting service, while others performed inserting services themselves) (App. Tab 14).

[32] *Compare* Aug. 9, 2012 Decl. of P. Savoie (contractors could negotiate insert fee per-piece rate, and cancel inserting fee authorization under the agreement) (App. Tab. 20), *with* Oct. 10, 2012 Decl. of F. Garcia ¶ 11 (was never told that inserting fees were optional) (App. Tab. 29), *and* Oct. 11, 2012 Decl. G. Valderrama ¶ 13 (was required to pay someone to insert parts of the newspaper; asked managers if he could insert but was told he was not allowed) (App. Tab. 33).

[33] *See* Pls.' Supp. Resp. to Def. SDUT's 3d Req. for Admission 369, 371, 373 (responding that representative class member testimony will be needed, including with regard to invoices that show carrier collect charges, insert charges ... bonding charges, and warehouse rent charges) (App. Tab. 43).

(Decl. of A. Smith ¶ 10.) The Plaintiffs, however, claim that some carrier-collect subscribers failed to pay and that the UT then failed to cover the loss.[34] As a matter of policy, UT managers would determine on a case-by-case basis whether it would be appropriate to reimburse a contractor for a subscriber's failure to pay carrier-collect fees, and this determination would depend on whether the contractor had made reasonable efforts to bill and collect from the subscriber. (Decl. of P. Savoie, dated Dec. 6, 2012, ¶ 15 (App. Tab 21); Decl. of N. Ho ¶ 12 (explaining that it was contractors' responsibility to inform UT of non-payment, and to make reasonable efforts to bill and collect from carrier-collect subscribers) (App. Tab 7).) In some instances, the UT would refund the contractor for unpaid carrier-collect fees. (Decl. of D. Sonsteng ¶ 26.) Thus, to establish a right to recovery based on unpaid carrier-collect subscription fees, Plaintiffs would need proof of non-payment to particular contractors by particular subscribers, proof of reasonable efforts made to collect such fees, and proof that the UT did not reimburse for the subscribers' non-payment. Plaintiffs' discovery responses concede that individual testimony on the issue of carrier-collect charges would be necessary.[35]

Plaintiffs thus lack *common* evidence of damages as well as liability, whether on auto- or non-auto expenses. Contractors maintained no reliable records to document those expenses. (*See, e.g.*, Decl. of G. Rivera ¶ 8 (App. Tab 9).) Further, contractors incurred both auto and non-auto expenses in providing results for companies other than UT, thus requiring individualized inquiries as to whether the carriers incurred the expenses with relation to UT. Plaintiffs thus cannot prove damages through any reliable method of common proof.

Here, the variations among auto- and non-auto expenses are so large that no "community of interest" exists. The class should be decertified for this additional reason.

---

[34] *Compare* A. Valderrama Dep. 360:5-19 (would give his contact information to carrier-collect subscribers and contact them if he had any issues receiving payment from them, would always collect money from customers directly and keep the money) (App. Tab. 40), *with* Oct. 11, 2012 Decl. of G. Valderamma ¶ 9 (one carrier-collect subscriber was not paying plaintiff; reimbursements for deductions on wages were never given to plaintiff) (App. Tab. 33), *and* Oct. 10, 2012 Decl. of A Valderrama ¶ 12 (deductions made from plaintiff's account even after he reported to managers that subscribers had ceased paying him) (App. Tab. 32).

[35] *See* Plaintiffs' Supp. Resp.to Def. SDUT's 3d Req. for Admission 369, 371, 373. (App. Tab 43.)

IV. THE *GATTUSO* DEFENSE WOULD REQUIRE SUBSTANTIAL INDIVIDUALIZED INQUIRIES.

Under *Gattuso v. Harte-Hanks Shoppers, Inc.*, 42 Cal. 4th 554 (2007), employers can satisfy expense-reimbursement obligations by paying enhanced compensation, through "a means or method to apportion the enhanced compensation to determine what is being paid for labor performed and what amount is reimbursement for business expenses." *Id.* at 558. The UT relied on *Gattuso* for its Fifteenth Affirmative Defense: "The claim for unreimbursed expenses fails to the extent that Defendants have paid enhanced compensation to cover expenses actually and necessarily incurred." When Plaintiffs moved to strike this defense, the Court denied the motion, as "a triable issue of material fact exists whether the reimbursement plan of defendants ... meets the *Gattuso* criteria." April 24, 2012 Minute Order at 2. This is another important post-certification development warranting decertification now.

The UT is "entitled to litigate its defenses to the claims of each individual class member." *Williams*, 2012 WL 5354707 at 2. The litigation of the *Gattuso* defense would require individualized evidence because it would need a showing that (i) each class member received enhanced compensation to cover business expenses, and (ii) the UT provided the appropriate "means or method" to apportion the enhanced compensation between labor performed and reimbursement. The evidence necessary to establish whether the provision of enhanced compensation was sufficient to constitute a defense under *Gattuso* would vary depending upon, for instance, (a) whether that compensation covered all expenses, (b) whether the UT provided the appropriate means to apportion the enhanced compensation between labor performed and reimbursement of business expenses, and (c) whether the UT (under Plaintiffs' view of the law) adequately communicated its apportionment methodology.

The unmanageability of litigating *Gattuso* inquiries is further complicated by the number of different UT managers determining in their own ways how to set contractor compensation to cover contractor expenses. As a general matter, in setting contractor compensation, UT managers took into account the contractors' daily expenses, including such items as plastic bags, rubber bands, insurance premiums, distribution center rent, monthly bond expense, and mileage. (*See* Decl. of P. Savoie, dated April 6, 2012, ¶ 20 (App. Tab. 19).) There was no uniform practice among UT managers, however, as to apportioning compensation to cover contractor expenses; different managers used different methods in

apportioning compensation to cover expenses and negotiating with contractors.[36] The parties would need to present evidence as to UT managers' practice in apportioning and negotiating compensation. That task would be highly unmanageable and thus not a superior method of adjudication.

A need to evaluate a defense for each class member "weigh[s] heavily against certification." *Block v. Major League Baseball*, 65 Cal. App. 4th 538, 541, 544 (1998). And because the Gattuso defense depends on individualized evidence, UT would be wrongfully prejudiced by a class proceeding that would permit any recovery by a class member of expenses for which they have already been paid. For this additional reason, the class must be decertified.

CONCLUSION

To sustain their class action for expense reimbursement, Plaintiffs must first present common proof of employee status, proving under a multi-factor test on a classwide basis that all contractors were employees and not independent contractors. If Plaintiffs could present such proof, they would then to present common proof of liability as to each item of claimed reimbursement, showing that it was (1) an expense or loss and (2) reasonably incurred as a direct consequence of job duties. Plaintiffs would also need a common proof to adjudicate the UT's defenses and to calculate damages.

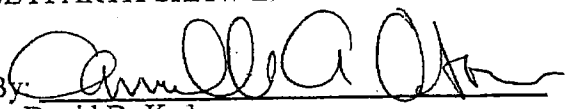
As to all of these issues, myriad individual pieces of evidence preclude "common answers apt to drive the resolution of the litigation." *Dukes*, 131 S. Ct. at 2551. The IC analysis is such that all factors must be considered in combination, and the evidence here would vary for different class members. The individual issues only multiply when one considers the forms of individualized proof needed to show Section 2802 liability, and the amount of damages in light of the available evidence and the adjudication and application of the UT's *Gattuso* defense. Due process forbids any Trial by Formula that purports to solve these problems by jamming presumed facts into an arbitrary procrustean model. *See Dukes*, 131 S. Ct. at 2561. This case is not suitable for class adjudication, and the class should be decertified.

---

[36] *Compare* Decl. of P. Prather ¶¶ 7-13 (explaining that as Zone Leader, he and another Zone Leader, Nancy Tetrault, devised and relied on spreadsheets listing contractor expenses as basis for setting contractors' pay rates) *with* Decl. of R. Kemp ¶¶ 7-10 (Zone Leader set contractors' pay rates based on personal knowledge of each route, and did not rely on any spreadsheets listing contractors' estimated expenses, as other managers did) (App. Tabs 16, 17). *See also* Decl. of N. Tetrault, dated Dec. 5, 2012, ¶¶ 11-19 (describing process for calculating appropriate level of enhanced compensation to cover expenses) (App. Tab 24); Decl. of D. Cramer ¶¶ 10-11 (rates were set to factor in all contractor expenses) (App. Tab 13).

DATED: December 6, 2012

SEYFARTH SHAW LLP

By: 

David D. Kadue
Camille A. Olson
Richard B. Lapp
Attorneys for Defendants THE SAN DIEGO UNION-TRIBUNE, LLC, THE COPLEY PRESS INC., PLATINUM EQUITY, LLC, and PROJECT JEWEL HOLDINGS, LLC

Sue J. Stott, Bar No. 91144
SStott@perkinscoie.com
PERKINS COIE LLP
Four Embarcadero Center, Suite 2400
San Francisco, CA 94111-4131
Telephone: 415.344.7000
Facsimile: 415.344.7050

Jeffrey A. Hollingsworth, Bar No. 11853 (*pro hac vice*)
JHollingsworth@perkinscoie.com
Andrew E. Moriarty, Bar No. 28651 (*pro hac vice*)
AMoriarty@perkinscoie.com
PERKINS COIE LLP
1201 Third Avenue, Suite 4900
Seattle, WA 98101-3099
Telephone: 206.359.8000
Facsimile: 206.359.9000

Lauren T. Howard, Bar No. 227984
LHoward@perkinscoie.com
PERKINS COIE LLP
1888 Century Park East, Suite 1700
Los Angeles, CA 90067-1721
Telephone: 310.788.9900

Attorneys for Defendants The McClatchy Company and McClatchy Newspapers, Inc. d/b/a The Sacramento Bee

SUPERIOR COURT OF THE STATE OF CALIFORNIA

COUNTY OF SACRAMENTO

LORIANNE SAWIN, an individual; MONICA GALLARDO, an individual; ROBERT LANGFORD, an individual; KIMBERLY HOLLIMAN, an individual; BILLY TRAHIN, an individual; MERLE RENSLOW, an individual; on their own behalf and on behalf of all others similarly situated,

Plaintiffs,

v.

THE MCCLATCHY COMPANY, a Delaware Corporation, d/b/a The Sacramento Bee; McCLATCHY NEWSPAPERS, INC., a Delaware Corporation, d/b/a The Sacramento Bee; and DOES 27 - 50, inclusive,

Defendants.

CASE NO.: 34-2009-00033950-CU-OE-GDS

ASSIGNED FOR ALL PURPOSES TO THE HON. ALAN G. PERKINS, DEPT. 35

MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT OF DEFENDANTS THE McCLATCHY COMPANY AND McCLATCHY NEWSPAPERS, INC.'s MOTION FOR DECERTIFICATION

Date: March 22, 2013
Time: 1:30 p.m.
Dept.: 35
Judge: Hon. Alan G. Perkins

BY FAX

TABLE OF CONTENTS

PAGE

TABLE OF AUTHORITIES ii

I. SUMMARY OF THE ISSUES 1

II. PROCEDURAL HISTORY AND NEW DEVELOPMENTS 3

A. Prior Class Certification Proceedings 3

B. Significant New Legal Authority Has Developed 4

C. Over a Year After Certification, No Plan Has Emerged for Establishing Liability, or Damages, Through Common Proof 6

III. ARGUMENT 7

A. New Legal Authority Establishes the Predominance of Individual Issues in the Multi-factor Balancing Test Used to Distinguish Contractors from Employees 7

1. The Independent Contractor Test is Unique to Each Individual 7

2. Variations Regarding Secondary Factors Mean That Individual Issues Predominate in the Contractor Analysis in This Case 8

3. The Supposed Common Questions and Evidence on Which Plaintiffs Rely Are Not Common or Not Predominant or Both 10

B. Post-Certification Discovery Shows That Individual Issues Will Predominate on Plaintiffs' Reimbursement ("Mileage") Claim 13

C. This Case is Unmanageable as a Class Action 17

D. A Class Action Is Not Superior 19

IV. CONCLUSION 20

TABLE OF AUTHORITIES

CASES	PAGE(S)
Aburto v. Verizon Cal., Inc., No. CV 11–03683–ODW, 2012 WL 10381 (C.D. Cal. Jan 3, 2012)	5
Ali v. U.S.A. Cab Ltd., 176 Cal. App. 4th 1333 (2009)	8, 16
Ayala v. Antelope Valley Newspapers, Inc., 210 Cal. App. 4th 77 (2012)	8
Basurco v. 21st Century Ins. Co. 108 Cal. App. 4th 110 (2003)	19
Bedoya v. Aventura Limousine & Transp. Serv., Inc., No. 11-24432-CIV, 2012 WL 1933553 (S.D. Fla. Apr. 10, 2012)	5
Bell Atlantic Corp. v. AT&T Corp., 339 F.3d 294 (5th Cir. 2003)	16
Brinker Restaurant Corp. v. Superior Court, 53 Cal. 4th 1004 (2012)	*passim*
Caro, 18 Cal. App. 4th at 645	16
Chavez v. Lumber Liquidators, Inc., No. CV-09-4812 SC, 2012 WL 1004850 (N.D. Cal. Mar. 26, 2012)	15
City of San Jose v. Super. Ct., 12 Cal. 3d 447 (1974)	18
Cruz v. Dollar Tree Stores, Inc., Nos. 07–2050 SC, 07–4012 SC, 2011 WL 2682967 (N.D. Cal. July 8, 2011)	5
Dunbar v. Albertson's, Inc., 141 Cal. App. 4th 1422 (2006)	17, 18
Evans v. Lasco Bathware, Inc., 178 Cal. App. 4th 1417 (2009)	16, 18
Frieman v. San Rafael Rock Quarry, Inc., 116 Cal. App. 4th 29 (2004)	16
Gales v. WinCo Foods, No. C 09–05813 CRB, 2011 WL 3794887 (N.D. Cal. Aug 26, 2011)	5

CASES	PAGE(s)
Gattuso v. Harte-Hanks Shoppers, Inc., 42 Cal. 4th 554 (2007)	14, 15, 17
Gawry v. Countrywide Home Loans, Inc., 640 F. Supp. 2d 942 (N.D. Ohio 2009)	16
Grissom v. Vons Cos., Inc., 1 Cal. App. 4th 52 (1991)	15
Guzman v. DIRECTV, Inc., Case No. BC410983 (L.A. Cnty. Super. Ct. Dec. 13, 2012)	4
Harris v. Vector Mktg. Corp., 753 F. Supp. 2d 996 (N.D. Cal. 2010)	15
Kaewsawang v. Sara Lee Fresh, Inc., 2012 WL 1548290 (Cal. App. 2d Dist. May 3, 2012)	4, 11
Keller v. Tuesday Morning, Inc., 179 Cal. App. 4th 1389 (2009)	7
Mario v. United Parcel Serv., Inc., 639 F.3d 942 (9th Cir. 2011)	11
Martinez v. Joe's Crab Shack, Inc., No. BC377269, at 11-12 (L.A. Cnty. Super. Ct. May 23, 2012)	18
McCallum v. McCallum, 190 Cal. App. 3d 308 (1987)	8
Morgan v. Wet Seal, Inc., 210 Cal. App. 4th 1341 (2012)	11, 17
Narayan v. EGL. Inc., 285 F.R.D. 473 (N.D. Cal. Sept. 7, 2012)	4
Norris-Wilson v. Delta-T Group, Inc., 270 F.R.D. 596 (S.D. Cal. 2010)	12, 13
Novak v. Boeing Co., No. SACV09-01011-CJC(ANx), 2011 WL 7627789 (C.D. Cal. Dec. 19, 2011)	10, 13
Ruiz v. Affinity Logistics Corp., No. 05CV2125JLS, 2009 WL 648973	15
S.G. Borello & Sons v. Dep't of Indus. Relations, 48 Cal. 3d 341 (1989)	4, 8

CASES **PAGE(S)**

Scott v. NOW Courier, Inc.,
No. 1:10-CV-971-SEB-TAB, 2012 WL 1072751 (S.D. Ind. Mar. 29, 2012) 5

Sotelo v. MediaNews Group, Inc.,
207 Cal. App. 4th 639 (2012) (petition for review denied Sept.19, 2012) ..... *passim*

State Comp. Ins. Fund v. Brown,
32 Cal. App. 4th 188 (1995) 7

Takacs v. A.G. Edwards and Sons, Inc.,
444 F. Supp. 2d 1100 (S.D. Cal. 2006) 14

Velazquez v. Costco Wholesale Corp.,
No. SACV 11-00508-JVS, 2011 WL 4891027 (C.D. Cal. Oct 11, 2011) 5

Wackenhut Wage and Hour Cases,
2012 WL 3218518 (L.A. Cnty. Super. Ct. Aug. 1, 2012) 4

Wal-Mart Stores, Inc. v. Dukes,
131 S. Ct. 2541 (2011) ..... *passim*

Walsh v. IKON Office Solutions, Inc.,
148 Cal. App. 4th 1440 (2007) 7

Washington Mutual Bank, FA v. Super. Ct.,
24 Cal. 4th 906, 922-23 (2001) 17

Wilens v. TD Waterhouse Group, Inc.,
120 Cal. App. 4th 746 (2003) 16

Windham v. Am. Brands, Inc.,
565 F.2d 59 (4th Cir. 1977) 16

STATUTES

Business and Professions Code Section 17200 ..... 3, 4

California Labor Code § 2802 ..... 14, 15

OTHER AUTHORITIES

California Rule of Court 3.764 1

California Rule of Court 3.767(b) 7

Federal Rule of Civil Procedure 23(a) 13

I. SUMMARY OF THE ISSUES

Pursuant to California Rule of Court 3.764, Defendants The McClatchy Company and McClatchy Newspapers, Inc. d/b/a The Sacramento Bee ("Defendants" or "The Bee") respectfully move the Court to decertify the class certified by Order dated July 21, 2011 (the "Minute Order").

The class members are individuals who contracted with The Bee to provide newspaper delivery services for *The Sacramento Bee* newspaper. As detailed throughout this Memorandum, these individuals accomplished the delivery services in numerous and varied ways, *i.e.*, some accomplished delivery on foot; some by car; some by vehicles purchased specifically for their distribution business; some did not provide the services at all—subcontracting all of the delivery to others; and, some performed part of the services and subcontracted the rest. The certified claims involve alleged violations of the California Labor Code and a derivative unfair competition claim. The Labor Code applies only to employees, but The Bee classified and treated the service providers as independent contractors. Thus, the potentially dispositive threshold issue is whether a given class member was permissibly classified as an independent contractor. In certifying a class, this Court described it as a "close" question whether common legal and factual issues predominated in the classification analysis.

The question is no longer a close one. New authority from the United States and California Supreme Courts and the California Court of Appeal shows that common issues do not predominate in the classification analysis because (1) the broad "common questions" that Plaintiffs previously identified, such as "were the class members misclassified as independent contractors?" cannot be *answered* based on evidence common to the class, and therefore do not support certification; and (2) variation in some of the so-called "secondary" independent contractor factors renders each class member's contractor status an individual question. Several examples illustrate the point:

- Former named Plaintiff and current class member Glenda Compton, was a long-time contractor, delivering multiple routes. Statement of Facts ("SOF") ¶¶ 2-3.[1] During the class period, she and her helpers threw both *The Bee* and two competing publishers' newspapers. SOF ¶¶ 2-3. Compton knew that she was an independent contractor and saw many advantages to her contractor status. SOF ¶¶ 1, 4-5. Compton was proactive and businesslike in her distribution operation, and contacted customers directly by written notes to resolve any service issues. SOF ¶¶ 1-5.

- Named Plaintiff Bill Trahin has delivered *The Bee* on two routes since the 1990's. SOF ¶ 6. While Trahin recognized his independent contractor status based on his agreement, he claimed to have had additional "obligations" to The Bee that were not included in his contract, such as attending meetings. *Id.* Trahin selected his routes for convenience rather than profit potential. SOF ¶ 7. He made no effort to maximize efficiency in his delivery sequences. SOF ¶¶ 9-11. He recognized that he would be charged for subscriber complaints, if any, but he decided that avoiding a complaint charge was not worth redelivering a missed newspaper. SOF ¶¶ 8-9.

- Named Plaintiff Robert Langford delivered *The Bee* for approximately four months from September 2006 to January 2007. SOF ¶ 13. He used helpers and substitutes to assist him in delivering his two routes over this short period of time. SOF ¶¶ 15-16. Langford used multiple vehicles, never drove because he did not have a license, and took almost every Tuesday off. *Id.* Langford recognized that he was an independent contractor and, like Compton, understood the benefits of direct contact with subscribers to maintain and enhance the profitability of his routes. SOF ¶¶ 14, 17-8.

The Bee contends that each of these individuals was correctly classified as an independent contractor. The fact is, however, that The Bee's position is probably more compelling as to some contractors as compared to others. This is because evaluating contractor status under California law involves consideration of numerous factors. "These factors 'cannot be applied mechanically as separate tests; they are intertwined and their weight depends often on particular combinations.'" *Sotelo v. MediaNews Group, Inc.*, 207 Cal. App. 4th 639, 657 (2012) (petition for review denied Sept.19, 2012) (quoting *S.G. Borello & Sons v. Dep't of Indus. Relations*, 48 Cal. 3d 341, 351 (1989)). As a result, a finding of contractor status as to Compton and Langford—with their multiple delivery clients and/or regular helpers—would not *necessarily* apply to Trahin, who differs in these "secondary" attributes. As a further result, it would be fundamentally unfair to The Bee (and would deny The Bee due process) to try this case as if every contractor looked like Trahin. By the same token, to pretend that all of the contractors

[1] Given the fact-intensive issues raised in the motion to decertify, for ease of reference, Defendants have set forth the factual and evidentiary support for the motion in a Separate Statement of Facts, filed herewith.

looked like Langford and Compton would be unfair to Trahin. A class this varied on the critical facts governing the determination of contractor status cannot stand.

The complex individualized determinations implicated by Plaintiffs' Fourth Cause of Action for unreimbursed business expenses (the "reimbursement claim") also independently support decertification. The expenses sought pursuant to this claim are limited to "automobile expenses," to which Plaintiffs sometimes refer as "mileage expenses." Exhaustive post-certification discovery confirms that, contrary to Plaintiffs' representations in their certification briefing, the records maintained by The Bee do not come close to tracking "mileage." Moreover, the employer need not reimburse employee expenses by multiplying "mileage" by a reimbursement rate; the employer can choose to reimburse for actual expenses, which in this case would require highly individualized inquiries for any contractor deemed to have been an "employee." Plaintiffs have not offered the Court any plan for overcoming these problems.

Since certification, it has become clearer that common questions do not predominate. Plaintiffs have proposed no trial plan or other methods for managing this case. Plaintiffs have never shown that a class action is superior to individual actions. In 2011, the Court denied certification as to most of Plaintiffs' claims and came close to denying certification on all of the claims. It is appropriate now to decertify the remaining limited class.

II. PROCEDURAL HISTORY AND NEW DEVELOPMENTS

A. Prior Class Certification Proceedings

Plaintiffs are individuals who contracted to provide newspaper delivery services pursuant to independent contractor agreements with The Bee. Plaintiffs assert that they were not bona fide independent contractors and that The Bee did not comply with various sections of the Labor Code that would have applied if Plaintiffs had been employees. Plaintiffs also assert a derivative unfair competition claim under Business and Professions Code Section 17200.

In the Minute Order, affirming its earlier tentative ruling, the Court denied class certification as to most of Plaintiffs' substantive claims and denied certification of a class that included so-called "Large Distributors" and those who contract with them. For purposes of three causes of action, however—the Fourth ("Reimbursement of Business Expenses"), Eighth

("Accurate Payroll Records"), and Ninth (§ 17200) Causes of Action—the Court certified a class of individuals who contracted directly with The Bee in California beginning in February 2005 and ending on June 30, 2009. Minute Order (Ex. 12 to Howard Decl.); Tentative Ruling (Ex. 13 to Howard Decl.) ("TR") at 1. Regarding the threshold misclassification question, the Court concluded that common legal and factual issues predominated, but it found the question a "close" one. TR at 7.

B. Significant New Legal Authority Has Developed

Since the parties briefed their cross-motions on class certification, the United States Supreme Court, the California Supreme Court and the California Court of Appeal have clarified the law of class certification, both generally and as it applies specifically to independent contractor newspaper delivery cases.

First, shortly after the close of the certification briefing in this case, the United States Supreme Court decided *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541 (2011). *Dukes* held that a plaintiff seeking class certification must demonstrate the capacity of common proof to resolve liability as to the entire class. *Id.* at 2556-57. As a result, unless the questions in this case can be *answered* based on evidence common to the proposed class, broad common questions like "were carriers misclassified as contractors?" do not support class certification. *Id.* at 2551. Since this Court issued its certification order, several courts in California and elsewhere have applied this principle and denied or revoked class certification in cases where the plaintiffs claimed that the defendants misclassified workers and thus violated the Labor Code.[2]

[2] *See, e.g., Guzman v. DIRECTV, Inc.*, Case No. BC410983 (L.A. Cnty. Super. Ct. Dec. 13, 2012) (denying class certification finding that DIRECTV was entitled to test each Technician's claim as to whether he or she was an "employee" of DIRECTV... and was reimbursed for reasonable expenses, rendering trial unmanageable under the *Wal-Mart* standard); *Narayan v. EGL. Inc.*, 285 F.R.D. 473, 478 (N.D. Cal. Sept. 7, 2012) ("For purposes of class certification, the issue is whether these [*Borello*] factors may be applied on a classwide basis, generating a classwide answer on the issue of employee status, or whether the determination requires too much individualized analysis."); *Wackenhut Wage and Hour Cases*, 2012 WL 3218518, at 5 (L.A. Cnty. Super. Ct. Aug. 1, 2012) (decertification granted because plaintiffs' claims did "not involve the kinds of common questions that can support class certification under *Wal-Mart*."); *Kaewsawang v. Sara Lee Fresh, Inc.*, 2012 WL 1548290 (Cal. App. 2d Dist. May 3, 2012) (no

In April 2012, the California Supreme Court decided *Brinker Restaurant Corp. v. Superior Court*, 53 Cal. 4th 1004 (2012). Like *Dukes*, *Brinker* held that class certification is inappropriate if the plaintiffs' claim implicates "neither a common policy nor a common method of proof" and liability is contingent, at least in part, on facts particular to individual claimants. *Id.* at 1051. Applying these principles, the Court affirmed certification of a rest period class based on the defendant's uniform, facially unlawful written rest period policy. *Id.* at 1032-34. The Court also affirmed the *denial* of certification of an "off-the-clock" class because, in the absence of a similarly uniform and unlawful written policy, "proof of off-the-clock liability would have had to continue in an employee-by-employee fashion, demonstrating who worked off the clock, how long they worked, and whether [defendant] knew or should have known of their work." *Id.* at 1052.

In May 2012, the Court of Appeal decided *Sotelo*, and affirmed denial of certification of a class of newspaper distributors and carriers who claimed, as Plaintiffs do here, that they were misclassified as independent contractors and that Labor Code violations followed from that misclassification. Most importantly for the present motion, the *Sotelo* court held that, because

---

commonality because individuals who had multiple routes and hired employees/helpers are different from individuals who operated their own route - it would be necessary to examine the factual circumstances of each individual to determine whether he/she is an employee entitled to protections under the Labor Code any subsequent issues concerning damage); *Aburto v. Verizon Cal., Inc.*, No. CV 11-03683-ODW (VBKx), 2012 WL 10381, at *5 (C.D. Cal. Jan 3, 2012) (certification denied: whether all class members were "improperly classified as exempt will depend on answers unique to each potential plaintiff"); *Velazquez v. Costco Wholesale Corp.*, No. SACV 11-00508-JVS (RNBx), 2011 WL 4891027, at *5, *8 (C.D. Cal. Oct 11, 2011) (certification denied despite common proof regarding workers' generic duties; no common proof of how class members actually spent their working time); *Gales v. WinCo Foods*, No. C 09-05813 CRB, 2011 WL 3794887, at *6-10 (N.D. Cal. Aug 26, 2011) (same); *Cruz v. Dollar Tree Stores, Inc.*, Nos. 07-2050 SC, 07-4012 SC, 2011 WL 2682967, at *5, *7-8 (N.D. Cal. July 8, 2011) (decertification granted: plaintiffs' failure to demonstrate "reliable means of extrapolating from the testimony of a few exemplar class members to the class as a whole" was "fatal to continued certification"); *see also, e.g., Bedoya v. Aventura Limousine & Transp. Serv., Inc.*, No. 11-24432-CIV, 2012 WL 1933553, at *5 (S.D. Fla. Apr. 10, 2012) (denying class certification where issue was alleged misclassification of employees as independent contractors); *Scott v. NOW Courier, Inc.*, No. 1:10-CV-971-SEB-TAB, 2012 WL 1072751 (S.D. Ind. Mar. 29, 2012) (same).

each factor in the independent contractor test is relevant to the overall classification inquiry, "[e]ven if the factor is not dispositive, it is a factor which might be litigated, requiring individual testimony at trial." 207 Cal. App. 4th at 658. Thus, variability as to several of the "secondary factors" rendered individual issues predominant, precluding class certification. *Id.* at 657-60. The secondary factors that the *Sotelo* trial court identified as requiring individualized proof are the same factors that this Court has found will require individualized proof in this case—and this Court also found additional variation. TR at 8.

C. Over a Year After Certification, No Plan Has Emerged for Establishing Liability, or Damages, Through Common Proof

A year after this Court certified three supposedly discrete and manageable claims (one of which is derivative of the others), the parties remain mired in discovery. Since certification, Plaintiffs have served 27 Special Interrogatories (for a total of 101), 44 Requests for Production of Documents ("RFP") (for a total of 325), and five Form Interrogatories—a total of 76 requests since certification and 431 during the entirety of the action. SOF ¶ 78. The Bee has produced more than 3.4 million pages of documents. SOF ¶ 80. Plaintiffs, however, have continued to propound ever more (and ever more questionable) discovery. For example, inconsistent with their position that all class members are materially indistinguishable, Plaintiffs continue to seek individualized discovery about each and every class member, including filing a motion to compel production of such documents and responses to interrogatories. SOF ¶¶ 79, 82.

Far from illuminating the issues or posturing the case for trial, Plaintiffs' post-certification discovery has actually demonstrated the lack of common proof regarding the expense reimbursement claims. The Bee has long noted the absence of common proof regarding whether and to what extent class members incurred "reasonable and necessary" expenses relating to driving while delivering newspapers. Dfts' Opp. to Class Cert. Mot. at 34-36; *see* SOF ¶¶ 70, 78-82. Plaintiffs have insisted that "The Bee did keep track of the mileage for delivery areas." Pltfs' Reply ISO Mot. for Class Cert. at 22 (emphasis in original). Yet Plaintiffs have so far been unable to make any use of the information that The Bee has—bid sheets (containing hearsay mileage information for a small portion of the delivery routes in 2006), the so-called

Carrier Rate Guide (an electronic data base that contains old and unreliable hearsay "mileage" figures for some delivery routes), and a database containing the address and delivery information of every subscriber on every delivery route during the class period. SOF ¶¶ 78, 81, 82. None of this information establishes that any contractor drove any route in any particular order on any given day solely to deliver *The Sacramento Bee* during the class period (or ever).

III. ARGUMENT

Courts have great discretion to grant motions for decertification. Cal. R. Ct. 3.767(b). In considering decertification, the court applies the same standards that govern a motion to certify a class in the first instance. *Walsh v. IKON Office Solutions, Inc.*, 148 Cal. App. 4th 1440, 1451 (2007) ("The 'proper legal criterion' for deciding whether to certify or decertify a class is simply whether the class meets the requirements for class certification."); *Keller v. Tuesday Morning, Inc.*, 179 Cal. App. 4th 1389, 1396-97 (2009). Those standards have been extensively briefed in this case and are summarized in the Court's tentative ruling. TR at 5. "Changed circumstances" are not required for decertification, but, if they were, post-certification legal and factual developments would more than satisfy the requirement.

A. New Legal Authority Establishes the Predominance of Individual Issues in the Multi-factor Balancing Test Used to Distinguish Contractors from Employees

1. The Independent Contractor Test is Unique to Each Individual

Plaintiffs cannot prove that their underlying claims are amenable to class treatment without first demonstrating that they can resolve through common proof the threshold question of whether newspaper contractors are employees or independent contractors. TR at 5-6; *accord Sotelo*, 207 Cal. App. 4th at 656-57. Distinguishing independent contractors from employees requires the application of a multi-factor balancing test. *See id.* The analysis "is fact specific and qualitative rather than quantitative . . ." *State Comp. Ins. Fund v. Brown*, 32 Cal. App. 4th 188, 202 (1995). Courts consider the putative employer's "right to control" the manner and means of accomplishing the desired result, along with as many as fourteen "secondary" factors designed to explore the nature of the parties' business relationship. *Sotelo*, 207 Cal. App. 4th at 656-57.; *see also* TR at 6 (listing secondary factors). "These factors 'cannot be applied

mechanically as separate tests; they are intertwined and their weight depends often on particular combinations.'" *Sotelo*, 207 Cal. App. 4th at 657 (quoting *S.G. Borello & Sons*, 48 Cal. 3d at 351). No single factor is dispositive—including the right to control. *Id.* at 656-57. Formal agreements and any policies are relevant, but the parties' actual practices trump formalities. *See, e.g., Ali v. U.S.A. Cab Ltd.*, 176 Cal. App. 4th 1333, 1349-50 (2009). Because the test depends on a qualitative assessment and weighing of interlocking factors, *all* of the relevant factors must be considered *jointly* to determine whether a given person is an independent contractor. *Sotelo*, 207 Cal. App. 4th at 660 (affirming trial court: "the multi-factor test 'requires that the factors be examined together'").[3]

2. Variations Regarding Secondary Factors Mean That Individual Issues Predominate in the Contractor Analysis in This Case

Examining the evidence pertinent to the employee-contractor analysis, this Court noted that "there are distinctions among members of [the] direct-contract class of carriers" and "variability" in attributes relevant to the misclassification question. TR at 8. This Court expressly found variability as to the following secondary factors:

- The contractor's degree of investment and whether he or she holds himself out as an independent business: "Some carriers may have operated their delivery services as a business . . . whereas other carriers performed their deliveries solo." TR at 8; *see also* SOF ¶¶ 2, 54 (some contractors simultaneously provided services to The Bee's competitors; others did not); SOF ¶ 71 (some contractors purchased vehicles specifically to perform delivery services; others used their personal vehicles); SOF ¶¶ 48-49 (contractors determined how to package their papers, weighing costs of supplies against the risk of subscriber complaints); *id.* (some contractors purchase rubber bands and bags from the most convenient source; others conduct research to find the cheapest option); SOF ¶¶ 72-75, 76 (some contractors give business cards to

[3] A recent decision of the Second Appellate District vacated in part and remanded a trial court's denial of class certification based on the appellate court's view that all of the secondary factors reduce to the question of whether the generic job at issue "involves the kind of work that may be done by an independent contractor or generally is done by an employee." *Ayala v. Antelope Valley Newspapers, Inc.*, 210 Cal. App. 4th 77, 92 (2012) (petition for review pending before California Supreme Court). This view of the secondary factors is unworkable in practice, is not supported by any authority, and ignores *Sotelo* and decades of authority recognizing that "type of work" performed is just one of many secondary factors, not the focus of the entire secondary factor inquiry. *See, e.g., S. G. Borello*, 48 Cal.3d at 354 ("Each service arrangement must be evaluated on its facts, and the dispositive circumstances may vary from case to case."). Simply put, the *Ayala* decision is wrong, and the Court should follow the proper analysis as explicated in *Sotelo*. *See McCallum v. McCallum*, 190 Cal. App. 3d 308, 315 n.4 (1987) (when faced with a conflict in published authority, the Court must follow the most persuasive precedent).

their subscribers or otherwise attempt to build a direct relationship with subscribers; others do not), SOF ¶¶ 65, 67, 69 (some contractors deduct business expenses for tax purposes; others do not).

- The contractor's use of helpers, employees, or replacements: "Some carriers . . . subcontracted with one or more others, whereas other carriers performed their deliveries solo." TR at 8; *see also* SOF ¶¶ 34-41 (some contractors used helpers and substitutes; some rarely delivered their papers themselves; others did not use helpers or substitutes).

- The contractor's opportunity for profit and loss depending upon managerial skill: The Court noted that "[t]he degree of business acumen and sophistication in contract negotiations varied among carriers." TR at 8. For example, some contractors take initiative to maximize their profits by negotiating contract terms, engaging in direct customer relations, and developing the most efficient means of delivering their routes; others do not. SOF ¶¶ 42-47, 51, 65, 67, 69, 76. Some contractors maximize their profits by simultaneously delivering other publications; others do not. TR at 8; *see also* SOF ¶¶ 54-55.

- The duration of the relationship: "[M]any contractors served as carriers for mo[n]ths or years, whereas other may have served for shorter periods." TR at 8; *see also* SOF ¶ 61.

- Whether the parties believe they are creating an employer-employee relationship: "Some carriers likely have considered themselves independent contractors, while others have had a different understanding, both about application of that label to them and the label's significance." TR at 8; *see also* SOF ¶ 59.

The record also demonstrates variability as to at least one other secondary factor that the Court did not address in its certification order: whether the principal or the worker supplies the tools, equipment and place of work.[4]

Four of these same secondary factors were found to vary in *Sotelo*.[5] The Court of Appeal found such variation to be more than enough to deny class certification because, as explained above, all of the factors must be considered *together* when evaluating an alleged contractor's proper classification. As a result, even when there is common evidence as to some factors,

[4] Some contractors provided their own equipment and supplies (such as rubber bands and bags), others did not. SOF ¶¶ 24, 28, 48-49, 65, 67. Some contractors picked up and assembled their papers at a distribution center. SOF ¶ 50. Others picked up their papers on the street and assembled them in their own vehicles. *Id.; see also* ¶¶ 27, 31.

[5] *Sotelo*, 207 Cal. App. 4th at 657-58 (discussing variability as to the following factors: "(1) whether the one performing services is engaged in a distinct occupation or business; (2) the method of payment; (3) whether or not the parties believe they are creating an employer-employee relationship; (4) the hiree's opportunity for profit or loss depending on his or her managerial skill").

variations between class members with respect to other factors can result in different outcomes as to different individuals, meaning that individualized testimony is required to analyze contractor status. *Sotelo*, 207 Cal. App. 4th at 659-60.

Glenda Compton, Bill Trahin and Robert Langford, who were introduced above, illustrate the point. Presumably all of the common evidence discussed in the tentative ruling (pp. 6-7) applies equally to these individuals. Because they vary in secondary dimensions, however, they do not look the same when viewed through the lens of the multi-factor balancing test. A trier of fact would not necessarily *have* to reach the same conclusion as to all three individuals, and could not reach *any* conclusion about any of them without examining evidence specific to each of them. That is the antithesis of a proper class. *Brinker*, 53 Cal. 4th at 1052 (class should not require proof "in an employee-by-employee fashion"). The class in this case should be decertified.

3. The Supposed Common Questions and Evidence on Which Plaintiffs Rely Are Not Common or Not Predominant or Both

As Compton, Trahin and Langford illustrate, because the secondary factors can be dispositive of a service provider's status, the independent contractor analysis in this case is predominantly an individual one, even though common evidence exists as to some of the independent contractor factors. That general principle renders this class inappropriate. But *Sotelo* also rejects some of the specific predominance arguments that Plaintiffs have made in this case.

Plaintiffs have argued, for example, that "a defendant cannot validly claim that all of its workers are categorically independent contractors, and at the same time claim that individual issues predominate in determining if that categorical classification is proper." Pltf's Reply ISO Mot. for Cert. at 14; *see also* TR at 8 (referring to the fact that "Defendants treated all direct-contract carriers as independent contractors"). Many courts, however, have recently held that "a policy of classifying a particular group of workers" in the same way is insufficient to establish commonality as to misclassification where "'the policy may have accurately classified some employees and misclassified others.'" *Novak v. Boeing Co.*, No. SACV09–01011–CJC(ANx),

2011 WL 7627789, at *5 (C.D. Cal. Dec. 19, 2011) (quoting *Marlo v. United Parcel Serv., Inc.*, 639 F.3d 942, 948 (9th Cir. 2011) (granting motion to deny class certification because plaintiffs' mere showing that employees all had same job title and were all classified as exempt did not show that "exemption, the central issue in the case, may be resolved with common proof")); *Sotelo*, 207 Cal. App. 4th at 655 (all class members had been classified as contractors; appellants had not alleged "uniform practices or policies, *beyond the issue of employee misclassification*, that would establish liability for overtime or rest/meal break violations") (emphasis added); *see also Kaewsawang*, 2012 WL 1548290 at *1 (denying certification where all drivers were classified as independent contractors).

Plaintiffs have also pointed to the independent contractor agreements that carriers signed as a form of "common proof." *See* Pltfs' MPA ISO Mot. for Cert. at 41-42; *see also* TR at 8 (referring to The Bee's "standardized contracts"). Although the terms of The Bee's contracts with individual contractors are not actually uniform, *see* SOF ¶¶ 57-58, the terms of an independent contractor agreement are indeed relevant to independent contractor status. But unless Plaintiffs are prepared to stipulate that the terms of the contracts reflect the reality of the relationship, the contracts do not provide common evidence that is "'apt to drive the resolution of the litigation,'" as *Dukes* requires. 131 S. Ct. at 2541, 2551 (citation omitted). In *Sotelo*, the court said that independent contractor status cannot be determined from a contract alone. *Sotelo*, 207 Cal App. 4th at 648-49 (even had the putative class included only carriers who signed contracts, variability as to secondary factors would defeat predominance). Moreover, Plaintiffs in this case seek not to rely on the contracts, but to ignore them. *See* Pltfs' MPA ISO Mot. for Cert. at 42 (dismissing contracts as mere "labels" to be disregarded based on evidence of parties' actual circumstances). In this sense, the contracts here which facially establish an independent contractor relationship, are comparable to the facially lawful "off the clock" policy at issue in *Brinker*. Here, as in *Brinker*, Plaintiffs' contention is that the written document does not reflect reality. Here, as in *Brinker*, that contention means that the written document is not common evidence supporting class certification. *Brinker*, 53 Cal. 4th at 1051-1052; *see also Morgan v. Wet Seal, Inc.*, 210 Cal. App. 4th 1341, 1364-65 (2012) (affirming denial of class certification

because the employer's policies were not facially unlawful, and because "anecdotal evidence regarding [the employer's] application of its [lawful policies] is not substantial evidence of a class-wide practice") (petition for review pending before California Supreme Court).

The other sources of common proof on which Plaintiffs based their certification argument (*see* TR at 6-7) are inadequate for the same basic reason, *i.e.*, taken together or separately, they do not dispose of any claim or question in the case. Most of them go to the control factor, which is important to but not dispositive of contractor status. (In *Sotelo*, the trial court found little variation regarding control; this was no obstacle to denial of certification. *Sotelo*, 207 Cal. App. 4th at 656-58.) Many of them are not disputed; as such, they weigh but lightly in the predominance analysis. *Id.* at 657 (trial court assessing predominance correctly considered "the degree to which the factor was likely to be an issue of actual controversy at trial").[6] In any event, here—as in *Sotelo*—"even if [some] factors were able to be determined on a class-wide basis, those factors would still need to be weighed individually, along with the factors for which individual testimony would be required." *Id.* at 668.

At bottom, therefore, Plaintiffs' commonality argument fails because, while the threshold employee-contractor issue can be phrased as a "common question"—were the contractors misclassified?—that question cannot be *answered* for each plaintiff based on evidence common to the class. After *Brinker*, *Dukes*, and *Sotelo*, a common question carries no weight in the predominance analysis if it lacks a common answer. Older cases like *Norris-Wilson v. Delta-T Group, Inc.*, 270 F.R.D. 596 (S.D. Cal. 2010), on which Plaintiffs rely for the proposition that independent contractor class actions allegedly are "routinely" certified (Pltfs' Reply ISO Mot. for Class Cert. at 14; *see also* TR at 8), must be viewed with caution. *Norris-Wilson*, for example, holds that, without more, the question whether workers were properly classified as

[6] Some, however, are disputed. For example, while The Bee's website asked subscribers to contact The Bee with complaints, some contractors personally addressed subscriber complaints. SOF ¶¶ 72-74. Some distribution centers used fliers; others did not. SOF ¶ 52. With regard to training, the record shows that while some contractors received training, others did not. TR at 8; *see also* SOF ¶¶ 20, 53, 59, 77. But these disputes only highlight the substantial degree to which individualized evidence will be presented at trial.

employees or contractors satisfies Rule 23(a)'s commonality requirement. *Id.* at 604. Not so after *Dukes*, 131 S. Ct. at 2551; *see also Novak*, 2011 WL 7627789 at *5-6. The class should be decertified because the individualized independent contractor analysis would overwhelm any allegedly common questions.[7]

B. Post-Certification Discovery Shows That Individual Issues Will Predominate on Plaintiffs' Reimbursement ("Mileage") Claim

Post-certification developments demonstrate that individual issues predominate with regard to Plaintiffs' Fourth Cause of Action and independently support decertification (even in the absence of the new legal authority discussed above).

As already noted, extensive post-certification discovery has established that Plaintiffs were wrong in predicting that they could prove their reimbursement claims (at least as to distance driven) based on "mileage" records maintained by The Bee. The alleged common records do not exist. Plaintiffs have the addresses of every subscriber on every route during the class period. SOF ¶ 79. From the address information, Plaintiffs apparently intend to generate theoretical distances for individual routes based on assumptions about who did each route and the location from which the delivery person (who might well *not* be a class member) started the route. *See* Ex. 11 to Howard Decl. at 2 and Pltfs' MPA ISO Mot. for Cert. at 44. Plaintiffs then intend to multiply these "mileage" figures by the IRS rate for business tax deductions. Ex. 11 to Howard Decl. at 3. There are, however, significant factual and legal flaws in Plaintiffs' proposed methodology.

First, just as proof of employee status does not prove liability for overtime, meal periods, etc., associating a "mileage" figure with a particular delivery area does not establish liability to the individual who contracted with The Bee for that delivery area. Some contractors did not

[7] "Failure to keep records" is a viable claim only where common evidence proves that every individual in the class was an employee. *Sotelo*, 207 Cal. App. 4th at 650 ("any obligation . . . to track all members . . . depends upon the merits of the suit being brought."). The reimbursement claim regarding "mileage" depends upon the same threshold determination, *i.e.* contractor status of each class member, but is also not certifiable for additional reasons discussed below. The "unfair business practices" claim is derivative of the other claims. Decertification is proper as to each certified claim because each of them depends upon an individualized determination of employee versus independent contractor status.

incur any automobile expenses on a delivery route because they engaged substitutes to perform the delivery services. *See* SOF ¶¶ 16, 36, 37, 39, 42, 71. Some contractors shared a vehicle on delivery routes. SOF ¶¶ 34-41, 42. Accordingly, demonstrating that a contractor actually incurred an expense is an individualized inquiry.

Second, Labor Code § 2802 imposes liability only for failing to reimburse business expenses that were "reasonably and necessarily incurred." *Gattuso v. Harte-Hanks Shoppers, Inc.*, 42 Cal. 4th 554, 576 (2007). Whether a business expense is "necessary" is a question of fact, *Takacs v. A.G. Edwards and Sons. Inc.*, 444 F. Supp. 2d 1100, 1125 (S.D. Cal. 2006), which turns on the "reasonableness of the employee's choices," *Gattuso*, 42 Cal. 4th at 568, an analysis requiring close scrutiny of the specific facts surrounding the employee's expenses:

> For example, an employee's choice of automobile will significantly affect the costs incurred. An employee who chooses an expensive model and replaces it frequently will incur substantially greater depreciation costs than an employee who chooses a lower priced model and replaces it less frequently. Similarly, some vehicles use substantially more fuel or require more frequent or more costly maintenance and repairs than others. The choice of vehicle will also affect insurance costs. Other employee choices, such as the brand and grade of gasoline or tires and the shop performing maintenance and repairs, will also affect the actual costs. Thus, calculation of automobile expense reimbursement using the actual expenses method requires . . . detailed record keeping by the employee and complex allocation calculations, [and] also the exercise of judgment (by the employer, the employee, and officials charged with enforcement of section 2802) to determine whether the expenses incurred were reasonable and therefore necessary.

Id.

Here, some contractors devised maximally efficient routes, while others did not. SOF ¶ 51. Contractors who personally performed delivery used a wide variety of vehicles to deliver papers in a wide variety of ways, and differed in how, if at all, they tracked vehicle expenses. SOF ¶ 71. None of the data that The Bee can provide to Plaintiffs addresses how to calculate alleged expenses using the actual damage or increased compensation methods[8] or how to address

[8] The Bee negotiated multiple piece rates and buy sell rates with contractors. SOF ¶¶ 62-63. And, some contractors knew that their piece rate would cover their expenses. SOF ¶ 66. These are all relevant individualized inquiries using the increased compensation method.

individualized issues related to calculations such as "information about the automobile's purchase price and resale value (or lease costs)," what days, if ever, the class member used the automobile for the delivery of newspapers, and the costs associated with "fuel, maintenance, repairs, insurance, registration and depreciation." *Gattuso*, 42 Cal. 4th at 568.

Determining whether a particular expense such as mileage was in fact incurred, and was reasonable and necessary on occasions when it was incurred, thus presents a complicated, highly individualized liability question. Moreover, some contractors took business expense deductions on their taxes and others have not. SOF ¶¶ 65, 67, 69. Untangling or undoing expense deductions adds yet another layer of individual complexity to the damages and liability analyses.

In denying certification regarding most of Plaintiffs' causes of action, the Court recognized that the need for individualized proof of liability generally precludes class certification. *See* TR at 8-9. *Dukes* puts an even sharper point on the Court's observation, establishing that The Bee is entitled to litigate whether a given class member incurred an expense and, if so, whether it was reasonable and necessary. *Dukes*, 131 S. Ct. at 2561 ("[A] class cannot be certified on the premise that [Defendants] will not be entitled to litigate [their] statutory defenses to individual claims."). *Brinker* re-confirms that class certification is inappropriate where a parade of witnesses and individualized proof would be required to try a case. 53 Cal. 4th at 1052. Courts in California have repeatedly recognized the difficulties inherent in trying expense reimbursement claims as class actions.[9]

[9] *See, e.g., Chavez v. Lumber Liquidators, Inc.*, No. CV-09-4812 SC, 2012 WL 1004850, at *10 (N.D. Cal. Mar. 26, 2012) (denying certification of reimbursement claim where the court "would need to make individualized factual determinations concerning: (1) whether the claimed expenses were 'necessary' and incurred in direct consequence of the discharge of the employee's duties; (2) whether the employee actually sought reimbursement from [the employer] for the expenses; and (3) whether [the employer] reimbursed the employee for the expense"); *Harris v. Vector Mktg. Corp.*, 753 F. Supp. 2d 996, 1022 (N.D. Cal. 2010) (denying certification of reimbursement class where the record reflected variety as to (1) whether expenses were incurred; (2) the necessity of some expenses was "likely to be challenged" at trial; and (3) the plaintiff had "not demonstrated that evaluation under § 2802 of the 'necessity' of various expenses incurred in a variety of contexts may be done on a relatively uniform basis"); *Ruiz v. Affinity Logistics Corp.*, No. 05CV2125JLS, 2009 WL 648973, at *7-8 (quoting *Grissom v. Vons Cos., Inc.*, 1 Cal. App. 4th 52, 58 (1991) ("Whether expenditures were 'necessary' is a fact-intensive 'inquiry into what was reasonable under the circumstances'" and thus require a "case-by-case analysis" that renders individual issues predominate.).

Apart from the liability issues, the reimbursement claim presents complex individual issues relating to the measure of damages. For example, Plaintiffs assume that they can start their "mileage" calculation from a Distribution Center, but not all contractors picked up newspapers from a Distribution Center. SOF ¶ 50. Some contractors had multiple routes and thus picked up papers for multiple routes at a time; where a contractor made only one Distribution Center pickup for multiple routes, tacking on "distribution center mileage" to *each* of their routes would overcompensate them. SOF ¶¶ 2, 6, 13, 25, 26, 30, 43, 44, 50. Further, some contractors delivered other companies' products, such that their fuel costs would have to be apportioned between the contractors' various customers. TR at 8; *see also* SOF ¶¶ 54-55.

Plaintiffs have characterized these as mere damages calculations that do not bar class certification. They are, at a minimum, mixed liability and damages issues. Regardless, a court considering whether a class action would be fair and efficient can hardly be expected to completely ignore difficult individualized issues simply because they can be labeled "damages" issues. Thus, although individualized damages calculations do not bar class certification as a "general rule," *Brinker*, 53 Cal. 4th at 1022, they are at least a relevant consideration. In addition to the many cases in which class certification has been denied for insufficient commonality as to the *fact* of damage,[10] certification can also be denied based (at least in part) on the necessity for extensive individual proceedings regarding the *extent* of damages.[11]

[10] *See e.g., Caro v. Procter & Gamble Co.*, 18 Cal. App. 4th 664, at 645 (1993) (differences in the actual existence of damages or in the manner of incurring damages are appropriate considerations for denying class certification); *Ali*, 176 Cal. App. 4th at 1349-50; *Frieman v. San Rafael Rock Quarry, Inc.*, 116 Cal. App. 4th 29, 40 (2004) (when variations in proof of harm require individualized evidence, the requisite community of interest is missing).

[11] *See e.g., Evans v. Lasco Bathware, Inc.*, 178 Cal. App. 4th 1417, 1428 (2009) (class treatment inappropriate because ascertaining damages "[was] not amenable to estimation" due to a number of factors); *Wilens v. TD Waterhouse Group, Inc.*, 120 Cal. App. 4th 746, 755-56 (2003) (denial of class certification affirmed because individual damages would predominate over common issue of unconscionability); *Gawry v. Countrywide Home Loans, Inc.*, 640 F. Supp. 2d 942, 958 (N.D. Ohio 2009) (class certification not warranted where proposal to calculate individual damages is clearly inadequate or requires significant inquiry to determine necessary variables); *Bell Atlantic Corp. v. AT&T Corp.*, 339 F.3d 294, 306-07 (5th Cir. 2003) (class certification denied because estimation of actual damages suffered would require consideration of variegated nature of the businesses included in the proposed classes); *Windham v. Am. Brands, Inc.*, 565 F.2d 59, 68 (4th Cir. 1977) (class treatment inappropriate where damages does not lend itself to mechanical calculations).

Plaintiffs have also suggested that they can simply calculate damages using the IRS tax deduction rate for business mileage. California law, however, allows employers to select in the first instance one of three different methods for calculating automobile-related reimbursements—the "actual expense method," the IRS "mileage reimbursement method," or a base salary or commission rate sufficient to compensate the employee for incurred expenses. *Gattuso*, 42 Cal. 4th at 568-73 (discussing various methods employer may use to meet its reimbursement obligation). The Bee cannot be forced to use the IRS mileage rate, which is "inherently less accurate" than the actual expense method. *Id.* at 569.

In short, even if the threshold classification question did not bar certification, the reimbursement claim could not be tried on a class basis. Plaintiffs must prove, individual by individual, that a contractor actually and necessarily incurred a given expense and the extent of the expense. Individual issues predominate with respect to the Fourth Cause of Action.

C. This Case is Unmanageable as a Class Action

The Court should also decertify the class for the independent reason that this case cannot manageably be tried to resolution as a class action. Plaintiffs have the burden of demonstrating manageability. *Washington Mutual Bank, FA v. Super. Ct.*, 24 Cal. 4th 906, 922-23 (2001). A trial court cannot accept "on faith" a party's assertion that a complex case can be managed as a class action; "rather, the party seeking certification must affirmatively demonstrate the accuracy of the assertion." *Id.* at 924; *see also Dunbar v. Albertson's, Inc.*, 141 Cal. App. 4th 1422, 1432 (2006) (holding that the plaintiffs fail to meet their burden of showing manageability unless they explain how their proposed trial procedure "will effectively manage the issues in question"); *Sotelo*, 207 Cal. App. 4th at 647 (plaintiffs bear the burden of supporting each class certification factor "with a factual showing"); *see also Morgan*, 210 Cal. App. 4th at 1369 (affirming denial of class certification and noting that "[i]n the present case, appellants do not explain how their list of procedural tools can be used to effectively manage a class action in *this* case.") (emphasis added).

Here, while not extensively addressing manageability, the Court's tentative ruling concluded that variability in the contractor population could likely "be managed with subclasses

and, if necessary, refinements of the class definition." TR at 8. The Bee respectfully submits that subsequent case law developments demonstrate that this is not the case here. In *Dukes*, the Supreme Court emphasized that manageability problems in class actions have due process implications because a defendant has a due process right to present its defenses to individual claims. 131 S. Ct. at 2561. As a result, "a class cannot be certified on the premise that [Defendants] will not be entitled to litigate [their] statutory defenses to individual claims." *Id.* Nor can individual issues of liability (and damages) be managed through a "trial by formula" in which the jury is asked to extrapolate liability and damages across the entire class. *Id.*; *see also Martinez v. Joe's Crab Shack, Inc.*, No. BC377269, at 11-12 (L.A. Cnty. Super. Ct. May 23, 2012) (rejecting use of sampling to determine liability because "defendants' due process rights require that there be a class member by class member determination of their affirmative defense of exemption"); *see also Dunbar*, 141 Cal. App. 4th at 1430.

As discussed above, on the substantive reimbursement claim the centralized proof that Plaintiffs predicted has not materialized because it does not exist, and on the contractor-employee issue individualized inquiries will be required for each contractor before the merits of any claim could even be reached. Plaintiffs have proposed no mechanism for managing these difficulties, and none is apparent.

"Subclassing" is not the answer. *Sotelo* (which approves of subclassing in cases where it makes sense) shows why. The multifactor independent contractor test is qualitative and requires that all factors must be weighed *together* for each individual. *Sotelo*, 207 Cal. App. 4th at 660. The contractors in this case do not fall into neat categories—they present different and unique combinations of facts germane to the right to control and secondary factors. It is not possible to manage individual issues by certifying subclasses aligning with the presence or absence of particular secondary factors because there are no categorical distinctions to be had among the contractors. *Cf. Evans v. Lasco Bathware, Inc.*, 178 Cal. App. 4th 1417, 1434 (2009) (affirming trial court's rejection of subclassing proposal where subclasses "would merely resurrect all of the individualized issues"); *City of San Jose v. Super. Ct.*, 12 Cal. 3d 447, 463 n.10 (1974) ("[T]here are limits outside of which the subclassification system ceases to perform a sufficiently useful

function to justify the maintenance of the class action."). In any event, one could not ascertain which class member fell within which subclass without first conducting individualized inquiries—which would defeat the whole point of the exercise. Plaintiffs have not carried their burden of demonstrating that this case can be managed as a class action.

D. A Class Action Is Not Superior

Plaintiffs also have the burden of proving that litigating their claims as a class action would be a superior method of resolving the dispute, for both the litigants and the Court. Failure to establish superiority justifies denial of certification even if common questions predominate. *Basurco v. 21st Century Ins. Co.* 108 Cal. App. 4th 110, 120 (2003). In *Sotelo*, for example, the court concluded:

> [G]iven the nature of the multi-factor test for the employment relationship, which requires that the factors be examined together, even if certain issues were tried jointly as to a class or subclasses, the remaining individualized issues would have to be determined and then weighed along with the already-determined common issues in order to resolve whether each class member was an employee or independent contractor. It does not appear that trying common issues first would result in any appreciable savings of the court's or the litigants' time.

Sotelo, 207 Cal. App. 4th at 658 (quoting trial court order).

At least two of the superiority factors that this Court identified in its certification decision (TR at 10-11) look very different in light of the post-certification developments discussed above: (1) the difficulties likely to be encountered in managing a class action; and (2) the desirability of consolidating all claims in a single action before a single court. As already discussed, if this case continued as a class action there would be insurmountable problems with trying the case fairly and consistent with due process. And, as in *Sotelo*, there would be no appreciable benefit to trying the supposed "common issues" first before hearing individualized testimony as to each contractor regarding his or her employee/independent contractor status and, if necessary, liability on the underlying claims. To the contrary, trying these individualized claims collectively would amount to nothing more than superimposing a complex and unnecessary layer of management and coordination on claims that could be resolved more quickly, cheaply and fairly in individual

actions or proceedings before the Labor Commissioner. A class action is not the superior means of resolving this dispute.

IV. CONCLUSION

As Plaintiffs have not demonstrated and cannot demonstrate that this case can be tried as a class action with evidence that is common to each class member and that generates common answers regarding independent contractor status, liability or damages, the Court should decertify, dismiss the class members' claims without prejudice and allow the class members sixty days from the date of the Court's decision to file an individual action should they choose to do so.

DATED: January 7, 2013

PERKINS COIE LLP

By: _____
Sue J. Stott
Lauren T. Howard

Attorneys for Defendants THE McCLATCHY COMPANY, and McCLATCHY NEWSPAPERS, INC. d/b/a The Sacramento Bee

78388-0001/LEGAL25499599.3

Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs

February 2000

Planmatics, Inc.
15200 Shady Grove Road, Suite 450
Rockville, MD 20850

For

U.S. Department of Labor
Employment and Training Administration
200 Constitution Ave., NW
Room S-4231
Washington, DC 20210

ABSTRACT

This report presents the results of a study on independent contractors (ICs) conducted in 1998-99. It begins with a description of ICs in the alternative workforce and definitions and tests used by federal and state agencies to classify them. Next, the motivations of employers to use ICs, the motivations of workers to become ICs, and selected industries where they predominate are described. Profiles of employees misclassified as independent contractors are described, and the results of an attempt to determine the extent of misclassification of employees as ICs and its effects on Unemployment Insurance (UI) trust funds are presented. Then the efforts of state administrators in dealing with ICs and other significant workforce issues related to ICs are described. Finally, the report presents the findings and recommendations of the study.

Preface

Planmatics is pleased to offer this final report titled "Study of Alternative Work Arrangements: Independent Contractors." The project was funded under Department of Labor Contract No: K6878-8-00-80-30. The authors are Dr. Lalith de Silva, Mr. Adrian W. Millett, Mr. Dominic M. Rotondi, and Mr. William F. Sullivan. Ms. Elizabeth Fischer and Mr. Mark Sillings also contributed. The Department of Labor project officer for the study was Mr. Wayne Gordon.

Acknowledgements

A large number of people participated in the study over the past one and a half years and contributed to the results. At the U.S. Department of Labor, Mr. Wayne Gordon, the Project Officer directed the study and was constantly available to assist and encourage us. Dr. Esther Johnson, Dr. John Heinberg, Mr. Everette Hensley and Ms. Cindy Ambler provided assistance in designing and implementing the study, provided data, and offered useful comments and suggestions throughout the project.

We wish to express our appreciation to the following individuals, who provided invaluable information and assistance, both during and after our visits to the various states.

In California, cooperation was provided by Mr. Richard Curry, Ms. Kit Sun, Ms. Fran Yokota, Mr. James Legler, Mr. Bob Shute, Ms. Julie Gallagher, Mr. Timothy Dransart, Mr. Louis Barnett, Ms. Lynnda Waller, Ms. Linda Nicholson, and Ms. Deborah Bronow from the State of California Employment Development Department. We also met with Ms. Marylouise Zamora and Ms. Michelle Clabough from the State Worker's Compensation Insurance Fund.

In Florida, assistance was provided by Mr. Warner Sanford, Mr. Larry Harvell, Mr. Wayne Quigg, and Mr.Johnny Riff from the Florida Department of Labor and Employment Security.

In Maryland, cooperation was obtained by Mr. Thomas Wendel, Mr. John McGucken, Secretary John O'Connor, Mr. Ken Richard, Ms. Ileana O'Brian, Ms. Elizabeth Trimble, Mr. Jonathan Krasnoff, Ms. Hazel Warnick, and Ms. Susan Bass from the State of Maryland Department of Labor, Licensing and Regulation and Mr. E.A. Mohler, the President of the Maryland and Washington DC AFL-CIO. Mr.Harry Friedman, Ms. Sue Petro and Ms. Cindy Burns provided the data.

In New Jersey, cooperation was provided by Mr. Michael Malloy, Mr. Michael Tardiff, Mr. John Maroney, Ms. Dorothy Toth, Mr. Paul Kapalko, Mr. Bill Burns, Mr. William Suarz, Mr. Wayne Marlin, Mr. Frederick Cohen, Mr. Dominic Marchetti, Mr. Vincent Martorano, Ms. Mary Sieber, Mr. Charles Salmon, and Mr. James Phillips from the New Jersey Department of Labor. We also met with Mr. Jeff Stoller of the New Jersey Business and Industry Association, Mr. William Coyne of the New Jersey Capitol Regional Council, and Ms. Jean Bestafka of the Home Healthcare Services Staffing Association of New Jersey.

In Washington, cooperation was obtained through Mr. Howard Nanto, Mr. Charles Sadler Mr. Graeme Sackrison and Mr. Kurt Malizio. As can be seen by the length of this list, they arranged many interviews for us. We interviewed Ms. Tanya Brewster, Mr. Michael Cobb, Mr. Jim Schodt, Mr. Robert Wagner, Ms. Tesa Wanamaker, Ms. Brenda Westfall, and Mr. Donald Wilson of the Washington State Employment Security Department. Mr. Wayne Godwin provided audit data. Mr. Norm Ericson and Ms. Teresa Morris of the Commissioner's Review Office; Mr. Bill Lemke, Mr. John Loreen and Mr. Skip Wilson of the Office of Administrative Hearings; Mr. Pat De Marco, Ms. Joyce Roper and Mr. Steve Victor of the Attorney General's Office; Mr. Dale Zimmerman and Mr. Greg Mowat of the Department of Labor and Industries, and Mr. Gordon Wilson of the USDOL in Seattle were also interviewed. We also met with Mr. Harry Kepler of General Teamsters local union #174, Ms. Pam Crone of Unemployment Law Project, and Mr. Jonathan Rosenblum of Seattle Union Now (AFL-CIO).

We are most appreciative of those individuals who participated in the study, whom we did not meet, but communicated by mail and follow-up phone calls. Everyone was most helpful. Their collaboration made the results rich. In Indiana, Minnesota, Ohio, and Wisconsin, cooperation was obtained through Mr. Bill Browne of region 5 of the US Department of Labor.

In Indiana, Ms. Pamela Grenard provided the data from the Indiana Department of Workforce Development.

In Minnesota, the data was provided by Mr. Thomas Willett, Mr. John Svigel, and Mr. Dennis Evans from the Minnesota Department of Economic Security, and Ms. Carolyn Ganz from the Minnesota Department of Labor and Industry.

In Ohio, Mr. Brad Mayo and Ms. Joanne Davis of the Ohio Bureau of Employment Services provided the data.

In Wisconsin, Mr. Edward Pyykonen of the State of Wisconsin Department of Workforce Development provided the data.

In Colorado, Mr. Don Peiterson at the Colorado Department of Labor and Employment provided data.

In Connecticut, Mr. Carl Olandt, Mr. Dan Metz, and Mr. Bennett Pudlin at the Connecticut Department of Labor provided data.

In Nebraska, Mr. Gary Zook and Mr. Jim Kubovy of the Nebraska Department of Labor provided data.

In New Mexico, Ms. Casandra Encinias, Mr. Dale Ripley, Ms. Connie Reischman and Mr. Jason Lewis of the State of New Mexico Department of Labor provided data.

In Oregon, Ms. Jayne Martin and Mr. Dale Derouin of the State of Oregon Employment Department provided data.

In Pennsylvania, Ms. Patricia Jante, Mr. Alan Williamson and Ms. Laura Reohr of the Pennsylvania Department of Labor and Industry provided data.

In Texas, Mr. Mike Sheridan, Ms. Gloria Davis, and Ms. Margaret Shuping of the Texas Workforce Commission provided data.

At the Bureau of Labor Statistics, Ms. Sharon Cohany shared data and information on BLS activities and the Current Population Survey Supplement with regard to independent contractors.

We also met with interested parties at the following organizations:

- AFL-CIO in Washington D.C.
- Strategic services on Unemployment and Workers' Compensation (UWC).
- National Technical Services Association (NTSA).
- National Office of the Interstate Conference of the Employment Security Agencies.
- The National Council on Compensation Insurance.
- Mr. Maurice Emsellem, and Ms. Kathy Rucklehaus of the National Employment Law Project.
- Mr. Larry Norton of the Community Justice Project.
- Mr. David West of Center for Changing Workforce.

We thank everybody for his or her assistance.

TABLE OF CONTENTS

DEFINITIONS OF ALTERNATIVE AND NONSTANDARD WORK ARRANGEMENTS

EXECUTIVE SUMMARY

CHAPTER 1 INTRODUCTION 1

1.1 Policy and Economic Context 1
1.2 Purpose Of The Study 4
1.3 Design Of Evaluation 5

CHAPTER 2 INDEPENDENT CONTRACTOR CLASSIFICATION 7

2.1 The Alternative Workforce and Independent Contractors 7
2.2 Implications of the Classification Differences 12
2.3 Legal Classifications of Independent Contractors 14
2.4 Implications of the Variance in Classification 23

CHAPTER 3 EMPLOYER DEMAND OR WORKER PREFERENCE? 25

3.1 Employer Demand or Worker Preference? 25
3.2 Employer Motivation 26
3.3 Worker Motivation 28
3.4 Economic and Social Environment Conducive to IC Growth 31

CHAPTER 4 PROFILES OF MISCLASSIFIED INDEPENDENT CONTRACTORS AND THEIR EMPLOYERS 34

4.1 The Misclassified Independent Contractor 34
4.2 Selected Industrial Profiles 38
Trucking Industry *38*
Construction Industry *41*
Home Healthcare Industry *44*
High Tech Industry *47*

CHAPTER 5 THE MAGNITUDE OF IC MISCLASSIFICATION 52

5.1 The Employee-Independent Contractor Determination 52
5.2 The Measurement Process 55
5.3 Misclassified Employees and the Impact on UI Tax Revenue 56
5.4 Industrial and Occupational Distribution of Misclassified Employees 63
5.5 Impact of Misclassification on Trust Funds 65

5.6 Overall Assessment of Misclassification 70

CHAPTER 6 ADMINISTRATIVE AND LEGISLATIVE RESPONSES OF STATES TO WORKER PROTECTION ISSUES 72

6.1 Legislative Issues and Responses 72
6.2 Workers' Compensation 75
6.3 Information Sharing among Agencies 77
6.4 The Underground Economy 82
6.4.1 California's Response 83
6.4.2 New Jersey's Response 84
6.5 The Erosion of UI Coverage and FUTA 87
6.6 Overall Impact of Misclassification 87

CHAPTER 7 SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS 90

7.1 Summary of Findings 90
7.2 Recommendations 93

REFERENCES 96

APPENDIX A: LEGAL REVIEW
APPENDIX B: LITERATURE REVIEW
APPENDIX C: RANDOM VERSUS TARGETED AUDITS
APPENDIX D: DATA REQUESTED FROM EACH STATE
APPENDIX E: COMPUTATION METHOD
APPENDIX F: AUDIT DATA ANALYSIS PROCESS

TABLES

Table 2.1: The Alternative Workforce 9
Table 2.2: The Nonstandard Workforce 10
Table 2.3: Nonstandard Work Arrangements (AFL-CIO) 11
Table 2.4: Use of Tests and Statutes 20
Table 5.1: Misclassification by Industry and percentage in California – 1998 63
Table 5.2: Misclassification by Industry and percentage in Washington State – 1998 64
Table 5.3: Impact of Misclassification on the UI Trust Fund 67
Table 5.4: Estimated Average National Impact on the UI Trust Fund 69

FIGURES

Figure 2.1: Alternative Work Arrangements 12
Figure 2.2: Combination of BLS and EPI Worker Classification Systems 13
Figure 4.1: U.S. Independent Contractors vs. Traditional Work Arrangements 37
Figure 5.1: Percentage of Audited Employers with Misclassified Workers 57
Figure 5.2: Effect of Misclassification on UI Tax Revenues (1998) 59
Figure 5.3: Summary of Misclassification by Standard Industrial Classification (SIC) Code - Maryland 1998* 61
Figure 5.4: Summary of Misclassification by Standard Industrial Classification (SIC) Code - Wisconsin 1998 62

DEFINITIONS OF ALTERNATIVE AND NONSTANDARD WORK ARRANGEMENTS*

Alternative Work Arrangement – Individuals whose employment is arranged through an employment intermediary such as a temporary help firm, or individuals whose place, time, and quantity of work are potentially unpredictable.

Contingent worker – Any worker in a job which does not have an explicit or implicit contract for long-term employment. The BLS uses three different definitions; the broadest of which includes all wage and salary workers who do not expect their jobs to last.

Contract worker – Workers employed by a company that provides them or their services to others under contract and who are usually assigned to only one customer and usually work at the customer's work site. EPI defines a contract worker as anyone who does contract work regardless as to whether they work at the customers' work site or for more than one customer.

Day Laborers – Workers who wait at a location where employers pick up people to work for the day; a type of on-call worker.

Full-time employees – Wage-and-salary workers who work 35 hours or more each week.

Independent contractors – Individuals who are not employees in the traditional sense but who instead work for themselves; someone who obtains customers on their own to provide a product or service

Independent contractors: self-employed – Workers identified in the basic CPS as self-employed who answer affirmatively to the question in the CPS supplement, "Are you self-employed as an independent contractor, independent consultant, freelance worker or something else (such as a shop or restaurant owner)?"

Independent contractors: wage-and-salary – Workers identified as wage and salary workers in the basic CPS who answered affirmatively to the question in the CPS supplement, "Last week, were you working as an independent contractor, an independent consultant, or a free-lance worker? That is, someone who obtains customers of their own to provide a product or service."

Leased employees – A type of contract worker, but "in a classic leasing arrangement, a leasing company provides all the employees to a client firm. In contrast, contract workers usually fill specialized occupational niches within client firms, working closely with the permanent employees of client firms." (see Vroman)

Nonstandard Work Arrangement – any job that differs from standard jobs due to one or more of the following ways: the absence of an employer, a distinction between the organization that employs the worker and the one for whom the person works, or the temporary instability of the job. (see Kalleberg, Arne, and Rasell, Edith, etal)

Part-time employees – Wage and salary workers who work less than 35 hours a week.

On-call workers – Workers who are called to work as needed, although they can be scheduled to work for several days or weeks in a row. (Examples include substitute teachers and construction workers supplied by a union hall)

Outside worker – Where there is a difference between the employer directing the content of the work (the client employer) and the employer who hires and pays the worker (see Vroman). Examples include contract workers and temporary help agency employees.

Self-employed – Workers who identified themselves as self-employed in response to the following question in the basic CPS, "Are you employed by government, by a private company, a non-profit organization, or were you self-employed?" Includes independent contractors as well as other self-employed such as restaurant and shop owners.

Temporary worker – equivalent to a contingent worker; encompasses temporary help agency employees, on-call workers, and wage and salary workers who are temporary direct hires. (see Vroman)

Temporary help agency workers – Workers paid by a temporary help agency, whether or not their job was actually temporary.

*This glossary draws primarily on the original definitions from the Bureau of Labor Statistics but also includes variations as defined by other analysts.

EXECUTIVE SUMMARY

As the economy continues to change, workers seeking a more flexible work environment and some who were displaced by corporate downsizing have become independent contractors. Also, the changing nature of employment and the increased use of those in the alternative workforce by businesses, including independent contractors (ICs), has attracted the attention of policymakers, because the prevailing employment and labor laws often do not cover those in the alternative workforce.

The purpose of the study was to provide a better understanding of the IC work arrangement and its potential impact on Unemployment Insurance (UI). The research design addressed the following questions: Who are ICs? Is there a variance in the IC classification system? Which occupations and industries are they in? Is the IC phenomenon employer driven or worker driven? Do employers deliberately misclassify employees as ICs, and if so, what is the impact on trust funds?

In order to obtain information on ICs from as wide a variety of sources as possible, and in a cost-effective manner, the methodology used included a review of literature, research on the definitions and tests used by states to determine IC status and data collection on a variety of relevant issues. Interviews were conducted with representatives from State Employment Security Agencies (SESAs), Wage and Hour, Workers' Compensation, employer organizations, unions and advocacy groups to obtain insight on IC use, misclassification and the strategies implemented to regulate and monitor ICs.

Based on definitions of standard employer-employee relationships and the classification criteria used by the Internal Revenue Service (IRS) and SESAs, ICs are:

1. Those who are classified as ICs according to their state classification systems and receive the IRS form 1099-Misc from employers reporting receipt of "non-employee compensation,"

2. those employees who should receive the IRS form W-2 reporting receipt of "employee compensation," but are deliberately misclassified by employers as ICs and instead receive form 1099s, and
3. those ICs and workers who operate underground and don't receive either a 1099 or a W-2 from their employers.

The statewide variance in the IC classification system concerns many within the government and business communities. The legal research revealed that the basic rationale in determining IC status is the extent of control exercised by the employer over the manner and means under which an activity is to be performed by the worker. State laws dealing with classification vary and reflect each state's social and economic philosophy and are shaped and clarified by the judicial process. Ultimately, for UI purposes, in the absence of clearly defined standards for determining IC status and employer liability, in each state the administrative agency officials and courts settle disputes by consulting their state's definition, applying their state's test and law (ABC, common law or economic reality test).

The issue of which test is better continues to be debated because each side has a vested interest in safeguarding their legal position. Proponents of change want to introduce a greater degree of certainty and simplification to the classification process, asserting that the current system has outlived its usefulness and is not responsive to the changing ways in which individuals work and business is conducted. Those who oppose changes to the current system believe that the underlying reason is an attempt to shift most of the costs of social benefits and protections from employers to workers.

There is a debate as to whether the IC phenomenon is driven by worker preference or employer demand. Employers and conservative politicians believe that worker preference is driving IC growth. They focus on the benefits of the working arrangement and view ICs as a positive force shaping the economic and social landscape. Union leaders and liberal politicians focus on the human costs of independent contracting, without acknowledging that the new arrangements may also provide more productive

ways of organizing work in today's environment. They view the growth as being primarily employer driven and as a disadvantage to workers. They are troubled by the fact that employees who prefer the stability of regular full-time employment are being compelled by employers to accept IC status or are being deliberately misclassified.

The general consensus of the study respondents on the demographic profile ICs was that there is no typical profile. ICs are males or females and of all ages and of a variety of ethnic origins. They have different education and skill levels. The majority earns middle to low-level wages and has no health insurance or retirement benefits. Construction, trucking, home health and hi-tech industries were frequently mentioned as examples of industries most likely to use ICs or lure workers into becoming ICs and contain high incidences of misclassification.

The number one reason employers use ICs and/or misclassify employees is the savings in not paying workers' compensation premiums and not being subject to workplace injury and disability-related disputes. Another reason is the avoidance of costs associated with employee lawsuits against employers alleging discrimination, sexual harassment, and implementing regulations and reporting procedures that go along with having employees. Understanding and complying with all the labor and worker protection laws is often beyond the capabilities of many small businesses. Even governmental agencies use ICs to avoid conferring employee status and attendant benefits because they have authorization to spend money on contracted services, but not on full-time employees.

The report contains an analysis of aggregate employer audit data from nine states that was extrapolated to each state's workforce to provide a rough measure of the extent of employee misclassification as ICs. The percentage of audited employers with misclassified workers ranged from approximately 10% to 30%. The percentages of UI tax revenues underreported due to misclassification varied from 0.26% to 7.46%.

A national-level estimate of the impact of misclassification on the trust fund was also computed for the period 1990-98. It showed a net impact on trust funds ranging from a

$100 million outflow in 1991 to a $26 million inflow in 1997. Assuming a 1% level of misclassification over the 9-year period, the loss in revenue due to underreporting UI taxes would be an annual average of $198 million. If unemployment remained at the 1997 level, the benefits payable to misclassified claimants would be on average $203 million annually. ***A more significant item of concern is that annually there are estimated to be some 80,000 workers who are entitled to benefits and are not receiving them. One observation expressed by most interviewees was that an increase in the unemployment rate could precipitate an avalanche of IC related issues.*** Workers operating under what at present looks like a good IC agreement would be filing UI claims alleging employee status. The administrative burden associated with a significant rise in contested claims could prove disruptive to orderly claims processing.

A new breed of accountants and attorneys has emerged to counsel employers on how to convert employees into ICs to reduce payroll costs and avoid complying with labor and workplace legislation. In every state that participated in the study, in occupations where misclassification frequently occurs and is discovered by audit staff, these firms have gone to the state legislatures to represent the employers and request exemptions from UI. Such efforts if they are successful, deprive claimants of the coverage they are entitled to and reduce the shared cost intent of the UI trust funds. The current mood in the judicial and legislative systems in many states is very pro-employer and political events are resulting in even more occupations receiving exclusions.

A multi agency dialogue needs to be started to explore the feasibility of extending some or all of the social protections now available to employees to ICs, who are currently denied protection or cannot afford to take full advantage of its availability. For example, should ICs participate in unemployment insurance, including payment of contributions? Should workers' compensation be mandatory for them? Should independent contractor agreements be subject to certain requirements such as the payment of a minimum wage? These are a few of the questions that need to be answered in order to respond to the needs of this increasingly important segment of the nation's workforce.

CHAPTER 1
INTRODUCTION

This report presents the results of a study on independent contractors (ICs) commissioned by the Employment and Training Services Administration (ETA) of the United States Department of Labor (USDOL).

It begins with an overview of the classification systems and tests used by administrative agencies and state court systems to identify independent contractors. It then describes the reasons workers become ICs, why employers use them, demographic characteristics of employees misclassified as ICs and profiles of four industries which have a high concentration of ICs. Next, for selected states, it presents the results of an attempt to determine the extent of misclassification of employees as ICs, the effect of misclassification on unemployment insurance (UI) tax revenues, and the impact on UI trust funds. It then describes the experiences of state administrators in dealing with the phenomenon of independent contractors and other significant issues related to ICs that affect the workforce. Finally, the report presents the findings and recommendations.

1.1 Policy and Economic Context

As the economy continues to change, communications technology advances and more workers search for alternate ways of living their lives, there is greater interest in independent and part time work. Traditional employment used to mean holding a full-time job year round, a 40-hour workweek, an established schedule for reporting to work, and being paid by the firm for which the work was done. In addition, most of the workers were employees of the organization for which they carried out their assignments.

This picture has changed dramatically over the past decade or so, and many former employees, for a variety of reasons, are now working as ICs. Many workers displaced by corporate downsizing, and some of those seeking more flexible work environments, have

formed their own companies. These ICs work for themselves or their own company, obtain their clients, and run their own business.

Based on definitions of standard employer-employee relationships and the classification criteria used by the Internal Revenue Service (IRS) and State Employment Security Agencies (SESAs), there are:

1. those who are classified as ICs according to their state classification systems and receive the IRS form 1099-Misc from employers reporting receipt of "non-employee compensation",
2. those employees should receive the IRS form W-2 reporting receipt of "employee compensation," but are deliberately misclassified by employers as ICs and instead receive form 1099s, and
3. those ICs and workers who operate underground and don't receive either a 1099 or a W-2 from their employers.

In a typical employer-employee relationship, the employer has the right to control and direct the person performing the services, what is to be done, how it is to be done, the place where work is to be done, and the equipment needed to do the work. Where such a relationship exists, the employee is required to pay his or her share of Social Security and Medicare taxes. The business entity is required to pay its' share of Social Security, Medicare, and Federal Unemployment Tax, and the full premiums for workers' compensation and UI. Employees have a legal right to organize in unions, and to receive a minimum wage, overtime pay and UI compensation if laid off.

ICs on the other hand, are self-employed. They are not covered by employment and labor laws that were designed for employees. They are not eligible for unemployment compensation. They must pay the full Social Security and Medicare taxes on their net earnings from self-employment, pay quarterly estimated income taxes if the business entity does not withhold them, and pay for their medical insurance, worker's

compensation etc. because employers do not provide them such benefits. They are also exposed to incurring a financial loss from their business.

Determining who is an employee and who an IC is a question that concerns the business community. Employers are increasingly becoming aware of the issue because of media reports of businesses facing contested employee classification claims. Audits by the IRS and the state UI agency can be economically costly. If found guilty, the employer is subject to back taxes, interest, and penalties. In addition, an erroneous classification raises issues regarding workers' compensation benefits, overtime compensation, medical, retirement and other benefits and rights for which employees are typically eligible.

A burgeoning industry of accounting and legal firms has emerged recently to offer services to employers to determine who is an employee and who is an IC. They show employers how to avoid making mistakes in classifying employees and independent contractors that may lead to problems with the IRS and SESAs.

At the same time, the nature of work and employment arrangements in the United States is undergoing a transformation. Across the country, "workers are abandoning traditional jobs, and instead are moving from project to project, assignment to assignment, untethered to any particular employer, unattached to any large institution, relying on themselves, and living by their wits... Some have been pushed...Others have leaped."[1] On one side are those workers who leave traditional jobs and strike out on their own to write, photograph, design, consult, program computers, or sell insurance and real estate. On the other side are workers with little education, training or skill, who have been forced by employers into accepting independent contractor arrangements with low pay and status and no health, pension, or retirement benefits.

There is a continuing debate as to whether the emergence of independent contractors is driven primarily by employer demand or by worker preference. Those who view the emergence of these new work arrangements as largely employer driven believe they are

[1] Daniel H. Pink, *New Republic*, April 27, 1998, p.19

to the disadvantage of workers and society at large. In contrast, those who believe worker preference is driving many of these changes welcome their appearance as a positive new force shaping the way business is conducted. Additional information on previous research on the phenomenon of ICs is contained in Appendix 2.

1.2 Purpose Of The Study

The changing nature of employment and the substitution of ICs for employees by business entities has attracted the attention of policymakers at the federal and state levels. According to standard measurement indicators, the current unemployment rate of approximately 4% is the lowest in three decades; incomes are rising and the economy is strong. Despite the strong growth in the economy and the labor market, a substantial portion of the workforce, including ICs, lives without job security and workplace protection. No comprehensive studies have been done on this emerging phenomenon.

The politics, needs, and wants of independent contractors, much like the form of their work, do not fit old categories. They operate under less secure job conditions. An organization that provides support services for ICs made the following comment about labor protection laws governing nontraditional workers. "It may have made sense to draw distinctions between employees and independent contractors in the manufacturing age...but with the shift toward more flexible arrangements, independent contractors often resemble workers in the manufacturing age in the tasks they perform, and in their relationships to employers...nearly one-third of the U.S. workforce is actually working under the labor conditions of the 1890's."[2] That was a period when workers had few rights and no employment and workplace laws and regulations to protect them.

Independent contractors are largely distinct from other types of workers engaged in flexible work arrangements according to information gathered from the literature. The purpose of the study was to provide a better understanding of the IC work arrangement

[2] "Your voice in the policy debate," *Working Today*, 1998.

and its potential impact on Unemployment Insurance (UI). The research design addressed the following questions: Who are independent contractors? Is there a variance in the IC classification system? Why do employers hire ICs? Why do workers enter such arrangements? Which occupations and industries are they in? Do employers routinely misclassify employees as ICs, and if so, what is the impact on the UI trust fund?

1.3 Design Of Evaluation

The objective of the study was to obtain information on independent contractors from as wide a variety of sources as possible, in a cost-effective manner. Three major tasks were undertaken:

- a review of available data and literature on ICs from publications, on-line databases, and the Internet,
- a determination of the breadth of variance of worker classification criteria across states, and,
- site interviews and data collection in a sample of states.
  - Site visits were made to Washington, New Jersey, Florida, California, and Maryland. UI benefit and tax administrators, administrative law judges, and appeals staff were interviewed to obtain insight on employee misclassification. The project team conducted in-depth data collection and analyses of employee misclassification on the state UI trust funds.
  - Representatives from workers' compensation, employer organizations, unions, and advocacy groups were interviewed to obtain information on issues specific to the needs and wants of ICs.
  - Data were also collected from UI administrators in Colorado, Connecticut, Indiana, Minnesota, Nebraska, New Mexico, Ohio, Oregon, Pennsylvania, Texas, and Wisconsin on states' legislative and administrative responses to the growth of the independent contractor industry.

Almost all of the interviewees equated employee misclassification with the operation of the underground economy.[3] In their view, there was little substantive difference between

[3] For the purposes of this report the underground economy is defined as composing of illegal activities, informal and unrecorded transactions, and income that is not reported.

reporting an employee as an IC and not reporting him or her at all. Some of those unreported operate in the underground economy. It is for this reason that a discussion of the operation of the underground economy is relevant to the study, especially how it is related to worker's wages.

CHAPTER 2
INDEPENDENT CONTRACTOR CLASSIFICATION

This chapter begins with a summary of research on the alternative workforce. Next, the various tests used by state judicial systems to determine who is an independent contractor, and how state agencies and judicial systems classify individuals as employees or independent contractors are described. It concludes with a discussion on the implications of the current classification system.

2.1 The Alternative Workforce and Independent Contractors

All the research to date on the size and magnitude of the alternative workforce is based on the classification system and data gathered by the BLS for the Current Population Survey (CPS) Supplement of Alternative and Contingent Work Arrangements. The BLS researched ICs in the context of other alternative and nonstandard work arrangements– temporary-help agency workers, on-call workers, and contract workers. The Economic Policy Institute (EPI) and the AFL-CIO also researched the issue of determining the size of the alternative workforce and its components, and used the CPS supplement published by the BLS as the basis for their analyses.

Although all the researchers describe the emergence of exceptions to the typical employer-employee relationship, they have different conceptions of what they believe should be considered typical and what they believe to be exceptions to the norm, which influences whether the phenomena are viewed in a positive or a negative light. What is known about ICs is clouded by the analysis of information on these other categories, especially when considering the varying motives of employers and workers who enter these arrangements.

The BLS published a CPS supplement on the alternative workforce in 1995, 1997 and 1999. The 1995 study was the first attempt to determine what portion of those employed

viewed themselves as being in nonstandard work arrangements. Since there are no significant differences in findings between the 1995 and 1997 surveys, the rest of this section focuses on the 1995 survey data. An additional reason for focusing on the 1995 survey is also to remain consistent with the other two studies that are reviewed here, which base their analyses on the same time period. The 1999 BLS data on ICs was not analyzed because it was not released in time for analysis for the final report.

The Bureau of Labor Statistics

Four alternative work arrangements (AWAs) are specified in the BLS classification: independent contractors, on-call workers, temporary help agency workers, and contract workers. Alternative work arrangements include all part-timers. Part time is defined as less than 35 hours per week. Exceptions to the typical work arrangement are "defined either as individuals whose employment is arranged through an employment intermediary such as a temporary help firm, or individuals whose place, time, and quantity of work are potentially unpredictable."[4] The latter portion of this definition applies to both independent contractors and on-call workers, while the role of an employment intermediary is the crucial element in defining the temporary help agency workers and contract workers.

The BLS defines ICs as those who work for themselves or their own company, bear the responsibility for obtaining clients, see that work assignments are executed, and otherwise run the business. These same criteria could also apply to other self-employed individuals, such as shop or restaurant owners. The BLS usually classifies as a wage-and-salary worker any self-employed individual who incorporates his/her business. However, for the purposes of this supplement, the definition of self-employed was extended to include the incorporated self-employed.

As shown in Table 2.1, almost 10% of the total labor force are in alternative work arrangements. Between 1995 and 1999, more than half of these workers (8.3 million in

[4] Anne E. Polivka,. "Contingent and alternative work arrangements, defined," *Monthly Labor Review*, October 1996, p.7

1995, 8.5 million in 1997, and 8.2 million in 1999) identified themselves as independent contractors, followed by on-call workers. Many individuals classified as wage-and-salary workers in the basic CPS survey also identified themselves as independent contractors in the three supplements.

Table 2.1: The Alternative Workforce

Categories	(Number millions)	% of total employed
Independent contractors	8.3	6.7
On-call workers	2.0	1.6
Temporary help agency workers	1.2	1.0
Contract workers	0.65	0.5
Total alternative workforce	12.15	9.8
Total workforce	123.2	100

Source: Based on data from Sharon R. Cohany, "Workers in alternative employment arrangements," The *Monthly Labor Review*, Oct. 1996, p 31-32.

Economic Policy Institute

Compared with the BLS, EPI's researchers have a different conception of what is considered a typical work arrangement although the same CPS data was used. In their view, the typical career paradigm is characterized by lifetime employment with a single employer, steady advances up the job ladder, and a pension upon retirement.[5] All exceptions to this picture of regular, full-time employment are "nonstandard work arrangements" (NSWAs), and differ from "standard" arrangements in at least one of the three following ways:

- the absence of an employer (as in self-employment and independent contracting),
- a distinction between the organization that employs the worker and the one for whom the person works (as in contract and temporary work), or

[5] Arne Kalleberg, and Edith Rasell, and others., *Nonstandard Work, Substandard Jobs – Flexible Work Arrangements in the U.S*, Economic Policy Institute, 1997, p.1

- the temporal instability of the job (as "characteristic of temporary, day labor, on-call, and some forms of contract work").

Similar to the BLS, the EPI classification system includes the role of an intermediary as one of its criteria for defining exceptions to the norm. However, the absence of an employer, rather than the unpredictable nature of their work, is the critical factor for including independent contractors in the nonstandard work arrangement. Using this criterion, those workers who do not have an employer, meaning the self-employed, are included in the nonstandard work arrangements. Unlike the BLS classification scheme, the EPI uses contingent or temporary work as criteria for identifying exceptions to standard work arrangements. EPI analysts also highlight the existence of two different categories of independent contractors, the self-employed and wage-and-salary ICs.

Table 2.2: The Nonstandard Workforce

Categories	(Number millions)	% of Total Employed
Regular part-time workers	16.0	13.7
Self-employed	6.4	5.5
Independent contractors/self-employed	6.6	5.6
Independent contractors/wage-and-salary	1.0	0.9
On-call workers/day laborers	1.9	1.6
Temporary help agency workers	1.1	1.0
Contract workers	1.4	1.2
Total NSWA	34.4	29.4
Total workforce	117.04	100.0

Source: Based on data from Arne L. Kallenberg, Edith Rasell, et al. *Nonstandard Work, Substandard Jobs,* Economic Policy Institute, 1997,p.9

As shown in Table 2.2, in its estimate of the total workforce, the EPI uses the smaller figure of 117,040,764 compared with the 123,202,000 reported by the BLS in Table 2.1. However, the inclusion of part-time workers and the self-employed increases the nonstandard workforce from, 9.9% of the total workforce to 29.4%. In addition, in its analysis of the BLS data, the EPI has more than doubled the number of contract workers

from 652,000 to 1,858,030. ICs no longer dominate because the self-employed are included. Nevertheless, ICs remain as one of the three dominant components of the nonstandard workforce.

AFL-CIO

Although part-time work is listed as a major exception to the standard work arrangement, it is not explicitly defined as such by the three criteria listed by EPI. Perhaps for this reason, the AFL-CIO accepts the EPI criteria, but adds a fourth: "the worker is guaranteed less than full-time employment (but may or may not work full-time hours)."[6] As shown in Table 2.3, by doing this, they explicitly include part-time work in nonstandard work arrangements.

Table 2.3: Nonstandard Work Arrangements (AFL-CIO)

Categories	(Number million)	% of total employed
Part-time work (regular only)	20.3	16.6
Work paid by a temporary help agency	1.2	1.0
On-call work	1.3	1.1
Day laborer work	0.1	0.1
Work paid by a contract company	1.7	1.3
Work paid by a leasing company	0.5	0.4
Independent contracting: wage and salary	1.1	0.9
Independent contracting: self-employed	7.0	5.7
Total NSWA	33.1	27.1
Total workforce	122.1	100.0

The inclusion of part-time and contingent work by the EPI and AFL-CIO researchers complicates the workforce classification system, since these are no longer discrete categories. Nevertheless, these analysts believe that the inclusion is necessary to accurately represent their concerns about the changing nature of the workforce. The

[6] Helene Jorgensen, *Nonstandard Work Arrangements: Downscaling of Jobs*, Department of Public Policy, AFL-CIO, March 1998.

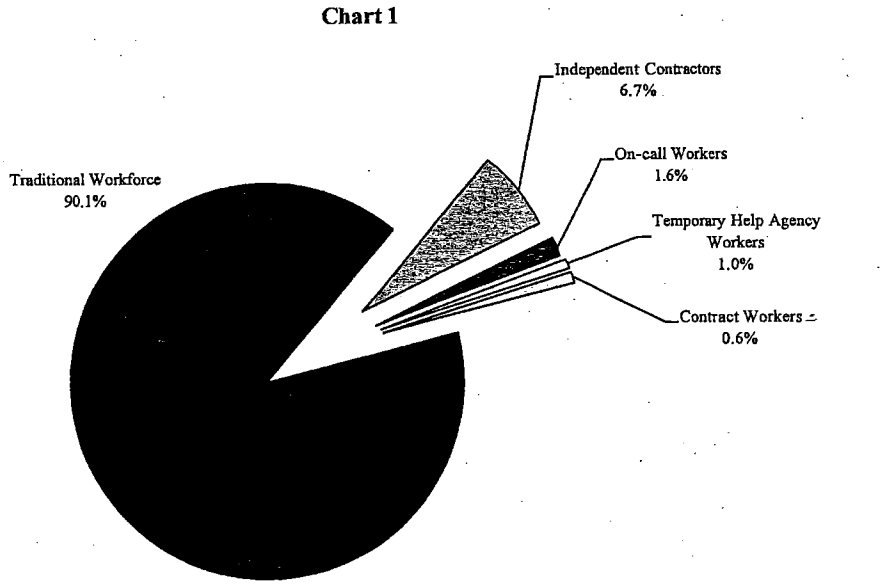
researchers also accept the EPI subcategories of ICs. Unlike the EPI however, except for ICs, self-employed are not included in a nonstandard work arrangement classification.

2.2 Implications of the Classification Differences

These different classification systems affect the understanding of the IC phenomenon because they are inevitably linked to the analysis and interpretation of the other emerging work arrangements. This is shown in the illustrations Figures 2.1 and 2.2.

Figure 2.1 represents the workforce classification system as it is conceived by the BLS, including the percentage of the overall workforce represented by each work arrangement. Alternative work arrangements have over 12 million workers (or 10% of the workforce). All other work arrangements, representing almost 90% of the workforce, are defined as traditional within the BLS classification system.

Figure 2.1: Alternative Work Arrangements

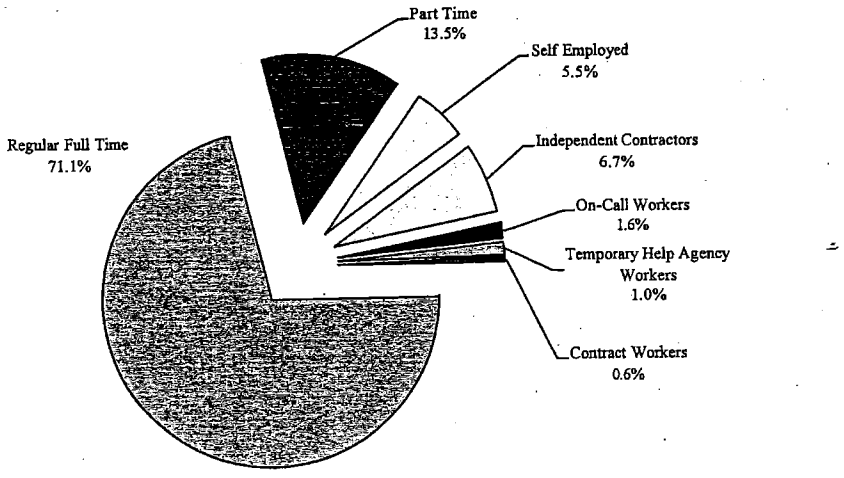


Source: Based on data from Sharon R. Cohany, "Workers in alternative employment arrangements," *The Monthly Labor Review*, October 1996, p36.

The BLS and EPI classification systems are combined in Figure 2.2, which retains the data reported by the BLS in the 1995 supplement. It shows how adding part-time and self-employed workers to the BLS classification system dramatically increases the size of the nonstandard workforce as a percentage of the overall workforce. Independent contractors as a percentage of the workforce are the same in both charts. Within the EPI classification system, all standard work arrangements (primarily regular full-time workers) represent only 71% of the workforce. The nonstandard workforce including part-time and self-employed workers, represent the remaining 29% of the workforce.

Not surprisingly, the larger figure (29%) has a tendency to appear more frequently in publications featuring information on independent contractors and other alternative workers. This may contribute to the perception that the number of ICs is larger than that reported by the BLS.

Figure 2.2: Combination of BLS and EPI Worker Classification Systems



Source: Planmatics analysis based on data from 1995 Current Population Survey Supplement integrating Bureau of Labor Statistics and Economic Policy Institute classification systems

Further discussion on the independent contractor measurement issues is described in appendix 2 of this report.

2.3 Legal Classifications of Independent Contractors

Given its long and tortured history, a certain level of humility is needed in answering the question as to who is an employee and who is an independent contractor, because the line between them shifts over time. It is not a recent question or even one that first arose in this century. Its origins can be traced to fourteenth-fifteenth century England.[7] According to Linder, the judicial distinction between employees and independent contractors has undergone a transformation in its accommodation to radically different socioeconomic and political contexts over the past six centuries.

The arrangements under which services are provided by one individual to another are extremely diverse, are susceptible to immeasurable nuances, and are changing. The prevailing versions are neither new nor self-explanatory. Statutes governing the determination of employee and IC status have been on the books for over half a century. However, there continues to be a great deal of uncertainty in many industries today in making a proper determination. There are no universal rules or ways to apply each state's definition of employee to specific situations because unemployment insurance violations are within the state realm, not the federal realm. In the absence of clearly defined standards for employee status and employer liability, administrative agency officials, administrative law judges, and the state courts must settle disputes. Ultimately, the state determines which individuals are employees and which are independent contractors.

Legal research was conducted to determine how the variance between federal and state law within states and from state to state affects worker classification. The nature of a particular job is immaterial with respect to a claim for unemployment compensation if an

[7] Marc Linder, *The Employment Relationship in Anglo American Law: A Historical Perspective (Contributions in Legal Studies, No 54)*, Greenwood Publishing Group, 1989.

employer supervises and directs an employee and the occupation or profession performed is not exempted from benefits under the relevant unemployment compensation act. The determination of whether independent contractors are covered by a particular labor, employment, or tax law hinges on the definition of "independent contractor." Each state's definition of covered employment, employee and IC were researched. Case law research illustrated how the definitions were applied to a particular set of circumstances and the resulting judicial interpretation; which states employed the most inclusive and least inclusive employee definitions; which states used the ABC test or the common-law test; and which industries had IC related issues.

The various statutes[8] and the reasoning employed by the states and the federal government in determining who is an employee and who is an independent contractor are described below. Fourteen states plus the District of Columbia use the common-law test to define employees for purposes of UI coverage, while twenty-two use the ABC test, ten states use their own test and four states use the IRS's 20-point test.

The Common Law Test

The common law definition is based on a master-servant type of relationship in which the employer (the master) retains the right to control the way work is done by the employee (the servant). Within the context of the Unemployment Insurance Act it is the contractually reserved right rather than the actual exercise of it that defines the relationship contractor. However, if this right has not been reserved, supervision of the person doing the work does not automatically institute the right of control or change the relationship to one of master and servant.

Control is often hard to define due to the individual nature of each job that is completed and state judiciaries often turn to secondary factors and circumstances of the relationship for guidance in making the determination. For example, if an individual is working at his own pace, with his/her own tools, is being paid for the job he/she is completing, and only

[8] The variance in state classification of workers' compensation laws applicable to independent contractors is not covered in this report.

being supervised to ensure the work is being completed according to the contract, then he/she is an IC. If an individual is subject to control in details of employment, is required to report to work at a certain time and to stay for a certain period of time, paid hourly wages, required to use the employer's tools and is supervised, then he/she is an employee. It is these secondary factors, the statutory exemptions already in place and the judiciary's interpretations that contribute to the variance in classification.

ABC Test

The distinction between an employee and an IC under the ABC test depends on the existence or nonexistence of the right to control the means and the method of work. Employment consists of service performed by an individual, regardless of whether the common-law relationship of master-servant exists, unless and until it is shown to the satisfaction of the agency that (A) the individual has been and will continue to be free from any control or direction over the performance of services both under his contract and in fact; (B) the service is either outside the usual course of the business for which it is performed, or is performed away from its business; and (C) the individual is customarily engaged in an independently established trade, occupation, profession, or business that is of the same nature as that involved in the service.[9] These three requirements must be concurrently satisfied; the inability to satisfy any one requirement may result in the unavailability of unemployment compensation.[10]

While the first criterion requires proof that the individual is in fact free from control and direction in the performance of the services, the courts have never held that there must be an absolute and complete freedom from control.[11] The second criterion requires an enterprise to demonstrate that in order to prove that an individual is not an employee and enterprise has no liability, that the enterprise performs activity on a regular or continuous basis, without regard to substantiality of activity in relation to enterprise's other business activities. The enterprise must prove that all services by the individual were performed

[9] *Tachick Freight Lines, Inc. v. Department of Labor, Employment Security Division,* 773 P.2d 451 (Alaska 1991); *New Hampshire, Labor, Unemployment Compensation Act,* Section 282-A:9

[10] *Jack Bradly, Inc. v. Department of Employment Security,* 585 N.E.2d 123 (Ill. 1991).

away from the enterprises' business or that the services provided by the individual were outside the enterprise's usual course of business. To satisfy the third criterion, it must be established that the individual has an enterprise created and existing separate apart from the relationship with the particular employer, that will survive termination of the current relationship.

The three requirements under the ABC test are the same for all states. How one becomes labeled an employee or an IC depends upon how the judiciary interprets the facts of the case concurrently with the prongs of the ABC test. The primary concern is not with the language in a contract that characterizes an individual as an IC, but on what the IC does and whether requirement has been met. The courts look at the actual circumstances of employment to discover whether the relationship falls within ambit of statutory exclusion of relationship from the definition of "employment" for UI tax purposes.

IRS Test

The IRS uses a common-law standard that focuses on a business's control over a worker.[12] A worker may be treated as an independent contractor only if the business she or he works for does not direct and control or have the right to direct and control the means and methods used to do the work. In other words, if an employer can tell a worker how, when, and where to work, that worker is an employee.

The IRS uses 20 factors to determine if an employer directs and controls its workers. A worker does not have to satisfy all of the factors to be classified as an independent contractor. It is the totality of the responses to the 20 factors that identify the correct legal status of the worker. Some factors carry more weight than others do. They are: (1) the business does not give detailed instructions on how to perform the job; (2) the business does not provide job training; (3) the worker realizes a profit or a loss from

---

[11] *American Transp. Corp. v. Director*, 39 Ark.App. 104 (1992). See also, *Twin States Pub. v. Indiana Unemployment*, 678 N.E.2d 110 (Ind.App. 1997), *Hill Hotel Co. v. Kinney*, 138 Neb. 760 (1940).
[12] *Bureau of Business Practice*, "Independent Contractor or Employee? The Practical Guide to IRS Worker Classification," (1998).

working for the business; and (4) the business does not give the worker benefits such as health insurance and vacation pay.

Economic Realities Test

Some states use the economic realities test, which is the broadest test for worker classification. If a worker is financially dependent upon one business for a substantial part of her or his livelihood, then an employer-employee relationship exists. Courts have used some of the following IRS common-law factors to determine the extent to which a worker is financially dependent on a business. They are: (1) the nature and degree of control a business has over the way the worker performs a job; (2) the extent to which the services rendered are an integral part of the business; (3) the permanency of the relationship between a business and a worker; (4) the amount of a worker's investment in facilities and equipment; (5) a worker's opportunity for profit and loss; and (6) the amount of initiative, judgment, or foresight that a worker needs to show or use in order to be successful in open market competition with others.

AC Test

Some states use a two-part test that takes criteria one and three from the ABC test. For purposes of UI, services performed by an individual for remuneration are considered employment, unless it is shown that: (1) the worker has been and will continue to be free from control or direction in the performance of his work, both under contract of service and in fact; and (2) the worker is engaged in an independently established trade, occupation, profession, or business.[13] "Employment" is not confined to common-law concepts, or to the relationship of master and servant, but is expanded to embrace all services rendered for another for wages.[14]

The requirement that the individual be free from control can be met by establishing that the individual: (1) is not an agent of the company (does not have an employer name tags), (2) can work extra hours or change hours without clearing it with the company, (3) can

[13] *Oregon Unemployment Insurance Act*, Title 51, Section 657.040 and Section 670.600 (1998).
Sewing M[14] Singer ach. Co. v. Industrial Commission, 104 Utah 175 (1943).

control the means and direction of his day, and (4) could work for any of the employer's clients following termination of the arrangement with the employer.[15] The requirement that the employee's occupation be independently established and that he be customarily engaged in it, means that the business must be created and exist separate from the relationship with the particular employer. It also means that the individual's business must survive the termination of the relationship and that the individual must have enough of a proprietary interest so that the business can be operated without any help from any other individual. In deciding whether an individual is an IC, each case must be determined on its own facts and all the features of the relationship must be considered.[16]

ABC plus 123

The state of Washington subscribes to the three criteria of the ABC test, but adds three additional criteria. These require that (1) on the effective date of the contract of service, the individual is responsible for filing a schedule of expenses with the IRS; (2) the individual has established an account with the Department of Revenue; and, (3) the individual is maintaining a separate set of books or records that reflect all items of income and expenses of the business that the individual is conducting.

The types of classification tests used by states are summarized below in Table 2.4. Additional information on the variance in classification is provided in appendix 1 of this report.

---

[15] *In re Hendrickson's Health Care Serv.*, 462 N.W.2d 655 (S.D. 1990). See also, *Unemployment Compensation Fund. Black Bull, Inc. v. Industrial Commission*, 547 P.2d 1334 (Utah 1976); *J.R. Simplot Co. v. State*, 110 Idaho 762 (1986).

[16] *Egemo v. Flores*, 470 N.W.2d 817 (S.D. 1991).

Table 2.4: Use of Tests and Statutes

STATE	*LEGAL CLASSIFICATION*			
	COMMON LAW TEST	ABC TEST	IRS TEST	OTHER TESTS
ALABAMA	✓			
ALASKA		✓		
ARIZONA				✓
ARKANSAS		✓		
CALIFORNIA	✓			
COLORADO		✓		
CONNECTICUT		✓		
DELAWARE		✓		
FLORIDA	✓			
GEORGIA		✓*		
HAWAII		✓*		
IDAHO				✓
ILLINOIS		✓		
INDIANA		✓		
IOWA	✓			
KANSAS	✓			
KENTUCKY	✓			
LOUISIANA		✓		
MAINE		✓		
MARYLAND				✓

Table 2.4: Use of Tests and Statutes (Cont)

STATE	*LEGAL CLASSIFICATION*			
	COMMON LAW TEST	ABC TEST	IRS TEST	OTHER TESTS
MASSACHUSETTS	✓			
MICHIGAN				✓
MINNESOTA	✓			
MISSISSIPPI	✓			
MISSOURI			✓	
MONTANA		✓		
NORTH CAROLINA				✓
NORTH DAKOTA	✓			
NEBRASKA		✓		
NEW HAMPSHIRE		✓		
NEW JERSEY		✓		
NEW MEXICO		✓		
NEVADA				✓
NEW YORK	✓			
OHIO		✓		
OKLAHOMA	✓			
OREGON				✓
PENNSYLVANIA		✓		
RHODE ISLAND			✓	
SOUTH CAROLINA	✓			
SOUTH DAKOTA				✓
TENNESSEE	✓			

960

Table 2.4: Use of Tests and Statutes (Cont)

STATE	*LEGAL CLASSIFICATION*			
	COMMON LAW TEST	ABC TEST	IRS TEST	OTHER TESTS
TEXAS			✓	
UTAH		✓		
VERMONT		✓		
VIRGINIA		✓		
WASHINGTON				✓
WASHINGTON DC	✓			
WEST VIRGINIA		✓		
WISCONSIN				✓
WYOMING			✓	

*Georgia and Hawaii employ a slight variation.

Source: Simon & Chuster, "Independent Contractor or Employee", The Practical Guide to IRS Classification, p74.

2.4 Implications of the Variance in Classification

The issue of which test is better continues to be debated because each side has a vested interest in safeguarding their legal position. Some of the administrative law judges who were interviewed viewed the ABC test as being somewhat rigid and failing to move with the times and respond to the changing conditions of the workplace. Under the ABC test, to be classified as an IC, all three requirements must be satisfied. They viewed the common-law test as less rigid, moves with the times because it deals only with the issue of direction and control. However, the proponents of the ABC test stated that applying the common-law test in employment tax issues does not yield clear, consistent, or even satisfactory answers, and reasonable people may differ as to the correct classification.

The prevailing classification system is a major issue of concern to the business community and to regulators. The 2000 small business owners that attended the 1995 White House Conference on Small Businesses voted a change in these determinations as a top priority. Critics of the current classification systems point to the differences among the federal and state rules as well as the differences within a state, particularly between the UI laws and workers' compensation laws. It is these differences, they maintain, that create the uncertainties that can place employers in financial peril.

Those who understand the current classification system point out that there are valid reasons for the differing approaches. First, the varying systems are much more alike than they are different. The basic rationale among them includes a determination of the extent of the control exercised over the manner and means under which an activity is to be performed. Another fundamental criterion is whether the individual performing the services is in fact in business for himself, and exposed to the financial risk commonly associated with operating a business.

Contributing to the differences in approach to classification is the fact that the criteria and their relative importance are constantly under review by the courts. The laws in the

individual states dealing with UI vary and, in the main, reflect the state's social and economic philosophy. These laws are then shaped and clarified by the judicial process established in that state. The end result can highlight the perceived differences, reinforcing the critics' claim of inconsistency. It should be pointed out that although the state legislatures are empowered to bring the differing IC criteria into uniformity, there is no evidence in the recent past that this is their inclination.

Many proponents of change have asserted that the present system has outlived its usefulness and is not responsive to the ever-changing ways in which business is being conducted. Those who oppose wholesale changes in the process argue instead that the underlying reasons are a thinly disguised attempt to shift most of the costs of social benefits and protections to the workers. The increasing use of all types of nontraditional workers, including ICs, has created renewed interest in changing the classification criteria so as to introduce a greater degree of certainty and simplification to the process. In any event, once a dialogue begins, it becomes readily apparent that a "one-size-fits-all" criterion cannot be applied to the dynamics of the workplace. As discussed later in Chapter 6, both the federal and state governments are revisiting the issue.

CHAPTER 3
EMPLOYER DEMAND OR WORKER PREFERENCE?

This chapter describes why employers use independent contractors, why workers enter such arrangements and the economic and social environment conducive to using ICs.

3.1 Employer Demand or Worker Preference?

There is a continuing debate as to whether IC use is driven primarily by employer demand or by worker preference. It is inevitable that the findings derived from any research study will create a context that affects how the analyst will interpret the phenomenon being investigated. The focus of this study was on all types of ICs and information pertinent to both sides of the debate was gathered. The results corroborated some of the findings on independent contractors contained in previous research.

Those researchers who believe that worker preference is driving employer use of independent contracting, view it as a positive force shaping the economic and social landscape, reflecting the changing ways in which business is conducted. Business owners and conservative politicians focus on the benefits of the IC working arrangement and de-emphasize the human cost aspect.

Union leaders and liberal politicians on the other hand, focus on the human costs of independent contracting, without acknowledging that the new arrangements also provide more productive ways of organizing work in today's environment. They view the use of the ICs as being primarily employer driven, and as a disadvantage to workers and society at large. They are troubled by the fact that employees who prefer the stability of regular full-time employment are being compelled by employers to accept IC status or are being misclassified. The misclassification issue is discussed in Chapter 4.

Employers' motives for using ICs and workers' motivations for entering such arrangements are complex and vary according to need and circumstance. In addition, the motives of employers who hire existing ICs are somewhat different from those who reclassify and convert their employees to ICs. Identifying the underlying motives of both types of employers and workers was crucial to objectively assess this work arrangement.

3.2 Employer Motivation

Commonly cited reasons for employers hiring independent contractors include:

- Flexibility to:

  - respond more quickly to rising demand and avoid layoffs of permanent staff
  - replace absences of regular staff
  - accomplish specific tasks for specific sums of money
  - gain access to workers with highly specialized skills on an as-needed basis
  - focus on core competency and supplement core staff on an as-needed basis
  - eliminate the time and expense involved in training employees and,
  - screening candidates for regular jobs.

- Saving in labor costs through savings on payroll tax and fringe benefits.

  - Employers increase short-term profits by replacing skilled workers with those less skilled, and by substituting full-time employees for more flexible, just-in-time workers. Union representatives of the trucking industry in Washington and Florida, and the construction industry in New Jersey and Maryland cited that it is a legal way for employers to restrict costly fringe benefits to a certain segment of their staff.

  - UI staff viewed the fact that employers are not required to pay their share of FICA and FUTA taxes and provide fringe benefits to ICs as a significant motive to misclassify employees as ICs and also to hire ICs. Employer and worker advocacy groups were unanimous in their complaint that businesses paying mandatory taxes on employees are unable to compete with those having small numbers of employees or no employees and large numbers of ICs. In fact, it induces otherwise complying employers to engage in such practices.

  - By hiring ICs, employers reduce costs directly by not being required to pay state unemployment taxes and workers' compensation insurance, and indirectly by reducing their exposure to costs associated with potential severance and

disability-related issues such as employee termination and workplace injuries. The savings generated by not paying the UI tax on ICs was not viewed as a significant motive in employer hiring. It was the savings gained in not paying workers' compensation premiums and not being subject to workplace injury and disability-related disputes that were cited as the most significant reasons to misclassify employees and hire independent contractors.

- In some industries and occupations (insurance, financial services), employers recruit employees, train them for a year, then make them switch status to independent contractors, but continue to use them under the same terms and conditions as before. Minneapolis-based financial advisors of American Express filed a lawsuit alleging this practice. In another federal lawsuit in California (AllState Insurance) agents alleged that the employer retained the authority of an employer without shouldering the accompanying financial responsibilities. The agents who sell products only for AllState got slightly higher commissions by switching employment status, but lost most of their benefits and business-expense reimbursements, while the employer maintained all prior elements of direction and control.

- Office space and equipment-related costs of conducting business operations are not incurred because employers do not provide ICs with office space or equipment.

- Reduced cost of doing business through circumventing compliance with federal and state labor and workplace legislation.

  - Especially in the case of small businesses, by hiring ICs, the size of the business entity can be kept below the number of acknowledged employees that triggers the need for compliance with many state or federal laws. For example, the Family Leave Medical Act becomes operative when a firm employs 50 or more employees. By hiring ICs, the business can stay below 50 employees and also deprive the legitimate employees of the benefits of the Act.

  - According to SESA administrators, what drives misclassification is the effort by employers to avoid the costs associated with employee lawsuits alleging discrimination, sexual harassment, and workplace injury; and the regulations and reporting procedures that go along with having employees. Understanding and complying with all the labor laws and worker protection laws is often beyond the capabilities of many small businesses.

- Access to a new breed of accountants, attorneys, and advisors on how to reduce payroll costs and avoid complying with federal and state labor and workplace legislation by converting their employees into independent contractors.

- UI appeals and tax personnel were concerned and agitated by the legal counsel provided by a new breed of law firms operating at state and national levels who specialize in advising employers on "circumventing but not breaking unemployment insurance laws." In some instances, former employees of SESAs staffed these firms. They represent employers before administrative law judges and state courts on employee status conversion, UI tax issues, and misclassification disputes.

- In occupations where misclassification frequently occurs and is discovered by UI auditors, these firms counsel and represent employers in lobbying state legislatures to request exemptions from unemployment insurance. If successful, they deprive claimants of the coverage they are entitled to as well as reducing revenue to the UI trust funds. All the study participants from UI agencies referred to at least one, but frequently to many such instances.

3.3 Worker Motivation

Interviews revealed two broad categories of workers entering employer-independent contractor relationships, those who did voluntarily and those who did not. Commonly cited reasons from both categories are discussed here:

Voluntary Choices

In the BLS surveys, there is little evidence that workers were forced to leave their regular, full-time jobs to start working for themselves as ICs. According to the BLS, independent contractors are "somewhat more likely to have voluntarily left their previous employment than were traditional workers." [17] "Among men, most said they worked as an independent contractor because they liked being their own boss"[18], whereas the common reasons given by women for being an IC included "the flexibility of scheduling and the ability to meet family obligations that the arrangement afforded."[19]

The CPS supplements showed that the vast majority of ICs (76%) cited personal reasons for becoming ICs. Less than 10% of respondents cited economic reasons. Nearly 84% of

[17] Polivka, Anne E. "Into Contingent and Alternative Employment: By Choice," Monthly Labor Review, October 1996, p58.
[18] Sharon. R. Cohany, "Workers in Alternative Employment Arrangements: A Second Look." Monthly Labor Review, November 1998, p6.
[19] Ibid

ICs stated that they preferred their alternative arrangement to a more traditional one. Less than 10% expressed a preference for a more regular, full-time position as a wage-and-salary worker. Finally, these ICs do not view their work as contingent, because they see their primary work relationship being with their occupation and other colleagues in their professional network, and not with any specific employer or organization. Nor do they view their current job arrangement as temporary.

Specific occupations that are represented by those who voluntarily became ICs include writers and artists, insurance and real estate sales agents, software and Web page designers, construction trade employees, and managers and administrators.

UI administrators in Colorado pointed out that they often encountered workers, particularly in construction, who have little knowledge of tax laws and who perceive the IC classification as an alternative or choice. The idea of being 'in business for yourself' sounds positive to these workers. The IC classification means that there is no tax withholding and the full salary is paid up front. They are not aware of the income and Social Security tax consequences until they have to file their income tax returns.

IC status gives workers the ability to claim business expense deductions from federal and state taxes. They can maintain a qualified retirement plan that permits greater annual contributions than regular IRAs available to employees, and deduct a portion of the cost of the health insurance premium. These workers also see their job situation as more secure than their traditional workforce counterparts.

Involuntary Changes

No data are kept on workers who have been compelled to becoming independent contractors since the UI agencies do not have the staff to maintain these records. Their staff described the following situations:

- In most cases, workers who should be legitimate employees were hired from the outset as ICs.

- Staff in Minnesota, Ohio and New Mexico reported that in most cases new hires, temporary, probationary, or part-time workers are initially misclassified as ICs. Some employers later change the status to employee once they are satisfied with the individual's work performance.
- Staff in Colorado and Oregon stated that problems arise when a claimant believes that he or she is not eligible for UI and does not contact the agency. Sometimes a claimant contacts the agency and then tells the benefit claims person that he was an IC or self-employed, and the agency may not investigate any further. Some employers intimidate workers not to file for unemployment by implying that they would never be rehired in the future. During the audits, the staff discovers employers that pay employees off the books, but it is often hard to prove because the claimants are afraid to speak out against their employer. "Without cooperation, we are many times unable to resolve these issues."
- Large employers "fired" mid-and upper-level managers with high levels of compensation and hired them back as ICs without benefits. Maryland, Texas, Colorado and New Jersey UI staff reported many cases where people "retired" and returned as independent contractors doing essentially the same work. The forced conversion occurred in all types of industries and all sizes of businesses.
- Reconversion from IC to employee status also occurs in order to avoid paying high worker's compensation premiums on all employees. Workers compensation representatives in California described how employers hire high-risk workers (such as roofers, construction workers, bicycle couriers) as ICs and convert them to employees if they get injured on the job, in order to claim coverage under the company's workers' compensation policy. This practice was prevalent in the other states also.
- The re-emergence of the take-home piecework concept is occurring in the semi-conductor industry in California and Washington State. Employers give work to employees to take home. Instead of paying overtime for take-home work, the employer categorizes the same employee as an IC and pays by the piece for work done in the home. Family members "help" and never show up on company books as employees or ICs.

- UI tax administrators discussed the collusion between independent contractors and employers in service industries to cheat on federal and state taxes. Employers misclassify employees and issue them Form 1099s instead of W-2s to save on payroll taxes. Misclassified employees believe they are better off by not having income taxes withheld from payments for their services. By being classified as ICs rather than as employees, they claim work-related tax deductions that were not incurred.

3.4 Economic and Social Environment Conducive to IC Growth

Most of the research on the alternative workforce attribute technological change, heightened international competition, new management paradigms, deregulation, and the increasing costs of payroll tax and fringe benefits as the leading economic factors generating the growth in the alternative workforce.

The forces increasing economic competition are creating new opportunities for workers prepared to take proactive advantage of them. Internet-based placement firms have emerged as brokers to locate independent contractors to work on projects for client employers.[20] The increased use of "long-term temps," described as a seeming oxymoron, is in fact a new and growing phenomenon in the American workforce and has been embraced by many corporations, especially high tech ones, including Microsoft, AT&T, Intel, Hewlett-Packard, and Boeing."[21]

Knowledge-based workers have increasingly become independent contractors to capitalize on the demand for their specialized services in order to take charge of their economic destinies.[22] These "free agents" no longer accept the idea that loyalty is given to an organization in exchange for job security. According to Terri Lonier of Working Solo, Inc., a company that advises independent contractors, "What we have today is not job security but skills security.... Being an individual entrepreneur, you are a lot more

[20] Anita Sharpe, "'Free Agent' placement firms flourish," *Wall Street Journal*, November 17, 1998.
[21] Steven Greenhouse, "Equal Work, Less-Equal Perks: Microsoft Leads the Way in Filling Jobs with "Permatemps," New York Times, March 30, 1998.
[22] Daniel H Pink, "The politics of free agents," *Blueprint: Ideas for A New Century*, Fall 1998

secure because you can diversify your income... If you work independently, you have many clients; your business is more resistant to market change."[23] According to William Halal, a professor at George Washington University, "It's a redefinition of the employment contract... Jobs once reserved for full-time workers are being done...by consultants, independent contractors...who act as free agents trading on their skill, time or knowledge. They operate much like SWAT teams, moving from job to job, project to project and company to company."[24]

Owing to the low setup costs of becoming an IC, workers of varying skill levels and wage rates populate the industry. On one end of the spectrum are "cyber agents" who work from home, using their own computers and telephones, often for distant employers. The employers are "offering what may be the workplace of the future: people using their computers, operating out of their homes paid minute-by-minute, as some distant employer needs them."[25] Cyber agents are frequently women with little education, homemakers, retirees, or welfare mothers who are classified as independent contractors by their employers. At the other end of the spectrum are the knowledge-based ICs who enjoy higher levels of remuneration, with similar basic requirements to establish themselves, a computer, answering machine, telephone, Web site, and an e-mail account.

Some believe that the changes in the family structure and work ethic are helping to maintain the momentum in the IC community. The arithmetic of the family has changed fundamentally, although the institutions of the workplace and home have not.[26] The traditional family had two adults and two jobs – the husband with a full-time paid job in the workplace and a wife with a full-time unpaid job at home. It has been replaced by two-career, three-job families still done by two adults, and one-career, two-job families done by one adult. Work is still governed by laws forged over 60 years ago, to address the needs of 40-hour-a-week full-time employees.

---

[23] John Carlin, "You Really Can Do It Your Way," *London Independent on Sunday*, November 30, 1997, copyright 1997 Newspaper Publishing P.L.C.
[24] Tammy Joyner, "Contingency Workers Go Where They Are Needed," *Atlanta Journal and Constitution*, Knight-Ridder Tribune Business News, October 13, 1997.
[25] John Dorschner, "Miami Company Plans to Add Clients, Help Agents," *Miami Herald*, Knight-Ridder Tribune Business News, January 17, 1999.

More women are joining the ranks of independent contractors because self-employment for at least one partner gives them employer-provided benefits and the autonomy and flexible work level they need. Between 1988 and 1996, the number of self-employed women grew at five times the rate of self-employed men and three times the rate of salaried women.[27] Employers, for whom the 40-hour week was once a mandated novelty, are now coping with variable careers. The new arrangements are increasingly being experimented with, not to replace the traditional workforce, but simply to supplement it.[28]

Some advocates of the alternative workforce are calling for public policy changes. In some occupations and industries where freelancing is common (construction, writers, screen actors), fringe benefits largely unavailable to workers outside the traditional employer-employee relationship are becoming available to ICs, to accommodate the periodic nature of their employment. "Working Today" an organization representing independent contractors, provides a variety of benefits at group rates, including health insurance, retirement planning, and low-cost Internet access services to its white collar professional ICs. However, worker protections such as UI and workers' compensation remain limited to employees. Advocates believe that such benefits should be tied more to the individual and become less dependent on the nature of their economic relationships. This would enable employers to enjoy the continued advantages of labor force flexibility, but not at the expense of individual workers.[29]

---

[26] Kathleen E. Christensen, and Ralph E. Gomory, "Three Jobs, Two People", *Washington Post*, 6.2.99
[27] Karin Schill, "Independent Spirits," *News & Observer*, Raleigh, NC
[28] Edward A. Lenz, "Flexible employment: Positive strategies for the 21st Century," *Journal of Labor Research*, 1996.
[29] Sara Horowitz, "Making Flexibility Fair," *Working Today*, 1998, Daniel A.Pink, "Free Agent Nation," *Fast Company*, December/January 1998 p.142.

CHAPTER 4
PROFILES OF MISCLASSIFIED INDEPENDENT CONTRACTORS AND THEIR EMPLOYERS

This chapter describes the demographic characteristics of employees who are misclassified as independent contractors. Four profiles are presented of industries with a higher than average use of ICs.

4.1 The Misclassified Independent Contractor

This section is based primarily on information provided by State Employment Security Agency personnel. UI administrators who make status determinations for unemployment insurance purposes were questioned about the typical demographic profile of misclassified ICs. Their response was:

"There is no typical demographic profile." – UI Connecticut, Maryland and New Jersey
"All social-economic levels of workers are part of the profile." - UI Nebraska
"The most common ICs are workers who can sell their services with minimal investment. –UI Wisconsin
"Mostly part-time workers and individuals paid by one piece rate." – UI New Mexico
"Many workers with low job skill levels in such occupations as residential framing contractors and landscapers ... We also find technical workers such as x-ray technicians and dental hygienists." – UI Ohio
"Low wage workers in construction/agricultural labor jobs." – UI Texas
"General labor ...followed by sales, technical and professional labor" – UI Minnesota

Misclassified ICs may well be male or female, and of White, Black, Hispanic, Asian or Eastern European origin. They come in all age groups, with different education and skill levels. Almost all have no health insurance or retirement benefits, earn middle-to low-level wages, and belong to a variety of occupations and industries.

Figure 4.1 illustrates the data from the BLS 1997 survey on alternative work arrangements. It compares the distribution of independent contractors by industry with traditional workers by industry, to ascertain whether ICs are attracted to certain industries. Services cover a wide array of occupations, including auto and other repair services, personal services, entertainment services, medical services, social services, and educational services. The largest proportion of ICs (39%) is in services. However, 34.5% of the traditional workforce are also in the service sector and there is no great disparity in this category. Twenty-one percent of ICs work in construction according to BLS figures, whereas only 5% of traditional workers are employed in this sector. There is also a greater percentage of ICs than traditional workers in the finance, insurance and real estate sector although the disparity is smaller.

SESA and Wage and Hour staff and advocates of employer groups and unions reported that a significant number of ICs operate in service industries such as home healthcare, landscaping, food preparation and processing and construction industries. Within the construction and home healthcare industries, there are many illegal immigrant workers of Hispanic and Eastern European origin. The garment and electronic assembly industries have high concentrations of ICs of Asian descent. New Jersey, Maryland and California had particularly high levels of Hispanic and Eastern Bloc workers in the residential construction industry. In Washington, in the trucking industry, there are large numbers of recent immigrants from the Ukraine, Russia, and Poland.

Many ICs in residential construction, trucking and home health care businesses possess a relatively low level of education. The independent contractors in the high tech industry who work as software engineers and computer programmers are educated individuals. However, the other category of ICs in the high tech industry consists of piece workers, who are Asian immigrants with little education and few skills.

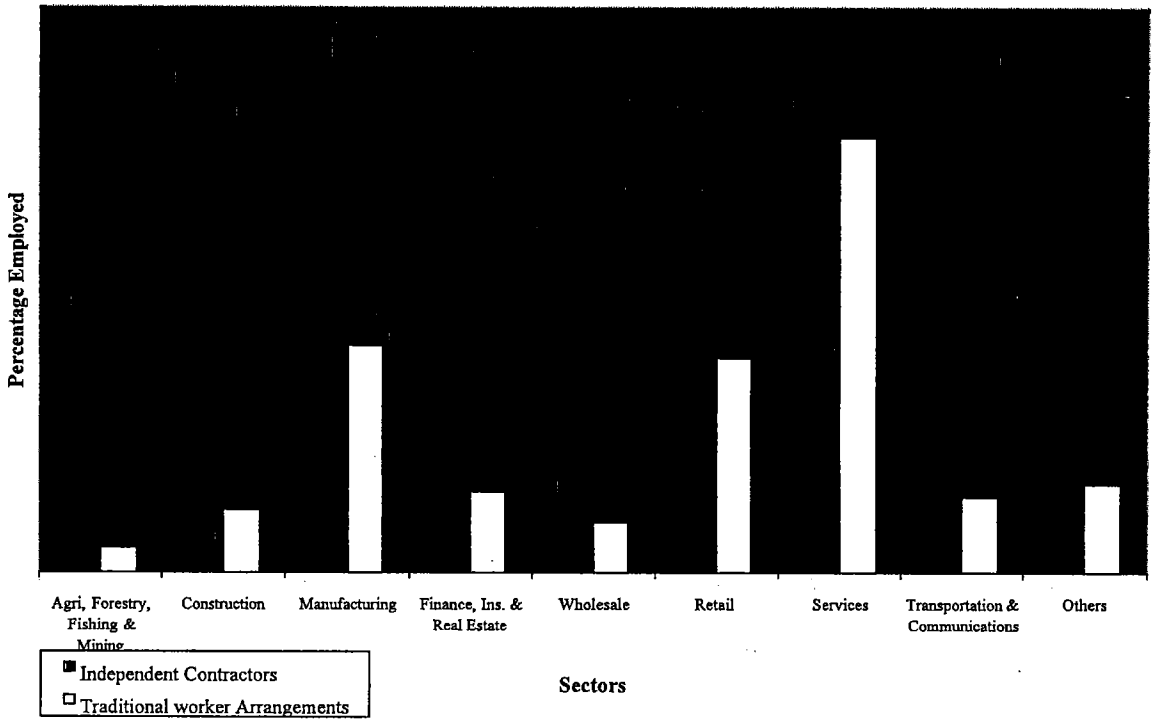
One particular subcategory of ICs, the recent immigrants who are legal and illegal, was resident in almost all the states that participated in the study. They are not their own bosses and do not own businesses or work equipment. These so-called independent

contractors are unaware of American worker arrangements, ethics, rights and laws, and are willing to work for low wages. Employers misclassify this group of employees as independent contractors and do not provide them with any benefits or rights, but maintain direction and control as employers.[30]

These workers are often discriminated against, and most often, exploited by employers belonging to their same racial or ethnic groups. However, the employers came earlier to the United States, sometimes in identical circumstances, and established themselves as legal business entities. These employers are confident that these independent contractors would not dispute their worker status – even if caused by discrimination, termination of the relationship, or a job-related injury – owing to fear of deportation, language barriers and ignorance of worker rights.

[30] Interviews with administrators at SESAs in New Jersey, Washington and California

Figure 4.1: U.S. Independent Contractors vs. Traditional Work Arrangements



Source: Based on data compiled by the BLS from the 1997 Current Population Survey Supplement of Alternative and Contingent Work Arrangements

4.2 Selected Industrial Profiles

Trucking Industry

In 1979, the trucking industry was deregulated, eliminating regulation of interstate and intrastate trucking. Essentially, federal, state, and local governments were prohibited from regulating the rates, routes, or services of any truck carrier. Now 20 years later, the truck drivers in Washington and in many other states appear to have come full circle. Owing to changes in economic conditions such as the increase in competition, declining earnings, and lack of benefits, truckers who once enjoyed their independent contractor status now wish to revert to employee status with union backing. Labor laws prohibit truckers who are independent contractors from forming unions.

Representatives of the labor unions in Washington State, California, and Florida reported that some of the truckers are legitimate employees of the freight companies, operating under the direction and control of the specific trucking company and that company's business license. However, their employers deliberately classify them as independents to reduce tax liabilities and avoid providing benefits.

Washington State

Nikolay Lavrentiev, an Estonian, is one of many immigrant workers who took a truck-driving course upon arrival in the United States to achieve the American dream of affluence and a better life than the one he had left behind. Unlike salaried union workers, Lavrentiev is an owner-operator, paid, not by the hour or by the week, but by the number of containers that he delivers in a day. He often spends half of his day waiting around the ports of Seattle and Tacoma for his next delivery. Sometimes only two or three containers are moved in a day at a rate of $28 to $40 per container. "I cannot afford to wait, but I have no choice" he says.[31] There are many drivers competing for the same work, and much of their day is spent waiting in line to enter the terminals.

[31] Patrick Harrington, "Teamsters tackle Seattle waterfront's low-paid immigrant truckers," *Seattle Times*, Knight-Ridder Tribune Business News May 23 1999.

The freight companies that employ Lavrentiev consider him an independent contractor, paid by the number of containers he hauls and not at an hourly rate. He does not qualify for benefits and is responsible for all the expenses incurred in delivering the containers. He makes $1100 monthly payments on his truck and considers himself lucky that he owns his truck. Others pay as much as 40% of their earnings to lease trucks from brokers. Lavrentiev also has to buy his fuel and works without health insurance and other benefits. He and many other truckers in similar situations are alleged to make only $7 per hour after expenses, which is in stark contrast to the unionized employees on Seattle's waterfront, who are alleged to be making around $100,000 annually. Lavrentiev is frustrated by this. "Some of those people are making three times more money than what we drivers do," he says. "We are like slaves to the big companies."[32]

The owners of the trucking companies say that deregulation has forced them to become heavily reliant on independent contractors. The companies viciously compete for business from shipping lines, driving down profits. For a given job, whether it requires the movement of a handful of containers or hundreds, the trucking companies submit their prices to shipping lines and the shippers award the job to the lowest bidder. The employers cannot afford under these bids to pay for benefits such as health insurance for the truckers and so they hire independents instead of employees.

One of the interviewees for this study, Kepler, who represents the General Teamsters Local Union 174, saw it differently. The Teamsters contend that the drivers are employees of the freight companies because they operate under the authority of a specific company and that company's business license. They believe that employers are deliberately misclassifying truck drivers. Kepler said, "If you are supposed to be an IC, then why is someone else's company name on the side of your truck." He also stated that in the case of truckers who are employees, "employers put it into your mind that you are an IC so that you don't even apply for UI; perhaps that you don't feel entitled to receive

[32] *Ibid.*

it." Some employers are alleged to deduct the cost of workers' compensation insurance from the wages paid to their employees.

The situation at the ports has changed dramatically over the past 20 years. In the old days freight companies used company-owned trucks and unionized drivers. Owing to non-union competition, most Teamster carriers have been driven off the waterfront by downward pressures on wages and benefits. Ever since trucking deregulation in 1979, Teamster members and owner-operators have been at each others' throats. According to the Teamsters, in today's economy, freight-moving firms use owner-operated trucks almost exclusively. Only a handful of the freight companies remains unionized.

The Teamsters are joining forces with the owner-operators. The way to protect Teamsters jobs and improve the wages for owner-operators is to put everyone on a level playing field by getting all waterfront companies under a master agreement with common wages and benefits, so that those employers hiring independents will not have a competitive advantage over trucking companies with union employees. That's how it was before deregulation, all waterfront truckers were employees of trucking companies, having the same labor costs. The Teamsters believe that when companies compete with each other they should do so based on efficiency and customer satisfaction, not on how little they can pay their drivers.

Florida

The situation is similar in Florida. Since independent contractors are not allowed to form unions, the Container Movers Association, a group of drivers who move freight from the port of Jacksonville want to form their own trucking company. This will enable them to form a union, and ensure that they will be able to negotiate wages and benefits and better working conditions. Currently the drivers own their own trucks, and contract with existing truck companies to move freight from the port. As majority owners of a trucking firm, the drivers would ask the management team to recognize them as employees, giving them the ability to form a union and to offer health-care plans and other benefits.

According to Hy Cohen, a labor activist, "this independent contractor scam is stripping workers of their rights and benefits. It is a scheme to break the unions."[33]

Construction Industry

The construction industry was the industry frequently cited by interviewees as most likely to use ICs, contain the highest incidence of misclassification, or as one that lures workers into becoming ICs.

In any industry, it makes economic sense to award a contract to the lowest bidder. The construction industry is no different. Many employers believed that hiring independent contractors was a way to cut their costs in order to improve their competitiveness and get more contracts. Employers who misclassify employees as ICs gain a distinct competitive advantage over those who pay taxes, provide benefits to their employees, and are placed on equal footing with employers who operate in the underground economy. The benefits to be gained in this arrangement greatly outweigh the risks associated of being caught.

The ICs in the construction industry belong to the low-skilled, less-educated group, of which many are recent immigrants. Employers exploit these workers by paying them very low wages "under the table," because they do not know or understand their rights as employees. The advantages to ICs that are paid "under the table" are:

- they can avoid paying taxes on income
- they can shield income sources from their creditors and/or former spouses
- they can make more per hour if paid in cash rather than by payroll check
- they can draw benefits such as welfare, unemployment insurance, or disability insurance if legally entitled to be employed in the United States

The construction industry is a lucrative source of employment opportunity for illegal immigrants. Work is plentiful because of the current tight labor market for unskilled workers. Most undocumented workers take jobs that are considered the most undesirable

[33] Tim Wheeler, "GOP tax bill strips workers of jobs benefits," *People's Weekly World*, July 26,1997

and unsafe. "In the past, that often meant toiling in the fields. But now other types of manual labor, often entry-level construction jobs, are the most prevalent work for undocumented workers."[34] In Florida, 95% of drywall installers and roofers are independent contractors. Employers who are willing to take risks in order to reap the above-mentioned benefits often ignore checking status to determine eligibility to work.

In 1986, Congress tried to clamp down on the number of illegal immigrants working in the United States by enacting the Immigration Reform and Control Act (IRCA), making it a crime for employers to hire undocumented immigrants. The act requires employers to verify the employment eligibility of a candidate before hiring by examining identification documents such as a Social Security card. The applicant must also fill an I-9 form (Employment Eligibility Verification).

The system has many loopholes. Counterfeiting is rampant and employers are hesitant to challenge all but the most obviously counterfeited documents for fear of being sued by legal workers alleging discrimination for questioning their status. In New Jersey, the INS will fine employers only if they prove that the employer knew the identification documents presented were fraudulent or counterfeit. Another loophole in the federal law is to claim that workers are independent contractors, exempted from filling out the I-9 work form or providing identification. In construction, workers go from job to job and from contractor to contractor, and it is difficult to find out who the actual employer is.

In Maryland, California, and Florida, the union advocates who were interviewed stated that misclassification was high in both residential and commercial construction. Building contractors force their employees to file the IRS 1099 form identifying themselves as independent contractors. Some pay cash. In Maryland and New Jersey, inspectors discovered that workers were being paid cash at federal construction sites. This type of activity is preventing the legitimate firms in the construction industry from competing for

[34] Diane Smith, Andrew Backover, "Working around the law as the government turns its attention elsewhere, North Texas employers increasingly rely on undocumented workers," *Fort-Worth Star-Telegram*, 4/18/99.

contracts. The boom in the industry and inadequate enforcement of standards by state agencies invite employers to circumvent labor laws and violate workers' rights.
In Florida, the unwritten rule in the construction industry is that all workers are considered independent contractors. There is no federal or state statute to mandate this, nor would the construction industry be able to satisfy an inquiry into direction and control with the level of satisfaction necessary to classify their worker as an independent contractor. If the courts determine that the workers of a particular construction company are employees, that company is unable to compete in the market. If a company cannot compete, then it cannot survive. Therefore the courts will not change the classification.

In New Jersey, the representative of the AFL-CIO stated that "misclassification is pandemic in residential construction." Immigrants from Poland, Russia, and other Eastern Bloc nations and Hispanic immigrants are being exploited. Hours worked and wages are falsified. The prevailing wage is often ignored. It is common for independent contractors and crew leaders to provide proof of insurance to start work in construction and then stop paying the premium shortly afterward. Workers are intimidated by their employers, have no desire to encounter enforcement staff from the Department of Labor, and are distrustful of government and its attendant regulations because of previous experiences in their homelands.

State and federal agencies have insufficient staff to crack down on employers who misclassify workers. States' resources need to be used prudently to pursue the "big fish." An example of this is the case against Houston Dry Wall which became the first of a dozen companies to catch the attention of a joint task force set up by the New Jersey Department of Labor and Division of Taxation to monitor the construction industry. Houston had a lot of contracts in New Jersey, but very few employees. They transported legal and illegal immigrants from Texas to New Jersey to work in residential construction sites, as independent contractors "who were closely supervised by crew leaders." The state was seeking around $136,000 in gross income tax and $459,000 in unemployment and disability insurance taxes, plus interest and penalties, from Houston Dry Wall.

According to Houston Dry Walls' attorney Robert Altar, the state agencies have incorrectly classified the workers by confusing the difference between an IC and an employee. He was quoted as saying "the workers were all out-of-staters, and the work in New Jersey was temporary. It all comes down to control. When you hire someone to perform a service for you, do you exercise a degree of control over that person?"[35] Altar argued further that "these guys have trades, they own vans and they work for other people."[36] However, the task force differs in their interpretation of the rules. According to them, if workers use materials purchased by the contractor, and their time is controlled and they are told where to work, they are employees and are subject to taxes.

After the Houston Dry Wall case, the state tax agency added 28 new investigators to ferret out potential violators. The tip that led investigators to Houston Dry Wall came from the Foundation for Fair Contracting, which operates in many states. It was set up by the building trades to ensure that contractors winning public work were complying with state labor laws, and to report to enforcement agencies on industries where fraud and abuse is very high. The executive director of the Building Contractors Association of New Jersey, who was interviewed for this study, stated that "anyone skirting the system and not paying what they are supposed to pay has an unfair advantage over the legitimate guy." This association of 160 small and large commercial contractors supports the efforts of the state task force in attacking this problem.

Home Healthcare Industry

Independent contractors are a visible presence in the home healthcare industry, which is growing rapidly. Some of the highest levels of misclassification prevail in this industry. According to the worker's compensation administrators who were interviewed the home healthcare industry is second only to the transportation industry in terms of the number of on the job accidents each year. This gives employers even more incentive to misclassify

[35] Dan Weissman, "Builder caught in state tax crackdown" *Star-Ledger Newark*, p 35, February 18 1999.
[36] *Ibid.*

employees as ICs in order to avoid the worker's compensation premiums that are synonymous with this industry.

The demand for home healthcare covers a whole range of occupations, from registered nurses and certified nursing assistants to home companions. The greatest demand is for certified nursing assistants. The demand for home health care has skyrocketed over the past decade because of the growing numbers of the population that can no longer take care of themselves in their home environment. An increase in the longevity of the overall population is the primary factor. Those who demand the services are comfortable at home and prefer to remain there, compared with the other options available to them. Many aging members of the relatively affluent population require certified nursing assistance around the clock, which means three people working 8-hour shifts.

Health insurance plans do not authorize extended hospital stays for most illnesses and instead provide in-home care options for patients. Owing to technological advances, today it is possible to provide in-home health services that were impossible a few years ago. These are two subsidiary reasons for the rising demand for home health care. On the supply side, the low unemployment rate and the availability of more lucrative careers have resulted in a shortage of workers in this field.

The difference between healthcare professionals who are employees and those who are independent contractors became unclear in the 1980s. Misclassification was deliberate on the part of employers, for the usual reasons. New Jersey UI staff described the "dry wall phenomenon" in construction and the "companion phenomenon" in home health care. The companion phenomenon occurs when employers in home health care engage independent contractors who are under the direct control and supervision of a senior staff person. It is not outside their usual course of business because it is their only business. The independent contractor does not have an independently established trade because without the work from the employer, he or she has no work.

Washington State UI officials stated that "it was a chronic legislative problem in the state, especially in the growth of personal services through referral agencies." Referral services are a new phenomenon within the home healthcare industry, where the agency pays their so-called ICs low wages and often take large commissions or charge fees from the ICs for finding them work.

Ms. Bestafka, the president of the Home Healthcare Services Staffing Association of New Jersey, who was interviewee for the study, also described the same phenomenon in that state. The growth in referral agencies is 100% greater than any other prior registry-type operation. These agencies are often small independent outfits run by families. Most of them deal with Eastern Bloc workers. ICs are kept "off the books", not issued with Form 1099s, and the I-9 forms are rarely checked. The referral agencies inform workers that no enforcement agency will ever check on them, and this is probably true. Typically, an independent contractor in the home healthcare industry in New Jersey makes approximately $400 per week, with the referral agency collecting $120 of that sum as its fee. Some agents collect daily fees because it has become such a lucrative business.

Ms. Bestafka also stated that there were 58,000 certified home health aides, and estimates that there may be up to 100,000 more independent-contractor companions who are misclassifed employees. She further stated that major hospitals and HMOs post the names of the referral agencies on their bulletin boards and provide them with business leads. The HMOs are apparently unaware that the agencies are exploiting the workers. Similar to the construction industry, it is difficult to track these home health aides and companions because they move from assignment to assignment quickly, and the only way to locate them is through the client. Employers are moving employees to IC status, particularly nurses and those in related occupations in order to compete with referral agencies. Legitimate employers are also "turning in" competitors who have moved employees to IC status because they are taking away significant amounts of business.

The state legislature in Maryland launched a five-month task force investigation of the home healthcare industry. One of their findings was that the workers sent out by the

referral agencies on assignments are frequently not informed that they are independent contractors. These individuals are paid the minimum wage and forced to sign noncompete contracts for 180 days, tying them to the referral agency. Sometimes it is made clear to them that although they are independent contractors, but they cannot make agreements with other agencies during the 180-day period.

High Tech Industry

The high tech industry is also one of the fastest growing industries in the United States and ICs play an important role in its growth. One significant difference between the high tech industry and the rest of the industries that have been profiled is that in the previous three industries, the employer gained most of the advantages of hiring ICs rather than employees. The ICs are mostly semi-skilled and less educated, and many are recent immigrants exploited because they do not know or understand their rights as employees. However, in the high tech industry, there is a combination of both highly and less educated ICs. The majority of workers actually chose to become ICs.

Aside from the usual motives for employers to hire ICs rather than employees, there are other factors associated exclusively with the high tech industry. The competition is intense and unrelenting. Rapid and often unexpected changes in technology have created a dynamic market environment where the advantage goes to those firms that can bring new ideas to the market the quickest. These conditions have encouraged the growth of highly adaptable organizations, but in the process of evolving they are changing the nature of work arrangements.

In Silicon Valley, the use of temporary workers and contractors is rampant. High tech firms need the flexibility to respond quickly to changing market conditions. The use of contractors and other types of contingent workers reduces employers' overall commitments to full-time employees, and enables them to reconfigure operations in response to changes in the marketplace. The independent contractors are entrepreneurial individuals who enjoy being independent specialists in performing such tasks. The

employer does not need to incur training costs on their behalf and it is easier to dispense with their services when the job is completed.

Shaun Walter and Samantha Portiz are employees of Manpower Inc. and specialists in Windows NT and Novell NetWare networking areas. In the past 18 months, they have worked at two different jobs in the chemical and airline industries. "The pay is very good, and the flexibility is definitely welcome,"[37] says Walter. "We avoid the politics of working inside a company, and we get exposed to a lot of different technologies."[38] Their adaptability is vital to the overall success of the high tech industry.

Contingent workers may stimulate the accumulation and creation of knowledge within a firm because they have been exposed to similar situations in other organizations. For example, a software engineer who has worked on specific development projects using concurrent engineering techniques may be able to articulate and transmit some of this knowledge to other organizations. Firms that hire these contractors gain firsthand knowledge of up-to-date technological developments, which enables them to remain as informed as their competitors.

The high tech firms hoping to reap the benefits of such arrangements may also be subject to lawsuits claiming these contractors are misclassified employees who are entitled to benefits. In the early 1990s, the IRS determined that Microsoft Corp. had improperly classified a few hundred ICs who should have been considered employees. According to Stephen Fishman, a self-employment attorney, "Microsoft did pretty much everything wrong. These contractors worked only for Microsoft, were supervised by company managers, received keys to the office, and were allowed to use company facilities for years."[39] Many of the same contractors sued Microsoft for back benefits provided to regular employees, including participation in Microsofts' immensely attractive employee stock purchase program. In 1998, the U.S. Supreme Court upheld a lower court ruling that favored the contractors. In 1999, the Ninth Circuit Court of Appeals ruled that

[37] W.J.H "Meet the 'new economy' temps" *Online U.S. News*, 08/30/99.
[38] *Ibid.*

Microsoft might have to extend its stock purchase program to long-term temporary staff working through temp agencies. Microsoft appealed but the ruling was upheld in early 2000.

Microsoft is far from alone in its temporary worker troubles. San Francisco Bay Area companies such as Pacific Bell and PG&E are also grappling with lawsuits by former temps and contractors who claim they should have received the same perks as regular employees. "This is going to be the next wave of employment litigation,"[40] said Larry Shapiro, editor of the California Employer Advisor newsletter in Tiburon. "The Microsoft case sounds a siren of alarm. Employers should be very careful because, later on, if their contractors or temps are classified as employees, they may be eligible for very expensive retroactive benefits."[41]

There are two types of ICs associated with the high tech industry. The first type are free agents who are skilled professionals, in high demand, moving from project to project. They become ICs because there is a shortage of labor in the information technology (IT) field and they are sought after. Money is not always the motivating factor, it's the need to be masters of their own professional fate. "I could make more money getting a salary, stock options and benefits as a full time employee at a Silicon Valley company"[42] says the 46 year old Mr. Burns, who works out of his home. "But, as an independent contractor who charges $100 an hour, I'm free from the pressures to take vacations at a certain time, work on certain projects and do favors for the boss," he says. "I have control."[43]

The piece workers are often low skilled immigrant laborers, working at home, paid by piece rate for components in apparent violation of labor, tax, and safety laws. They represent the low tech underbelly of the high tech industry, whose work arrangement is a

---

[40] Ileana DeBare, "The temps strike back/companies face more lawsuits claiming they misclassified workers," *San Francisco Chronicle*, pB1, May 28 1999.
[41] *Ibid,*
[42] Sheila Muto, "Bill to assist self-employed gets new life," *Wall street Journal*, May 19 1999 p.ca1,
[43] *Ibid.*

throwback to working conditions at the turn of the century. In many ways, home assembly paid by the piece is similar to the way Silicon Valley companies routinely use freelancers for anything from data entry to programming. The same complex guidelines and laws apply to all these situations, with each case hinging on whether the definition of IC is met.

Electronics contract manufacturers, ranging from small firms like Compass to multibillion-dollar giants such as Solectron Corp. have been involved in illegal piecework arrangements. These contract manufacturers build parts and systems for companies such as Hewlett-Packard Co; Sun Microsystems, Inc; and Cisco Systems, Inc. The electronics companies want the flexibility to work without enormous overhead when they need to meet very tight deadlines. "Sometimes when the job is so hot.... even if you add OT you can't make the schedule,"[44] says Kiet Anh Huynh, a Solectron production manager from 1983 to 1992, describing the typical circumstance in which work was sent home. "We give the workers 100 boards and the next day they have to bring back 100 boards. Maybe at home they do it faster if they have brothers or sisters helping them."[45] The companies that pay for piecework generally regard the workers as ICs for whom they would have limited responsibility.

"Whole families, particularly in the Vietnamese immigrant community can be found working late into the night soldering tiny wires, stripping cables and loading hundreds of different colored transistors onto printed circuit boards, at kitchen tables and garage workbenches, for as little as a penny per component."[46] Most of the workers work for the same company during the day as regular employees, whereas at night they become independent contractors. Some employees are afraid to say no to piecework in case they lose their regular day jobs. In other cases, employees who need the additional income view the arrangement as a benefit rather than a burden.

---

[44] Miranda Ewell, "California Hi-Tech Firms Employ Hidden Labor," Knight-Ridder Tribune Business News, June 27 1999.
[45] *Ibid.*
[46] *Ibid.*

Paying by the piece for work isn't illegal, but the piece rate is subject to minimum wage and overtime laws. Full-time employees who are given work to take home should be paid at rates of time-and-a-half for such work. Family members help with the work and never show up on company books, making it impossible to calculate if an individual worker is earning the equivalent of California's minimum wage. Giving the work to the employee but paying the spouse for it "does seem to indicate fraud"[47] says Craig Wirth, head of San Jose's employment tax division of the IRS. Despite laws barring children under the age of 14 from industrial work, youngsters often help with electronic assembly done at home.

The employers also violate industrial safety standards under Occupational Safety and Health Administration (OSHA) laws when work is taking place at home. "If work is taking place at the kitchen table then the kitchen table becomes that part of the house subject to the act,"[48] says Michael Mason, chief counsel for the enforcement arm of the state's OHSA program. Some companies advise employees to get a business license for a relative in the same household whom the company can pay for their work as an "independent contractor."

[47] *Ibid.*
[48] *Ibid.*

CHAPTER 5
THE MAGNITUDE OF IC MISCLASSIFICATION

This chapter presents the results of an attempt to estimate the number of employers that potentially have misclassified workers, the impact on state UI tax revenues and the industries where misclassifications occur. It then describes the impact of the misclassification on trust funds.

5.1 The Employee-Independent Contractor Determination

When employees are misclassified as independent contractors, Social Security, worker's compensation, unemployment insurance revenues and their social protections are significantly reduced, and compliance with other labor and employment laws are avoided to their detriment. Much of the commentary contained in previous research described in the Literature Review (appendix 2) covered a variety of workplace issues relevant to independent contractors,[49] the exception being the issue of employee misclassification.

The subjective nature of misclassification does not lend itself to standard survey methods. Direct surveys of employers or workers will at best provide opinion-based information. Classification is often in the eye of the beholder. The BLS researchers recognized this inherent difficulty. Many individuals classified as wage-and-salary workers in the basic CPS survey also identified themselves as independent contractors in the CPS supplements. In the 1995 supplement, 85% (7 million) of ICs are classified as self-employed, the remaining 15% (1.3 million) are classified as wage-and-salary independent contractors. However, it is not possible to conclude from these data that these 1.2 million wage-and-salary independent contractors are misclassified employees.

[49] Susan N. Houseman, "New institute survey on Flexible Staffing Arrangements," *Employment Research*, Spring 1997; Arne Kalleberg, and Edith Rasell, et al., "Nonstandard Work, Substandard Jobs – Flexible Work Arrangements in the U.S." *Economic Policy Institute*, 1997

Cohany[50] recognizes that "it may be tempting to classify ...(them) as workers who otherwise would have been employees of the company for which they were working or individuals who were 'converted' to independent contractors to avoid legal requirements." However, she further states that "the basic CPS questionnaire does not permit this distinction...as two individuals who are in exactly the same arrangement may answer the question...differently, depending on their own interpretation of the words 'employed' and 'self-employed.' There is no way to determine which responses are "correct" from a legal perspective and which are not.

An alternative source of data on employees and employees misclassified as independent contractors is available at SESAs which maintains employee wage record information filed by employers. The status units of the agency are charged with the determination of whether services performed for an employer were done as an employee or an IC.[51] Such determinations are triggered by employer site audits and by claims filed for unemployment compensation by discharged employees that are contested by their employers.

The tax division of the agency, as a basic component of its tax compliance effort, conducts annual site audits on a percentage of registered employers in the state. The sample of employers to be audited is drawn either on a random basis, or is selected on a targeted basis because of some prior evidence of possible non-compliance, or as a combination of the two. In addition, tips from a variety of sources (referrals from other agencies, comparison of payroll and workers' compensation records, information from persons regarding employment practices of a specific employer that may be in violation of law) also trigger employer audits. Federally-mandated Quality Control investigations also occasionally detect independent contractor misclassifications.

---

[50] Sharon R. Cohany, "Workers In Alternative Employment Arrangements: A Second Look," *Monthly Labor Review*, November 1998.

[51] The IRS, the state workers compensation agency and the Department of revenue also make similar classification determinations for their own purposes. Although the issues are relevant to independent contractors, they have not been examined in depth because they are beyond the scope of the study.

During the audit, the auditor examines payroll records and Form 1099-Misc issued by the employer. Expense records are also examined for possible items of unreported or misreported payroll. The auditor may identify a person or persons receiving money for services that have not been included on the employer's quarterly tax report, which alerts him to look for payments to other persons in similar circumstances. The determination may include a single employee or a class of employees.

Status determinations are also triggered when an individual is discharged by an employer and files a claim for benefits. The claimant's employer is notified and requested to provide information regarding employment and the reason for separation. At this time, the employer may raise the issue that the claimant was not an employee, but an independent contractor. Information is then obtained from both the employer and the individual claiming benefits and a determination is issued. If the determination was that the employee was misclassified, the employer is subject to back taxes, interest, and penalties. If there are others working in substantially similar situations, the employer will be required to pay UI taxes on those employees as well. In addition, an erroneous classification makes the employee eligible for workers' compensation benefits, and overtime, medical, retirement and other benefits if offered by the employer to other employees. There is an administrative hearing process in place that affords the employer and the claimant an opportunity to challenge the determination made by the agency.

Contested claims are the principal source for identifying misclassified workers. In many cases the claimants are unaware that their employer did not consider them employees. "In fact over 86% of the time when a claim is filed and the employer alleges that the individual was an independent contractor, the determination of the department is that the individual performed services for the employer in insured employment."[52] In Colorado and Florida, contested claims have led to reclassification of ICs to employees in approximately 90 to 95% of the cases.

[52] Study of Independent Contractor Compliance, Minnesota Department of Jobs and Training, February 1994, page 5

Wisconsin and Connecticut UI staff have witnessed an increasing number of employers' inquiries regarding use of independent contractors and the agency's rules in determining their status. Staff in Minnesota stated that employers in recent times are asking more specific details with regard to classification rules as they apply to a particular industry or type of employment. Oregon has seen a change in employers' attitudes in recent years. In the past, where employers would call for information and accept it, now they are more inclined to challenge or disbelieve the explanation. That may be because they are aware of other employers and their competitors treating employees as ICs. It may also be as a result of the increasing number of professional organizations offering their services in providing advice as to how status changes may be undertaken.

For purposes of estimating the number of employers who misclassify workers, the unpaid UI taxes, and the industries they are found in, this study relied on audit data provided by the UI agencies in a selected number of states.

5.2 The Measurement Process

The availability of data for analysis was entirely dependent on the willingness of state UI tax administrators to allocate their scarce resources to cooperate in our study. Some states were willing to cooperate, but their audit data were not stored in a manner that allowed easy access to the formats required for the study.[53]

The process outlined below represents an effort to estimate misclassification from the available employer audit data and extrapolate the data on misclassified workers to each state's workforce. Some inherent constraints in the audit data limit the accuracy of the estimates. In most states, the selection of employers for audits is conducted partially on a purely random basis and partially on a pre-determined or targeted basis. The targeting is a function of prior audit results and/or the probability of reporting error. Generally, audit results are not maintained by the method of selection. Therefore, in states where the

[53] The UI Tax staff in Maryland went the extra mile to convert vast amounts of data stored in paper audit records to an electronic format to comply with the study request.

audits are selected predominantly on a nonrandom basis or a combination of random and nonrandom, the estimates are not representative of the entire state employer population. Despite these limitations, the measurements were done to provide a rough magnitude of the scope of the misclassification.

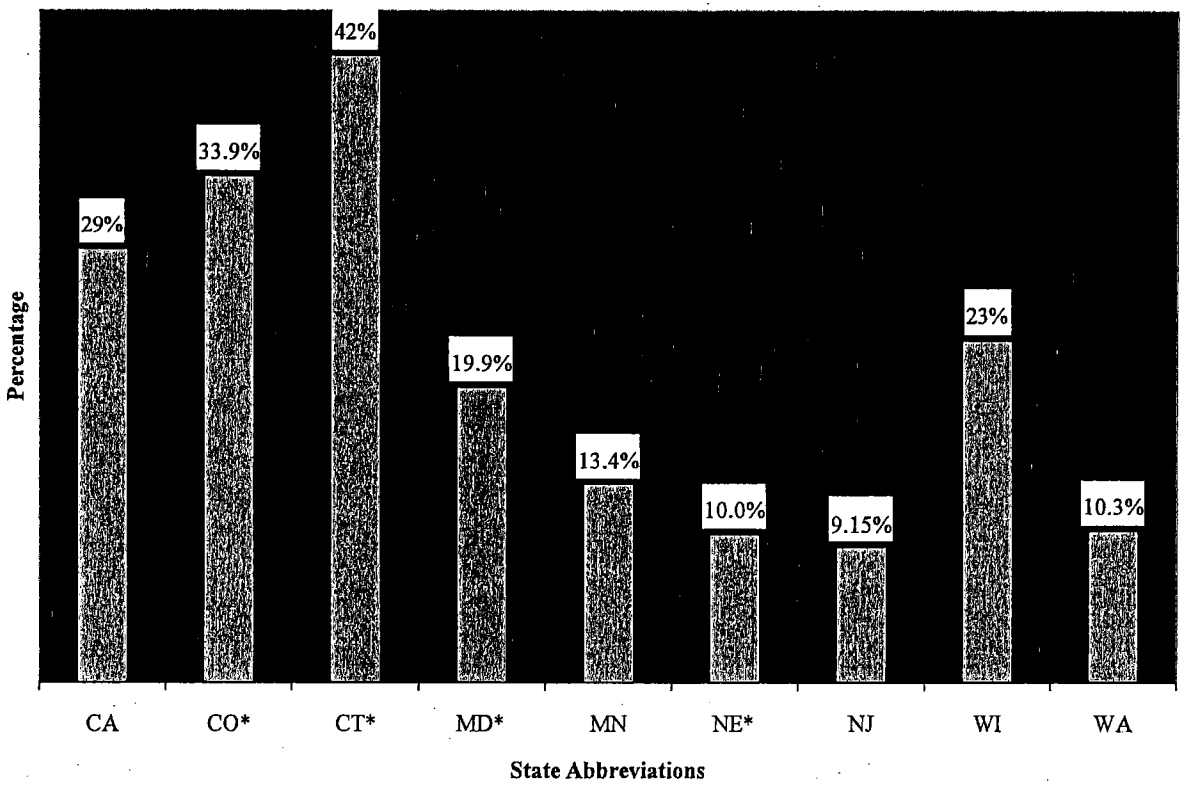
The types of data used, the computations and results for selected states are provided in appendices 3, 4 and 5.

5.3 Misclassified Employees and the impact on UI Tax Revenue

Among the states who provided data, there is a wide variation in the percentage of audited employers with employees misclassified as independent contractors. A random audit is likely to uncover fewer misclassified workers, whereas a targeted audit approach uncovers many more because specific employers and industries where misclassification is perceived to be higher are given priority in the audit selection process. Figure 5.1 displays 1988 data relating to random audits only. Targeted audits are not included.[54]

[54] NB: These results are based purely on each state's audit program in compliance with DOL audit recommendations. These results do not reflect states' own targeted audits. For example, California's percentage would change from 29% to 65% by incorporating targeted audits into the calculation.

Figure 5.1: Percentage of Audited Employers with Misclassified Workers



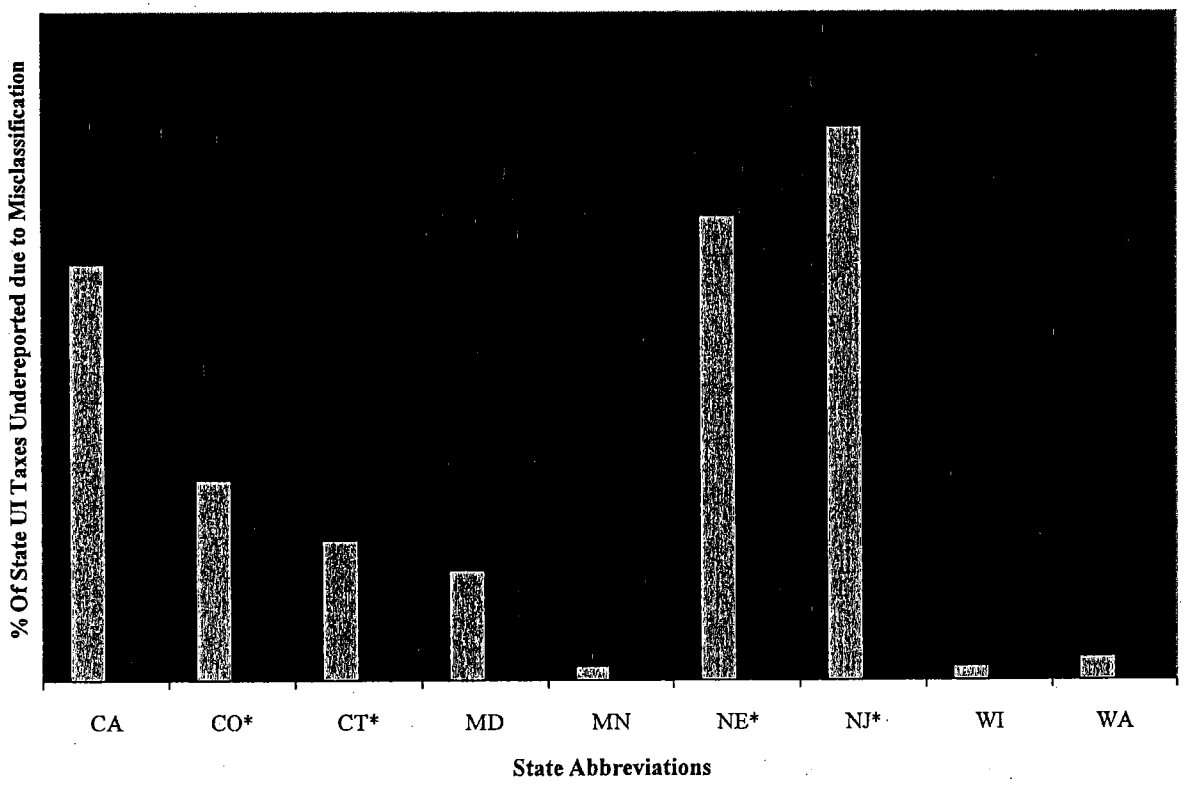
Source: Data supplied by each respective state Unemployment Insurance Department. * Only partial data was provided. The rest was estimated..

In New Jersey,[55] Nebraska, Washington and Minnesota, approximately 10% of the employers audited had employees misclassified as independent contractors. The relatively low percentage may be attributed to the high level of randomness in the audit sample selection processes. Approximately 30 to 50% of these audits were randomly selected. In the case of Wisconsin, a lesser percentage of the audit group (18%) was randomly selected, and as expected a higher percentage (23%) of the audited employers had misclassified employees. The estimates for Colorado and Maryland show that despite the high level of randomly selected audits (90% of Colorado's and 100% of Maryland's) high percentages of the audited employers (34 and 20%) had misclassified workers. However, since Colorado and Maryland were unable to supply all the data required for all the computations, some components of necessity were approximated and the results may not be accurate. California and Connecticut have a much higher proportion of audited employers with misclassified workers, 29% and 42% respectively. In the case of California, the randomly selected 1% of the audits (classified as USDOL compliant) was used for the estimate. One out of every three employers who was audited had employees misclassified as independent contractors, a ratio roughly consistent with Colorado and Maryland where the randomly selected employer sample was over 90%.

The estimated percentage of UI tax revenues underreported due to misclassification of employees is shown in Figure 5.2. Some states were unable to supply all the information required because this level of detail is not required in their reporting systems. They either provided estimates for some of the requested data or the missing components were calculated based on the other audit data that were provided. These computations are presented in appendix 4.

[55] In New Jersey, 30% of all audits are random and the other 70% is made up of a combination of re-audits, referrals from UI agencies, and leads.

Figure 5.2: Effect of Misclassification on UI Tax Revenues (1998)



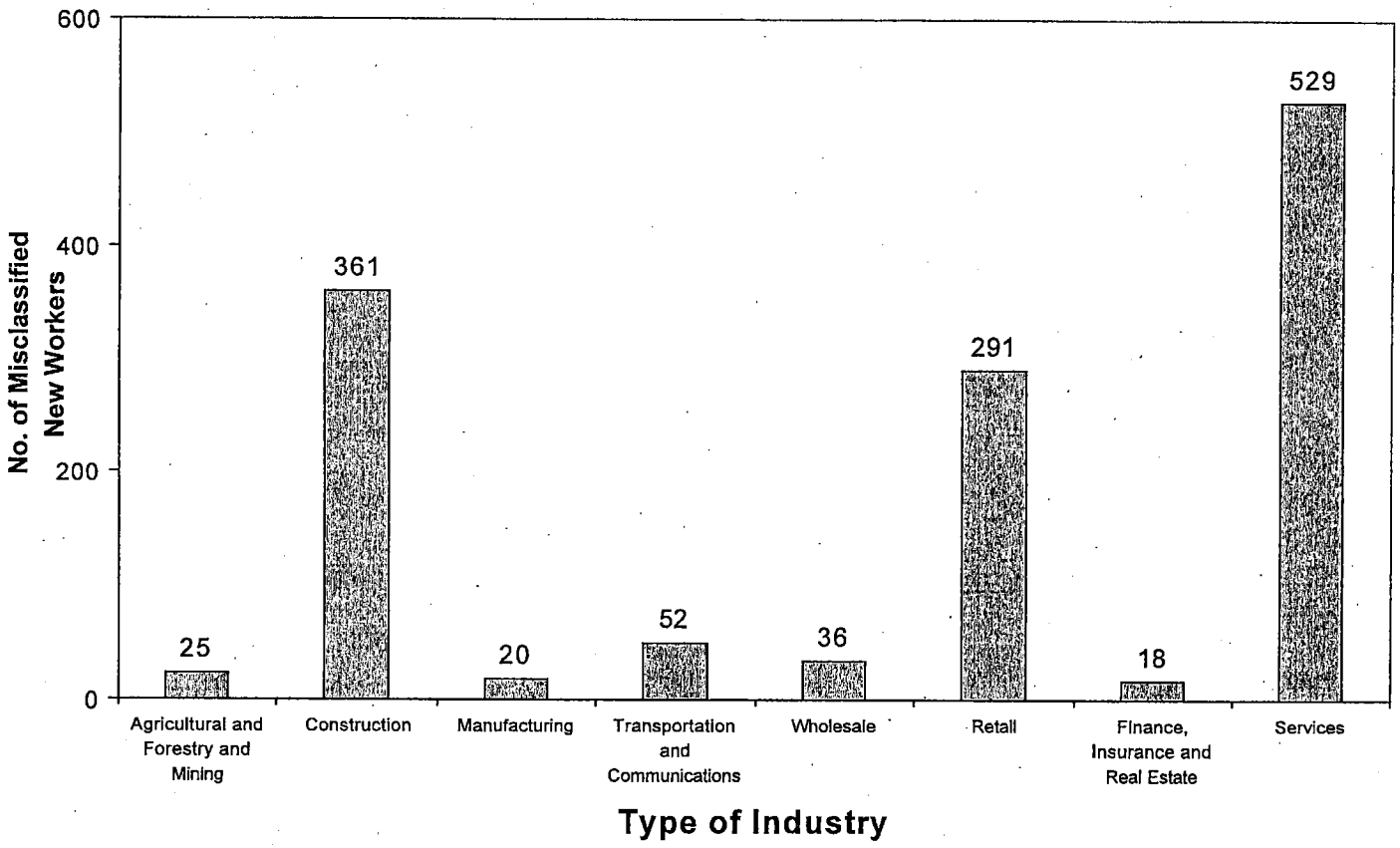
Source: Data supplied by each respective state Unemployment Insurance Department.
* Only partial data was provided. The rest was estimated.

According to the calculations, the effect of misclassification on UI tax revenues also vary significantly among the selected states. New Jersey and Nebraska have the highest percentages of underreported tax revenues, at 9.9% and 8.3%, respectively. However, it must be stressed that these two states were unable to supply all the data needed for the study computations therefore the computations relied more heavily on estimates. Excluding them, the range varied from less than one half of 1% to 7.5%, again a significant range of variance. California had the highest percentage of underreporting at 7.46%. Colorado, Connecticut and Maryland ranged between 2% and 3.6% and Minnesota, Wisconsin, and Washington all were under 1%.

The results essentially validated the opinions of state agency personnel. That is, the percentage of lost revenues derived solely from audit results would be relatively low compared to total revenues. Maryland UI administrators stated that the official audit statistics report captures only a "sliver" of the hidden wages present in the economy. They suggested that a more flexible audit approach might be more effective at identifying the full extent of worker misclassification and its impact on UI revenue. Other interviewees expressed this same viewpoint.

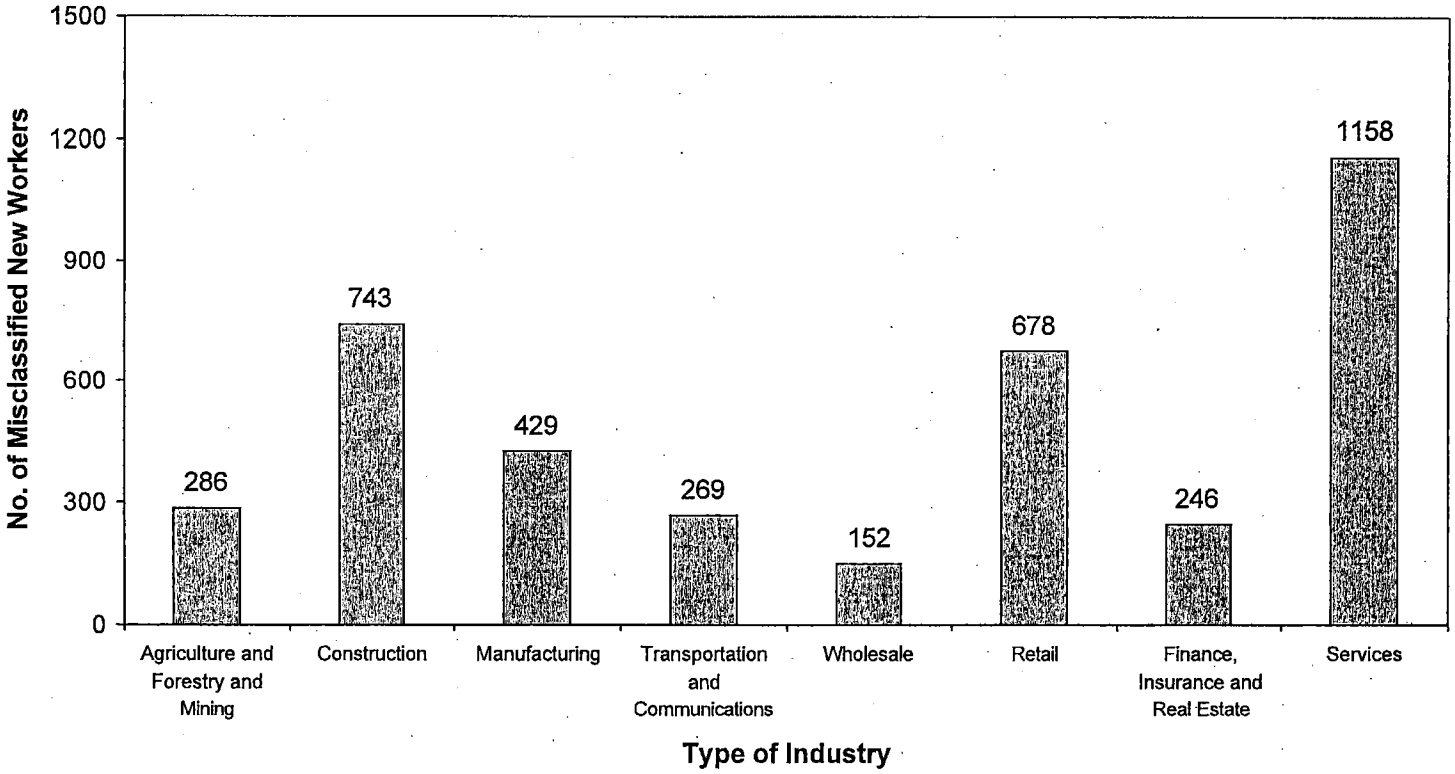
Administrators in Colorado offered an additional reason for states not capturing the full impact of misclassification in the employer audits. When states select the random audits, some of the employers with the lowest UI tax rates (such as .000, .001, and .002) may be dropped from the selection because of the perception that there is a higher probability of misclassification if the employer tax rate is higher. Because of low unemployment and a decline in the claimant population, trust fund balances are higher, and a lot of employers have low tax rates. Therefore in targeting the higher tax rate employers, the audits selected may be eliminating a segment of the misclassified workers in the lowest rated employer categories and minimizing the impact on tax revenues. This effect lends credence to the proposition that if the audits are to be selected on a random basis, then the selection must be truly and completely random if its results are to be used as an indication of the employer universe's compliance

Figure 5.3: Summary of Misclassification by Standard Industrial Classification (SIC) Code - Maryland 1998*



Source: Based on data supplied by the Maryland Department of Labor, Licensing and Regulation. * The information is not for the entire year.

Figure 5.4: Summary of Misclassification by Standard Industrial Classification (SIC) Code - Wisconsin 1998



Source: Based on data supplied by the state of Wisconsin Department of Workforce Development.

5.4 Industrial and Occupational Distribution of Misclassified Employees

Figures 5.3 and 5.4, shown above, provide a summary of employer misclassifications by industry for Maryland and Wisconsin, based on data supplied by their respective audit agencies for 1998. The data validate the opinions of UI staff and advocates for employers and unions. The data are organized by Standard Industrial Classification (SIC) Code into eight industrial sectors. The highest level of misclassification across each state was the service sector, followed by construction, retail and manufacturing which all showed high levels of misclassification.

Tables 5.1 and 5.2 illustrate the type of industry and the total number of new jobs created in 1998 for California and Washington. The highest percentage of misclassified workers in California was in the transport and communications sector, followed by construction and manufacturing. Washington also had high percentages of misclassified employees in construction and manufacturing.

Table 5.1: Misclassification by Industry and percentage in California – 1998

Industry Type	Total No. of New Jobs in 1998	No. of Misclassified Employees*	% of Misclassified
Agriculture, Forestry & Fishing	N/A	586	N/A
Construction	61,200	1741	2.8%
Manufacturing	37,000	964	2.6%
Transport & Communications	5,400	305	5.6%
Wholesale	24,700	121	0.5%
Retail	50,000	751	1.5%
Finance, Insurance & Real Estate	41,100	663	1.6%
Services	199,000	4347	2.2%
Total	**418,400**	**9,478**	**2.3%**

Source: Based on data supplied from the state of California Employment Development Department.
*The number of misclassified employees is derived from the 2% sample of employer audits.

Table 5.2: Misclassification by Industry and percentage in Washington State – 1998

Industry Type	Total No. of New Jobs in 1998	No. of Misclassified Employees*	% of Misclassified
Agriculture, Forestry & Fishing	4,736	148	3.1%
Construction	5,938	260	4.4%
Manufacturing	8,599	329	3.8%
Transport & Communications	3,750	28	0.7%
Wholesale	2,954	85	2.8%
Retail	12,880	290	2.3%
Finance, Insurance & Real Estate	6,956	185	2.7%
Services	31,465	942	3.0%
Total	**77,278**	**2,267**	**2.9%**

Source: Based on data supplied by the state of Washington Employment Security Department.
*The number of misclassified employees is derived from the 2% sample of employer audits.

Since only five of the states maintained an industrial breakdown of misclassified ICs by SIC code, the state audit department staff were asked to list the industries where they frequently encounter misclassifications. Their responses are provided below:

California –Services, landscaping, construction, manufacturing

Colorado - Construction, mortgage loan refinancing, consultants and services

Connecticut - Construction, insurance, real estate, trucking and delivery services, painting, medical offices, product demonstration, amusement companies, computer consulting, telephone and door to door solicitors, newspaper distributors and deliverers

Florida – Trucking, construction, home health

Indiana - Landscaping, trucking, construction, mortgage, insurance, and real estate

Maryland – Construction, cleaning services, home health, trucking, catering, cable and carpet installers, hygienists referred to dentists, secretaries to attorneys,

Minnesota - Service, retail & wholesale and construction, finance, insurance and real estate

New Jersey – Construction, home health, food processing and packaging,

New Mexico - Law firms, medical staffing for hospitals (temp. services), home health care, construction, trucking, product demonstrations, sales, and cleaning

Ohio - Construction, sales and trucking

Oregon - There does not seem to be any industry that does not use ICs. Construction, information systems, training and consulting

Texas - Eating and drinking establishments, trucking, warehousing, oil & gas industry, real estate, farm labor, non-residential building construction, special trade contractors, employment agencies, and general automotive repair shops.

Washington – Home companions, construction, high tech.

Wisconsin - Construction (especially drywall installers and roofers), carpet & tile installers, delivery persons, computer consulting & software development, janitorial, cleaning maintenance service, modeling & talent industry, medical (home health care, nurses, medical insurance examiner, and caregiver), sales, trucking, and entertainment/dancers.

5.5 Impact of Misclassification on Trust Funds

The measurement of the number of misclassified independent contractors in the workforce defies precision because SESAs do not maintain audit records and records of contested claims of discharged workers by category. Anecdotally, the estimates ranged from 1 to 25%. It is believed that this range was a result in part of the interchanging of the terms "misclassified worker" and "underground economy worker."

A national-level estimate of the impact of misclassification on the trust fund was done for the period 1990-1998. This type of aggregate estimate can be used to determine rates of misclassification in any particular state or region. The data used in the calculations for the average monthly covered employment, contributions collected, the number of first payments made, and benefits paid were obtained from the Bureau of Labor Statistics and The Unemployment Insurance Financial Data Handbook (ET 394). To arrive at a baseline estimate of the impact of misclassification on the trust fund, the calculations used certain assumptions:

- A 1% level of worker misclassification[56]; and

- The employment and earnings dynamics of the misclassified worker are expected to be the same as in the remainder of the workforce. These include the amount of taxable wages earned, the contributions on the earnings, the percentage of the workers who are likely to experience a spell of unemployment during the year, the duration of unemployment, and the amount of benefits payable.

The data illustrated in Table 5.3 are for nine consecutive years that encompass both an economic downturn and a sustained period of recovery. They show the outlying annual ranges of the estimated loss in contributions to the trust fund as a result of employers misclassifying workers, the benefits not paid by the fund due to underreporting, and the net potential impact on the trust fund.

As shown in Table 5.3, the net impact on the trust fund ranged from a $100 million outflow in 1991 to a $26 million inflow in 1997. The first 3 years 1990-1993, was a period of economic downturn, where the cumulative impact on the trust fund was an outflow of funds approaching $200 million. The last 3 years (1996-1998) included a period of economic expansion, where the cumulative impact shows an inflow of approximately $50 million. The 9-year cumulative effect, of a 1% level of worker misclassification on the trust fund is shown in line 12. It shows an outflow of $118 million, or an average annual outflow of approximately $13 million.

[56] Since five states provided the data to compute the effect of misclassification on UI tax revenue and four of the five showed an impact of less than 2%, a 1% level of misclassification was assumed.

Table 5.3: Impact of Misclassification on the UI Trust Fund

TAX CALCULATION		*YEAR*			
		1990	**1991**	**1992**	**1993**
1	*Average monthly covered employment*	87,008,189	84,905,782	85,098,137	86,850,536
2	*Contributions for the year*	$15,221,274,000	$14,510,670,000	$16,972,655,000	$19,831,045,000
3=(2/1)	*Annual contributions per covered worker per year*	$174.94	$170.90	$199.45	$228.34
4=(1%of 1)	*Number of misclassified workers*	870,082	849,058	850,981	868,505
5=(4x3)	*UI contributions not paid by employers*	**$152,212,740**	**$145,106,700**	**$169,726,550**	**$198,310,450**
BENEFIT CALCULATION					
6	*Number of first payments*	8,628,557	10,074,550	9,243,338	7,884,326
7	*Benefits paid for the year*	$17,320,777,000	$24,582,501,000	$23,956,510,000	$20,687,678,000
8=(7/6)	*Average benefits per first payment*	$2,007.38	$2,440.06	$2,591.76	$2,623.90
9=(6/1)	*First payment recipients/covered employment*	9.92%	11.87%	10.86%	9.08%
10=(4x9)x8	*Estimated payments not made to claimants due to misclassified workers*	**$173,207,770**	**$245,825,010**	**$239,565,100**	**$206,876,780**
	UI contributions not paid by employers	$152,212,740	$145,106,700	$169,726,550	$198,310,450
	Benefits not paid to claimants	$173,207,770	$245,825,010	$239,565,100	$206,876,780
11	*Net Potential effect on trust fund*	***-$20,995,030***	***-$100,718,310***	***-$69,838,550***	***-$8,566,330***
12	*Cumulative effect on the trust fund*	***-$20,995,030***	***-$121,713,340***	***-$191,551,890***	***-$200,118,220***

Table 5.3: Impact of Misclassification on the UI Trust Fund (Cont.)

TAX CALCULATION		***YEAR***				
		1994	**1995**	**1996**	**1997**	**1998**
1	*Average monthly covered employment*	89,690,770	92,328,088	94,685,734	97,837,884	100,247,482
2	*Contributions for the year*	$21,802,069,000	$21,970,828,000	$21,577,968,000	$21,247,040,000	$19,825,155,000
3=(2/1)	*Annual contributions per covered worker per year*	$243.08	$237.96	$227.89	$217.17	$197.76
4=(1%of 1)	*Number of misclassified workers*	896,908	923,281	946,857	978,379	1,002,474
5=(4x3)	*UI contributions not paid by employers*	**$218,020,690**	**$219,708,280**	**$215,779,680**	**$212,474,567**	**$198,249,258**
BENEFIT CALCULATION						
6	*Number of first payments*	7,959,281	8,035,229	7,989,615	7,325,279	7,331,890
7	*Benefits paid for the year*	$20,433,832,000	$20,122,189,000	$20,634,904,000	$18,605,353,000	$18,433,293,000
8=(7/6)	*Average benefits per first payment*	$2,567.30	$2,504.25	$2,582.72	$2,539.88	$2,514.13
9=(6/1)	*First payment recipients/covered employment*	8.87%	8.70%	8.44%	7.49%	7.31%
10=(4x9)x8	*Estimated payments not made to claimants due to misclassified workers*	**$204,338,320**	**$201,221,890**	**$206,349,040**	**$186,053,560**	**$184,332,779**
	UI contributions not paid by employers	$218,020,690	$219,708,280	$215,779,680	$212,474,567	$198,249,258
	Benefits not paid to claimants	$204,338,320	$201,221,890	$206,349,040	$186,053,560	$184,332,779
11	*Net Potential effect on trust fund*	***$13,682,370***	***$18,486,390***	***$9,430,640***	***$26,421,007***	***$13,916,479***
12	*Cumulative effect on the trust fund*	***-$186,435,850***	***-$167,949,460***	***-$158,518,820***	***-$132,097,813***	***-$118,181,334***

The average annual national impact that would be representative of the 9-year period was also computed. The median annual contribution per person (1993) and the median average benefit (1997) were applied to the most recent number of workers in covered employment (1998). The calculation is shown in Table 5.4 below.

Table 5.4: Estimated Average National Impact on the UI Trust Fund

UNREALIZED REVENUE	
1. 1998 average monthly covered employment	100,247,482
2. 1993 annual contributions (median value for 9 years)	$19,831,045,000
3. Annual contribution per person per year (line 2/ line 1)	$197.82
4. No. Of misclassified workers(1% level of misclassification assumed)	1,002,474
5. Estimated revenue lost (line 4 * line 3)	**$198,309,406**
UNPAID BENEFITS	
6. 1996 number of first payments (median value for 9 years)	7,989,615
7. Ratio of first payments to covered employment (line 6/line1)	8%
8. 1997 average benefits per claimant (median value for 9 years)	$2539.88
9. No. of misclassified workers filing for benefits(line 7 * line 4)	80,197
10. Estimated unpaid benefits (line 8 x line 9)	**$203,690,756**

The results suggested that over this 9-year period, assuming a 1% level of worker misclassification, the loss in revenue from underreporting UI taxes would be an annual average of $198 million. If the unemployment level remained at the 1997 level, the outflow of benefits payable to the misclassified claimants would be on average $203 million annually.

Although the calculation indicates an estimated difference between revenue and benefit payments, such a difference, whether a positive or a negative number, would, over the longer term, likely be overcome by the workings of the experience rating system. This system assigns annual contribution rates to employers based on the existing reserves in the UI system relative to the potential current exposure to worker unemployment. ***A more significant implication of misclassification is that annually there are some 80,000 workers who are entitled to benefits, but do not receive them.***

5.6 Overall Assessment of Misclassification

Misclassification of workers is not new and will continue to occur. Typically, employers are trying to reduce expenses, and labor and its associated costs are easiest to control. The interviewees have expressed several reasons for this. Chief among these is the rising costs of workers' compensation premiums. Other reasons cited were the fact that corporate downsizing has led workers to feel that their long-term financial security rests in their taking control of their careers rather than remaining vulnerable to the perceived vagaries of the economic cycle. Increased automation is changing the manner in which business is conducted lessening the degree of supervision, direction and control that is a fundamental component in determining employment status.

These and other factors noted earlier in this report have contributed to the likely increased incidence of misclassification, although not all interviewees agreed. Connecticut, Oregon and California's staff have seen increases in assessments and reclassifications. Staff in Nebraska, New Jersey and California believes that there are more workers who are readily agreeing to accept IC status, often times out of desperation. It has become more difficult to get claimants to testify against employers, which weakens the agency's case against an employer. According to a member of the Ohio audit staff "misclassification of worker is a never ending cycle that will continue until changes are made to cover all workers performing services for a business. In many cases, employers caught will continue to use the same methods of classifying workers because they get away with it."

If an employer and worker agree to an independent contractor arrangement, the court system seems to condone the agreement. Florida, Nebraska, and Maryland UI staff commented that the current judicial decisions seems to be pro-employer and eroding a basic premise of the UI program. The Florida appeals staff reported that most frequently the courts ruled against the agency and determined that workers were independent contractors. For example, the courts determined that drywall installers and individuals working for cleaning contractors are ICs. In every state that participated in the study, one or more groups are requesting exemptions. The Oregon governor in his veto of a bill to

confer independent status on a segment of the pharmacist profession expressed concerns about this trend of requesting exemptions.

When the economy is strong, workers who lose their job often find new jobs very quickly. In most states this has led to the lowest unemployment rate in more than 25 years. Employer contribution rates are also very low and trust fund reserves are increasing. The number of IC/employee rulings has decreased somewhat in the last 3 years. One observation expressed by most interviewees was that an increase in the unemployment rate could precipitate an avalanche of independent contractor related issues. Workers operating under what at present looks like a good IC agreement would be filing UI claims alleging worker status. The administrative burden associated with a significant rise in contested claims could prove disruptive to orderly claims processing.

CHAPTER 6

ADMINISTRATIVE AND LEGISLATIVE RESPONSES OF STATES TO WORKER PROTECTION ISSUES

The first section in this chapter summarizes recent legislative responses of state legislatures and UI agencies on independent contractor issues. Next the issues of workers' compensation, the underground economy, and information sharing are described. The chapter concludes with an overall assessment of the impact of worker misclassification.

6.1 Legislative Issues and Responses

The issue of misclassification has received an increasing amount of attention in recent years in areas unrelated to unemployment insurance. The absence of a clear definition of contingent workers could affect businesses detrimentally as independent contractors and other contingent workers litigate their status and force courts to decide the issue. This sometimes results in awards of back pay and benefits to plaintiffs who challenged their independent contractor status. According to Employment Benefit Research Institute economists "In the absence of congressional activity, employers of independent contractors could be forced to give up considerable managerial control of these workers to ensure that they are not seen as common law employees. If not, they risk incurring substantial costs for retroactive tax payments and benefit expenditures, in addition to the cost of treating current and future independent contractor as employees."[57]

Chief among these is the Microsoft Corporation case in which the company's policy of excluding its long-term temporary workers from participation in its employee benefit plans was overturned by the court. In a case against Pacific G&E it was also held that employees of temporary service agencies engaged by Pacific G&E were to be considered employees for purposes of rights to the company's employee benefit plan unless they

[57] Contingent Workers and Workers in Alternative Work Arrangements, EBRI, 1999

were specifically excluded by written contract. While not specifically ruled upon, this finding is potentially applicable to independent contractors as well.

In 1998, the USDOL brought suit against the Time-Warner Corporation, alleging that the company misclassified some 1000 workers to avoid their entitlement to the company's retirement and health benefits plans. Many believe that the USDOL's action will be the forerunner of further legal actions in this area.

Governmental entities are not immune from this issue. In 1998, *Washington State's* King County settled a class-action lawsuit brought by temporary employees because of their exclusion from employee benefit plans. The county agreed to a $24 million settlement.

On the legislative front, there is evidence of renewed interest in finding a means to introduce a greater degree of certainty in the classification process. In 1995, a bill was introduced in the U.S. House of Representatives by Congressman Jan Christenson for this purpose. In 1996, senators Nickles, Bond, and Snowe introduced the Independent Contractor Tax Simplification Act. This bill was supported by over 50 trade and industry associations, who asserted that because Americans are becoming more entrepreneurial and are increasingly working at home, it makes sense to classify more workers as independent contractors. Senator Nickles termed the present common-law test "the bane of workers and employers across the country." Labor unions opposed the bill, insisting that it would shift millions of employees to IC status and eliminate basic protection.

In 1999, representatives Jerry Kleczka and Amory Houghton sponsored the Independent Contractor Clarification Act, to bring up the issue of recognizing that workers as well as employers are disadvantaged by the current criteria. Their proposal would replace the present common-law rules with ones that would make determination of IC status less subjective. They propose to get rid of the 20-factor test of the IRS, and classify service providers as employees unless they exercise control over their own work, are free to handle more clients, and assume some entrepreneurial risk.

States, too, are beginning to revisit this issue. In New York, Governor Pataki recently signed Executive Order 78 establishing the Governor's Task Force on Independent Contractors. He cited the need to establish a system by which determinations of employee and independent contractor status are made simply, consistently, and fairly. The task force held public hearings and developed a series of recommendations that are now before the governor for review and implementation.

In 1994, the Montana Legislative Council, in fulfilling the requirements of House Joint Resolution 33, submitted a report to the governor and the legislature on concerns regarding independent contractor status, licensing, and employee leasing. Particular emphasis was placed on the IC exemption from workers compensation. A proposal has been considered in Washington state to fund a study to assess the impact that the increasing use of IC's and other contingent workers, has had on workers, their families, and the economy in general.

It has been observed that most state legislative actions on this issue have been to enact specific exclusions from the definition of employment. One exception was Oregon, where a proposal to exclude certain pharmacists was vetoed by Governor Kitzhaser. In his veto message, the governor commented that many proposals had been introduced and enacted in the past to exclude certain employees from unemployment insurance coverage and that the cumulative effect of these exclusions had been to erode the protection intended by the system. "As the number and scope of proposals to erode coverage has increased over the years, I have become progressively more concerned about the cumulative effect of these exemptions....It is time that we adopt a state policy recognizing the importance of having an inclusive program..."[58]

In California, Assembly Bill 70 (AB70) introduced by Assemblyman Jim Cunneen, and sponsored by the California Chamber of Commerce, proposes a clarification of rules to distinguish employees from ICs. It proposes to changes the state guidelines for determining the tax status of an IC to conform to the "safe harbor" provisions of the

[58] John A Kitzhaser, Letter to Speaker of the House, July 14th, 1999.

federal law of 1996 (Small Business Job Protection Act). AB70 mirrors the federal law, but extends the safe harbor relief to employers who hire technology workers (engineers, computer programmers, systems analysts, and other similarly skilled workers). Businesses and conservative interests support this clarification, which relaxes the UI employee classification criteria by making UI criteria more like those used by the IRS. Unions oppose the bill because it would make it easier for employers to reclassify existing workers and hire new ones as ICs.

Under current federal labor law, independent contractors are not allowed to form or join unions. The AFL-CIO's legislative agenda includes a proposal to protect full-time workers from being labeled by their employers as independent contractors to hold down labor costs. Unions argue that when employees are turned into independent contractors, society at large will have to foot the bill for those without insurance or pensions. Unions have been struggling to maintain membership, and their numbers will not change unless they capture new workers.

Healthcare, high tech, trucking, and temporary workers working on a long-term basis are the biggest groups where worker misclassification abounds. In 1987, the California State courts ruled that some 180,000 homecare aides were independent contractors and thus were without the right to unionize. In 1992, the legislature created authorities to carry out the state's homecare programs utilizing these workers as employees. This year, 74,000 of these workers voted to unionize in order to obtain certain employee benefits that were previously denied. It is anticipated that unionization efforts will extend to other areas in California as well as New York, Oregon, and Washington State.

6.2 Workers' Compensation

In researching this report, the question arose as to the principal factor or factors that were driving the observed incidence of worker misclassification. The avoidance of the payment of unemployment insurance contributions, while a cost factor, did not seem to

be of enough value to warrant the degree of risk associated with misclassification. In discussions, governmental officials were unanimous in citing the present cost of workers compensation as the single most dominant reason for misclassification. Employers avoid the costs of paying workers compensation premiums by allowing or mandating that persons who work for them have an independent contractor exemption. This allows those employers to underbid the legitimate employers who provide coverage for their employees.

There are problems in regulating the proof of workers' compensation or independent contractor exemption status. Workers' compensation agency officials in Florida and California described the retroactive use of workers' compensation, where independent contractors file claims for benefits as employees when they are injured. The insurers have to pay benefits for workers they never received premiums for. Some workers, who have been independent contractors and therefore exempted from workers' compensation for many years, become employees and get covered under workers' compensation without having paid premiums for all of the previous years and claim injury-related compensation.

These officials indicated that the costs of workers' compensation in the construction and homecare industries were among the highest of all industries. These costs contributed to the relatively high incidence of misclassification within these two industries. This issue is not limited to the private sector. State agencies also use independent contractor status to avoid conferring employee status and paying workers' compensation because they are given the authorization to spend money on contracted services, but not on full-time employees.[59]

This opinion was borne out in large measure in discussions with representatives of workers' compensation agencies and staff members of the National Council on Compensation Insurance (NCCI). The workers' compensation officials pointed out that

[59] Workers' Compensation Emerging Issues: Independent Contractors, Contractor Licensing, and Employee Leasing, Montana Legislative Council, November 1994, p 7

medical services were a major component of workers' compensation awards and that the continually rising costs of medical care contributed significantly to the premium costs.

Another factor cited by the NCCI was that the cost of premiums has led to the miscoding of workers by occupation to gain a more favorable rate. The occurrence of miscoding (termed misclassification by the insurance industry) has increased to such an extent in the past 5 to 10 years that the insurance industry has doubled its audit and compliance activities during this period. The miscoding shifts costs to other employers, thus contributing to the increasing rates. This increase, in turn, provides the financial incentive for the misclassification of workers.

6.3 Information Sharing among Agencies

State Employment Security Agencies and the IRS

SESAs have data-sharing agreements with the IRS under state law and Internal Revenue Code Section 6103 which pertains to confidentiality and disclosure restrictions related to release of information to assist in tax enforcement efforts. Both agencies collect taxes; both rely on voluntary compliance in order to meet revenue forecasts; and both conduct employer audits, some random and some targeted. In addition, both the IRS and the states determine employer-employee relationships based on their respective laws, regulations, and policies. However, little information is in fact shared.

Employers report employee wages to the IRS on Form W-2, whereas payments to ICs are reported on IRS Form 1099-Misc. The IRS also receives reported income (Form 1040s) from employees and independent contractors. Employers are only required to report wages to the SESA. Unless the state conducts an audit, or a worker files a claim for unemployment insurance benefits that results in a blocked claim, the only other recourse available to a UI agency in determining an employer-employee relationship is to conduct an investigation. In discussions with state officials, it was understood that the extent of the information sharing was generally limited to providing unemployment insurance audit results to the IRS. It was an exception when information flowed in the other direction.

There is no doubt that the sharing of 1099-Misc information on a systematic basis would enhance the operations of the UI tax operation. If the IRS routinely provided the SESA with 1099-Misc information, the data could be matched with UI tax information to determine if employers were converting employees to IC status. In addition, companies known to have large numbers of independent contractors and very few employees could be investigated for possible misclassification.

In discussions with California UI officials, it was learned that IRS data was an integral component of their multi agency task force efforts devoted to uncovering misclassified employees as well as unreported wages. The primary data used in this effort were from Form 1099-Misc on which non-employee compensation is to be reported to the IRS. Despite the fact that the 1099-Misc data received by the UI agency is one and a half to two years old, this data has proved to be extremely effective in terms of successful rates of discovery. It was pointed out that access to this kind of data was more readily available in California than in other states because UI taxes are collected by the state's Employment Development Department along with the state's withholding tax. Connecticut also uses 1099s from the Department of Revenue Services to assist in selection of audits and in uncovering misclassified employees and unreported wages.

It was not entirely clear as to why this type of information exchange was not routinely used by other states in their unemployment insurance tax enforcement programs. Some state officials (e.g. Ohio) were of the opinion that the disclosure of these data was not permissible under the current data-sharing agreements. Others suggested that their budget resources would not permit an undertaking of any meaningful magnitude. Wisconsin and New Mexico officials acknowledged that having 1099-Misc would be of value and that USDOL should develop software and a computer program to extract the useful data from the IRS 1099 tapes so any state could use them.

In Texas, 1099s issued to ICs over a certain dollar amount and reviewed during the course of an audit are investigated for liability under the Texas Unemployment Compensation Act if they do not have an established account with the agency. UI

officials stated that the results of employment tax audits conducted by IRS were sharable under the agreements. However, it was understood that these kinds of audits were so limited in number as to be an insignificant part of their enforcement efforts. The rationale advanced was that misclassified workers would still be subject to income taxes and self-employment taxes, and that the net financial effect of an audit would be largely offset by taxes reported as independent contractors. This rationale, of course, does not apply to either state UI taxes or the federal unemployment tax.

Other Best Practices

Connecticut conducts joint audits with its departments of revenue services and consumer protection. Indiana passed a change in state law effective July 1, 1999 that enables its UI agency to perform joint audits with other state agencies. Oregon conducts a few joint audits. A staff person who believes an employer is incorrectly reporting to most agencies usually initiates them. Most requests come from the Department of Revenue and UI staff assists the revenue agents by conducting a majority of the audits.

The SESA staff in Connecticut reported that their public relations campaign in educating employers regarding the use of ICs and its aggressive audit program have resulted in a minimal impact of misclassification on their UI program.

In Massachusetts, the Foundation for Fair Contracting, which monitors construction projects across states, run ads on cable networks to warn workers about the illegal labor practices of "unscrupulous contractors who know the law but choose to break it."[60] The TV spots warn workers that contractors who pay below the prevailing wage, refuse to pay overtime, or misclassify employees as ICs are violating state law.

New Initiatives

In addition to the initiatives outlined above, there are several other efforts being undertaken that will improve a state's ability to uncover misclassified workers. Some of

[60]Diane E. Lewis, "Ads warn workers on illegal labor practices," Boston Globe, April 5th 1999

these have been undertaken by the USDOL, while others are joint efforts between state and federal agencies. Some of these are described below:

Effective January 1, 1999 the USDOL modified its Field Audit Function to require that the discovery by the states of misclassifications during the field audit process are to be recorded and reported to the national office on its Form ETA 581. This is an excellent first step in the attempt to quantify the extent of misclassifications and will be valuable when viewed in a timeline reference. It is also valuable in that it utilizes existing data reporting mechanisms thereby contributing little additional burden on the state staffs.

However, there are drawbacks to using the data accumulated under this process. Most states "target" their audits toward employers or industries where past results have indicated that erroneous reporting is likely to occur. Resulting data would have to be carefully analyzed to accommodate the skewing effect of the audit selection process. Additionally, the number of audits conducted in the recent past is quite low and, if this level of audits continue, the resulting data would require extra analytical modification.

Montana has formed a partnership between its Department of Revenue, Department of Labor and Industry, and the Internal Revenue Service to enable employers to file a combined Montana state and federal tax report giving UI tax, state income tax, and withholding data. The state UI tax and income tax units have been combined within the state's Department of Revenue. On the same form that is submitted quarterly, employers report federal income tax withholding, Social Security and Medicare taxes, advance earned-income credit payments, and federal tax deposits made each month during the quarter. All state taxes are submitted on one check. Federal taxes, however, must be submitted separately to the IRS. However, this represents a significant improvement in cross-matching and utilizing data to ensure consistency in reporting. It enhances the state's ability to allocate its scarce audit resources so it can target employers that are potentially misclassifying their workers.

Wyoming has initiated a Joint Reporting Project for Unemployment Insurance and Worker's Safety & Compensation. The project has grown significantly with 12,000 employers now submitting a combined report. The report is submitted to the Wyoming Employment Resources Division. It has greatly facilitated the selection of employers for joint audits.

Inter-Agency Task forces

California created the Joint Enforcement Strike Force in 1993. Two enforcement efforts were implemented - the Employment Enforcement Task Force (EETF) and the Construction Enforcement Task Force (CEP). The goal was to maximize resources in a way that would reach lawbreakers in order to clamp down on those who illegally undercut competitors and deny their workers the benefits that they deserve.

Member agencies include the Employment Development Department, which was also the lead agency; the Department of Consumer Affairs; the Department of Industrial Relations; the Office of Criminal Justice Planning; the Franchise Tax Board; the Board of Equalization; and the Department of Justice.

The strike force has achieved significant results. The collective enforcement capability allows participating agencies to address multiple rather than single violations of law. The multiple enforcement efforts with their associated citations, penalties, and assessments have had a significant effect on businesses in the underground economy. Because of the strike force's actions, these companies are either being driven into the legitimate economy or put out of business. The pressure of unlawful competition is being reduced for honest businesses.

Information sharing between member and nonmember agencies continues to improve. The members have access to each other's databases. The strike force continues to refine and improve its detection and investigative techniques. This improvement is attributed to new techniques for developing needs, increased joint investigations with other law enforcement agencies, and more experienced EETF staff. The introduction of the CEP

has illustrated how flexible a strike force can be in adopting different enforcement techniques to different industries.

6.4 The Underground Economy

In conducting research for this report, almost all of the interviewees equated employee misclassification with the operation of the underground economy. There was little substantive difference between reporting an employee as an IC and not reporting him or her at all. It is for this reason that a discussion of the operation of the underground economy is relevant here, with particular emphasis on how it is related to worker's wages.

This section reviews some aspects of the underground economy by looking at some of the typical schemes that are currently in operation. As will be seen, misclassification in all the schemes is done to avoid employment taxes and applicable labor laws.

In the underground economy, workers and business owners, both small and large, and from a variety of industries, are breaking labor and tax laws. They need to either gain a competitive advantage on a rival firm, or to catch up with a rival who may have been operating within the underground economy for some time. There are several schemes[61] commonly used by employers including:

- Skimming. Businesses record and report only a percentage of their sales in order to reduce their taxable income and gross receipts.
- Refunds/rebates. A customer intentionally overpays for supplies and receives a refund check for the difference. The refunds are not paid into the business account and are used as a source of cash for paying undocumented wages. This occurs in any business where the purchase of materials is commonplace, e.g. construction.
- Laundering (money exchange). There is usually collusion between two contractors. Checks are issued to the subcontractor and recorded as legitimate expenses in the books. The subcontractor cashes the checks, usually at the prime contractor's bank, keeps a percentage, and returns the balance cash to pay undocumented wages. Alternatively, the subcontractor acts as a paymaster and distributes the checks to the prime contractors employees.

[61] Source: Joint Enforcement Strike Force on the Underground Economy, February 1,1999 by the State of California Employment Development Department

- Payments to crew leaders. A supervisor or other trusted employee is required to disguise the payment of wages. The crew leader receives payments disguised in the company accounts as legitimate business expenses along with his regular paycheck. The crew leader uses the disguised business expenses to issue cash payments to crew members. The crew leader may receive an incentive as a reward for participating in this scheme.

- Fraudulent disbursement records. Fraudulent entries are made in cash disbursement journals, payroll journals, or check registers. These records will agree with reported wages. In reality, these entries will not agree with the amounts on canceled checks. Common discrepancies include different payees, different payment amounts, and missing payments. The result is deliberately underreported wages.

- Dual records. In the underground economy, contractors often maintain two sets of books. One set shows all transactions used for tax purposes, and the other set documents transactions that the contractor wishes to withhold from the IRS. Another device is to pay for an individual's services partially as an employee, (thus making him available for all the social benefits and safeguards, such as social security, worker's compensation and union membership). The other part is paid off the books or as rental for building equipment or trucks.

6.4.1 California's Response

As indicated earlier, California's response to the underground economy was to create two enforcement agencies in 1993. The EETF became operational in February 1994 and as of December 31, 1998 had accomplished the following: 6361 investigations had been conducted resulting in the issuing of 5360 citations for violations of the labor code. The investigations also initiated 3102 payroll tax audits, of which 2522 have been completed, resulting in assessments totaling $35,467,454 in unpaid employment taxes, penalties, and interest. As a further result of the investigations, 22,873 workers who should have been classified as employees were identified. Average EDD Payroll tax assessments resulting from EETF referrals have increased dramatically, from $3397 in 1994 to $21,085 in 1998. In 1998, the average assessment was 1.7 times greater than the average assessment resulting from the regular audit program. Average labor code

citations resulting from EETF investigations also increased from $3118 in 1994 to $6206 in 1998.[62]

The investigative techniques used by the EETF were not effective in the construction industry, which led to the implementation of the construction enforcement task force (CEP). The CEP was initially implemented as a 9-month pilot project in the Sacramento area; however, it was expanded to a statewide effort on December 31, 1995 because of its outstanding success during the pilot period. Since 1994 the CEP has initiated 935 audits in the construction industry, of which 746 have been completed, resulting in assessments of $32,062,263 in unpaid unemployment taxes, penalties, and interest. In addition, 12,320 workers were identified who should have been classified as employees, but were not.

6.4.2 New Jersey's Response

In 1997, New Jersey's Commission of Investigation carried out an investigation into the underground economy and in particular the contract labor business. New Jersey's agricultural and manufacturing industries have been subverted at taxpayers expense by a lucrative underground economy that benefits contractors who trade in cheap, and sometimes illegal immigrant labor.[63]

The employers consist of owners and managers of commercial agricultural processing plants and industrial manufacturing facilities that need workers who will perform menial tasks for which traditional full-time labor or machinery is too expensive. Factory managers informed the commission that they have turned to the immigrant worker supply because they were unable to fill the positions with employees from the local economy, who are not willing to take jobs at or below minimum wage. These tasks include removing bones from poultry, shelling clams, sorting and packing produce and readying finished products.

---

[62] *ibid*

The labor pool is made up of immigrants from South and Central America and Southeast Asia who are willing to take jobs at or below minimum wage. These people are picked up at street corners in overcrowded vans and driven to factories to work long shifts.

Labor violations similar to those in California were discovered and recommendations were made to clamp down on the illegal activities. Neither the contract-labor provider, nor the processor or manufacturer using the provider's services took responsibility for the proper withholding and submitting of state income and employment taxes. Each took the stance that the worker was an IC responsible for his or her own filing of taxes, although this was blatantly not the case.

The Case of the Vegetable Processing Industry

The systematic abuses currently being carried out in the underground economy can be illustrated with an example from the vegetable processing industry. Between 1993 and 1996, several firms based in New Jersey, including a leading processor of fresh fruit and vegetables, paid over $18 million for contract labor supplied by a succession of individuals. The individuals were all members of the same extended family, and they have used these family ties as one of several devices in a scheme to plunder the tax system.

During that same 4-year span, no federal or state income taxes were withheld from the wages of thousands of workers who were supplied to the processors. The labor providers substantially understated their own corporate earnings for tax purposes, and failed to pay on behalf of their workers approximately $2.4 million in federal payroll taxes for Social Security and Medicare, and a further $119,000 in state unemployment and disability insurance taxes. Many of the workers possessed bogus Social Security numbers.

[63] Source: Contract Labor - The Making of an Underground Economy, September 1997 by the State of New Jersey Commission of Investigation (pp.3-12)

The provider was a Cambodian immigrant who served as a crew leader, supplying workers to plants in the poultry and vegetable processing industries. A 1993 audit of his books by the New Jersey Department of Labor discovered that he had been underreporting his worker's wages for the previous 5 years. At this point, the labor provider relinquished control of his business to his wife and several in-laws who ran the business in their name before forming a new corporation. Ploys such as this one enabled the crew leader to effectively dodge state efforts to collect the unpaid UI/Temporary Disability Insurance obligations.

Under the current arrangement, the firm provides approximately 195 workers per day to a plant that processes lettuce and other salad condiments pre-prepared for retail outlets. The crew leader receives a lump sum from the plant equating to $6.75 per hour of labor worked by his staff, who are paid at a rate of $5.05 per hour in cash. The labor provider received a gross amount of $18,262,829 for the period 1993-1996 from all processing plants. No money was withheld from workers pay packets for state and federal tax purposes, and payroll taxes were not deducted.

The labor provider takes the position that the workers are independent contractors and are responsible for compliance on their own. However, a written agreement entered into between plant officials and the labor provider clearly states, for example, that the provider is responsible for deducting unemployment and worker's compensation as well as the employee's share of Social Security. Officials of the processing plant, meanwhile, regard the workers as direct employees of the labor provider and play no role in oversight of tax compliance involving the workers.

The commission recommended a joint employer for tax purposes. Other recommendations included a proposal to consolidate contract labor providers under one regulatory scheme, the transfer of UI/TDI collection functions to the Department of the Treasury, and the expansion of employee verification programs.

6.5 The Erosion of UI Coverage and FUTA

Excluding certain employment and wages from state unemployment insurance seems to be popular these days. During recent years, some employers have gone to their state legislatures for special exclusions from UI. These same employers were caught as a result of their ex-employee independent contractors filing unemployment insurance claims and were therefore subject to audit investigations and tax assessments. Political events in many states are resulting in even more occupations receiving exclusions. Advocates of new exclusions have pointed to previous exclusions as the rationale for their group. As the number of federally impermissible exclusions has increased, employment security staff has become concerned about the erosion of UI coverage for workers.

Under the current FUTA, a tax credit is applied against the full FUTA tax of 6.2% only on those wages that are subject to the state's UI tax. The IRS Employer Tax Guide Circular E makes an oblique reference in the deposit instructions as "If any part of wages subject to FUTA are exempt from state unemployment tax, you may deposit more than the .008 rate." These instructions do not inform employers on what rate to use for making deposits and how the total tax is to be computed. If an employer had wages subject to FUTA but **not** subject to the state, then the employer would not be allowed the credit and be required to pay the full 6.2% FUTA tax. Thus, if certain wages are subject to FUTA but not to UI, then no credit is allowed and the full FUTA tax is payable on those wages. It appears that there is no process in place, on either the state or federal level, to ensure that this provision is enforced.

6.6 Overall Impact of Misclassification

The employer community is not totally free of the adverse impacts of misclassification. Cost considerations and aggressive competition are twin pressures that induce an employer to engage in behavior that creates an inequitable playing field in the business community for employers who correctly classify their employees and pay taxes.

Many employers believe the risk is acceptable when viewed against the survival of their business. Their view of the risk involved, however, is mostly limited to the retroactive payment of some payroll taxes and possibly some fringe benefits. Other infringements of the law can carry substantial liabilities. Among these are the retirement and health benefit rules under ERISA, the Age Discrimination in Employment Act, the Americans with Disabilities Act, and the Fair Labor Standards Practices Act, as well as similar laws within the states. Employers, particularly small employers, need to be aware of these risks, which, are potentially of greater impact than payroll taxes.

Misclassification has little impact on workers who file claims. Once a claim is filed, their rights are protected and the employment security agency ensures that the individuals receive benefits if they are eligible. It must be stressed however, that misclassification has a big impact on individuals who believe their employers when they inform them they are not employees, but are independent contractors. Such individuals do not file for unemployment, though they could be eligible. It affects them financially and affects their ability to sustain themselves and their families during times of unemployment.

There are also the independent contractors operating in the underground economy who are often misclassified employees, and who are paid in cash for their services. Most of them do not file for unemployment either. It is difficult to estimate what percentage of unemployed workers do not file claims for the above reasons.

Misclassification imposes real hardships on workers, both in the near term and in the future. In the near term it deprives the worker of the social protections that have long been commonplace in the workplace. Chief among these is unemployment insurance and workers' compensation. These and other workers' benefits are now taken for granted, but they were extremely contentious issues when they were first proposed. The sharing of health insurance costs with employers that has become commonplace over the years, and is often considered a primary condition of employment is unavailable to an IC although it may be partially offset by some pay differentials.

In the long term, it presents another serious issue, particularly for those at the lower end of the pay scale. The issue is one of pensions. The trend in recent years has been to reduce planning for future retirement, particularly without the financial support and discipline of an employer-sponsored program. While it is true that the Internal Revenue Code provides tax incentives for independent contractors, utilization of those incentives is largely out of reach for those with limited earning capacity. According to Horowitz, an advocate for ICs, "We're heading into a two-tiered economy. The first tier has a New Deal safety net, protected by all the different labor laws. Then there is a second tier that's short term, flexible, many of them independent contractors. That tier does not receive benefits..."

CHAPTER 7

SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

This chapter provides some recommendations for addressing a problem that may become significant if the economy undergoes a downturn and the level of unemployment increases.

7.1 Summary of Findings

The primary purpose of this study was to supplement existing knowledge on independent contractors and their role in the alternative workforce in order to provide policymakers with a more objective basis for understanding this work arrangement. BLS surveys of nonstandard workers in 1995 and 1997 found that ICs were the largest category, with 8.3 million & 8.5 million workers respectively, or 6.7% of the workforce. In the 1999 BLS survey, ICs were still the largest component of the alternative workforce, however their share had diminished slightly from 6.7% to 6.3%. Although the BLS results show a decline in ICs, the perception of the majority of those interviewed for the study was that independent contractor use is indeed growing.

There are no universal rules to determine who is an employee and who is an IC because the line between them shifts over time. Each state determines which individuals are employees and which are ICs by consulting the state definition and applying the state test (common law or ABC) and the state law. Critics assert that the current system has outlived its usefulness and is not responsive to the ever-changing ways in which business is being conducted.

Many workers displaced by corporate downsizing, as well as those seeking a more flexible work environment, have become independent contractors. Compared with the traditional workers, independent contractors are disproportionately found in construction, insurance, finance, real estate and services.

Some employees voluntarily left their regular jobs to start working for themselves as independent contractors for a variety of reasons. Independence, choice of employer and work hours, control over one's destiny, job stability, and higher levels of remuneration were the reasons frequently given by writers and artists, insurance and real estate sales agents, software and Web page designers, construction trade employees, and managers and administrators. However, there are other workers who left regular employment involuntarily and who prefer the stability of regular full-time employment, but were compelled by employers to accept independent contractor status. These are found in all types of occupations and industries.

In the study reported here, the demographic characteristics of independent contractors compiled from data provided by UI agency staff and advocacy groups indicate a great deal of variability in the makeup of ICs. ICs are males or females and of all ages and of a variety of ethnic origins. They have different education and skill levels. The majority has no health insurance or retirement benefits and earns middle to low-level wages.

One of the major issues of concern to federal and state policymakers at the labor department as well as many employers is the misclassification of employees as ICs. This particular practice is not only denying many workers protections and benefits they are entitled to, but it also has important implications for the financial viability of UI trust funds. Analysis of employer misclassification by industry for five states in this study showed that construction, manufacturing, home healthcare and retail had high levels of misclassification.

There was also a perception among employers and workers, especially those in the medium to high wage occupations that the designation of employee or independent contractor status was an option to be agreed upon by both parties. What mattered was the existence of a written agreement between both parties.

The economic factors that encourage employers to misclassify employees as ICs include heightened competition, new management paradigms, deregulation, and downsizing. The use of ICs allows employers to save on payroll taxes, fringe benefits, and workers compensation. They circumvent compliance with labor and workplace legislation designed to protect employees. They increase their workforce flexibility by hiring ICs to replace and supplement regular employees on an as needed-basis.

The number one reason for misclassifying workers or hiring independent contractors is the savings in not paying workers' compensation premiums and thereby not being subject to workplace injury and disability-related disputes. In high-risk industries, workers' compensation was the single most dominant reason for misclassification. Many employers believe the risk of being caught is acceptable if it means the survival of their business. Their view of the risk involved, however, fails to take into account violations of federal statutes that have substantial penalties.

Misclassification has a significant impact on those individuals who are told by their employers that they are ICs, not employees. These individuals are generally not financially able to make contributions to a retirement program and do not file for unemployment, although they could be eligible. In the long term, their retirement benefits are significantly reduced and in the short term, they do not collect unemployment insurance if they become unemployed. Utilization of IRS incentives such as self-employment plans is not a viable option for ICs because of their limited earnings.

UI employer audit data from selected states were used to estimate the proportion of employers who misclassify employees and the impact of misclassification on UI revenues and the trust fund. States that relied on targeted audits had a range of 30 to 45% of audited employers with misclassified employees. The proportion was around 10% in states with high levels of randomness in their audit selection process. Underreporting of UI tax revenues due to misclassification ranged from less than one half of 1% to 7.5%.

Assuming a 1% level of worker misclassification, and unemployment at the 1997 level, the average loss in revenue to the trust fund resulting from employer underreporting of UI taxes from 1990 to 1998 would be $198 million. The average outflow of benefits, if paid to the misclassified claimants, would be $203 million. These estimates show that the financial impact of misclassification is nominal at present. However, thousands of workers who have a legal right to UI protection are not being afforded such protection because of misclassification. Other social protections are also being denied to these workers, who are often the ones most in need of such protection.

Furthermore, an increase in the unemployment rate could cause enormous increases in independent contractor-related issues that would have to be investigated. The additional claims would also drain the trust fund, and this drain would most likely have to be offset by assigning higher contribution rates to those employers that correctly classify their workers and pay their taxes, placing them at a further economic disadvantage.

7.2 Recommendations

The increasing use of all types of nontraditional workers, including ICs, has created renewed interest in changing the employee classification criteria. To date, state employment security agencies have dealt with this problem by enacting specific exclusions from the definition of employment. There is a need to establish a system that ensures that determinations of employee and ICs are made simply, consistently, and fairly.

To address the issue of misclassification, several states have set up task forces to monitor employers' classification practices and reporting on employees. IRS data are an integral component of these efforts. However, state officials indicated that in the majority of cases, the shared information consisted primarily of UI audit results provided by states to the IRS. This information sharing should flow both ways. The use of Form 1099-Misc on which non-employee compensation is reported to the IRS in California proved to be extremely effective in detecting employee misclassifications. Other states need to make

this type of information part of their unemployment insurance tax enforcement programs. The Employment and Training Administration (ETA) should take a leadership role in forging a strong relationship between the IRS and SESAs to routinely share 1099 data. The USDOL should develop software and a computer program that will extract data that are useful to the states from the IRS 1099 tapes.

The ETA must also develop a dialogue with other agencies within the USDOL and outside it, such as the Immigration and Naturalization Service, which have major interest in employer-employee relationships and other worker protection issues. State agencies that determine employee and independent contractor status, such as workers' compensation and state departments of revenue, should be encouraged to exchange relevant information. Information should be shared, not only among state agencies, but also between states and their neighboring partners. Several states such as Montana, Wyoming, Connecticut, and California have taken the lead in establishing interagency reporting and cooperation, and these efforts can be used as models by other states. There are new technologies (e.g. intelligent collection systems, pattern recognition) that can be used to track independent contractors and their employers.

Another workplace related issue that affects UI revenue and erosion of coverage is the increasing requests by employers for exclusion of certain job classifications and wages from the payment of state UI taxes. If an employer had wages subject to FUTA but **not** subject to the state, that employer should not be allowed a FUTA credit and be required to pay the full 6.2% FUTA tax. To offset the enactment of specific exclusions from the definition of unemployment at the state level, at the federal level there should be a way of fixing this obvious lapse in the process. It is this process that gives the federal government the sanction necessary to insure compliance among the states. (Note: If your state's law is not in compliance with the federal guidelines of the world, an employer's tax is increased eight-fold.) A workgroup should be established to assess whether the intent of this provision of FUTA is being met and how it may be used to prevent further erosion of UI coverage.

The USDOL should undertake a comprehensive campaign to educate employers on voluntary compliance (not only the publication of successful prosecution, but also a systematic continuing educational campaign). The ETA must develop a repository of information on independent contractor issues, best practices, new initiatives, and legislative measures. This information should be updated frequently and publicized, and its contents made accessible to agencies dealing with independent contractors.

The short and long term impact of the IC work arrangement on the individual workers are that social protections now available to employees are currently denied to independent contractors, and the majority of them cannot afford to take advantage of the available measures. A multi agency dialogue needs to be started to explore the feasibility of extending some or all of the social protections to them. For example, should ICs participate in unemployment insurance, including payment of contributions? Should workers' compensation be mandatory for them? Should IC agreements be subject to requirements such as the payment of a minimum wage? These are a few of the questions that need to be answered in order to respond to the needs of this workforce. The way in which they are answered may determine the well being, not only of ICs, but also of the American economy as a whole in the coming century.

REFERENCES

Aley, James. "The Temp Biz Boom: Why It's Good," Fortune, October 16, 1995.

Bleier, Brenton A., "An Independent Contractor or an Employee: That is the Question," *Bleir Law Firm Newsletter*, 1998.

Bregger, John E. "Measuring Self-Employment in the United States," *Monthly Labor Review*, January/February 1996.

"Independent Contractor or Employee? The Practical Guide to IRS Worker Classification," *Bureau of Business Practice*, (1998).

Burgess, Paul L., "Employer Compliance With Illinois Unemployment Insurance Requirements," prepared for Illinois Department of Employment Security, February 1990.

Carlin, John, "You Really Can Do It Your Way," *London Independent on Sunday*, November 30, 1997, copyright 1997 Newspaper Publishing P.L.C.

Christensen, Kathleen E., and Gomory, Ralph E., "Three Jobs, Two People", *Washington Post,* June 2, 1999.

Cohany, Sharon R. "Workers In Alternative Employment Arrangements," *Monthly Labor Review,* October 1996.

Cohany, Sharon R. "Workers In Alternative Employment Arrangements: A Second Look," *Monthly Labor Review*, November 1998.

Contingent Workers and Workers in Alternative Work Arrangements, EBRI, 1999.

Contract Labor - The Making of an Underground Economy, The State of New Jersey Commission of Investigation, September 1997.

Coopers & Lybrand, "Projection of the Loss In Federal Tax Revenues Due to Misclassification of Workers", prepared for Coalition for Fair Worker Classification, June 1994.

DeBare, Ileana. "Line between employee, contractor status a blur," *Denver Rocky Mountain News,* February 7, 1999.

DeBare, Ileana. "The temps strike back/companies face more lawsuits claiming they misclassified workers," *San Francisco Chronicle*, May 28 1999.

Ewell, Miranda. "California Hi-Tech Firms Employ Hidden Labor," Knight-Ridder Tribune Business News, June 27 1999.
Dorschner, John. "Miami Company Plans to Add Clients, Help Agents," *The Miami Herald*, Knight Ridder Tribune Business News, January 17, 1999.

Greenhouse, Steven. "Equal Work, Less-Equal Perks: Microsoft Leads the Way in Filling Jobs With 'Permatemps,'" *The New York Times*, March 30, 1998.

Greble, Thomas C., "A Leading Role for HR in Alternative Staffing," *HR Magazine*, February 1997.

Harrington, Patrick, "Teamsters tackle Seattle waterfront's low-paid immigrant truckers," *Seattle Times*, Knight-Ridder Tribune Business News, May 23 1999.

Himmelberg, Michele. "California Jury Confirms Labor Classification for Topless Dancers," *The Orange County Register*, Knight-Ridder Tribune Business News, December 31, 1998.

Horowitz, Sara. "Working Today – Making Flexibility Fair," 1998.

Houseman, Susan N., "New Institute Survey on Flexible Staffing Arrangements," *Employment Research*, Spring 1997.

Kalleberg, Arne, and Rasell, Edith, etal., "Nonstandard Work, Substandard Jobs – Flexible Work Arrangements in the U.S"., Economic Policy Institute, 1997.

Jorgensen, Helene. "Nonstandard Work Arrangements: Downscaling of Jobs," Department of Public Policy, AFL-CIO, 1998.

Joint Enforcement Strike Force on the Underground Economy, February 1,1999 by the State of California Employment Development Department.

Joyner, Tammy. "Contingency Workers Go Where They Are Needed," *The Atlanta Journal and Constitution*, Knight-Ridder Tribune Business News, October 13, 1997.

Lenz, Edward A., "Flexible Employment: Positive Strategies for the 21st Century," *Journal of Labor Research*, 1996.

Lewis, Diane E. "New Labor Battle Front: Job Classifications," *The Boston Globe*, December 20, 1998.

Lewis, Diane E. "Ads warn workers on illegal labor practices," *The Boston Globe*, April 5, 1999.

Linder, Marc. "The Employment Relationship in Anglo American Law: A Historical Perspective (Contributions in Legal Studies, No 54)", Greenwood Publishing Group, 1989.

Muto, Sheila "Bill to assist self-employed gets new life," *Wall street Journal*, May 19 1999.

Northrup, Anne and Kennan, Brian. *The IRS Attack on Independent Contractors – How It Affects Your Business Plans,* Copyright @1997 Davis Wright Tremaine.

Pink, Daniel H., "Free Agent Nation," *Fast Company*, December/January 1998.

Pink, Daniel H. "The 1099 Rebellion: The coming of 'free agent' politics," *The New Republic,* April 27, 1998.

Pink, Daniel H., "The Politics of Free Agents," *Blueprint: Ideas for A New Century*, Fall 1998.

Polivka, Anne E. "Contingent and alternative work arrangements, defined," *Monthly Labor Review*, October 1996.

Polivka, Anne E. "Into Contingent and Alternative Employment: By Choice," *Monthly Labor Review,* October 1996.

Schill, Karin "Independent Spirits," *News & Observer*, Raleigh, NC.

Sharpe, Anita. "'Free Agent' Placement Firms Flourish," *The Wall Street Journal,* November 17, 1998.

Simon & Chuster, "Independent Contractor or Employee", The Practical Guide to IRS Classification, 1998.

Sharpe, Anita. "'Free Agent' Placement Firms Flourish," *The Wall Street Journal,* November 17, 1998.

Smith, Diane. & Backover, Andrew. "Working around the law as the government turns its attention elsewhere, North Texas employers increasingly rely on undocumented workers," *Fort-Worth Star-Telegram*, April 18, 1999.

Srinivasan, Kalpana. "Were Workers Misclassified?" *The Associated Press*, October 27, 1999.

Study of Independent Contractor Compliance, Minnesota Department of Jobs and Training, February 1994.

Tulenko, Paul, "Independent Contractors Could Tax Your Withholding," *Bradenton Herald,* December 2, 1998.

Vroman, Wayne. "Labor Market Changes and Unemployment Insurance Benefit Availability," Unemployment Insurance Occasional Paper 98-3. Washington DC: U.S. Department of Labor, Employment and Training Administration, 1998.

Wall Street Journal, "Washington Lawmakers To Weigh In On Microsoft's Temp Worker Policy," Dow Jones Business News, February 10, 1999.

Weissman, Dan. "Builder caught in state tax crackdown" *Star-Ledger Newark*, February 18 1999.

Wheeler, Tim. "GOP tax bill strips workers of jobs benefits," *People's Weekly World*, July 26,1997.

W.J.H "Meet the 'new economy' temps" *Online U.S. News*, August 30, 1999.

Workers' Compensation Emerging Issues: Independent Contractors, Contractor Licensing, and Employee Leasing, Montana Legislative Council, November 1994.

"Working Today – Your Voice in the Policy Debate," 1998.

United States Government Accountability Office

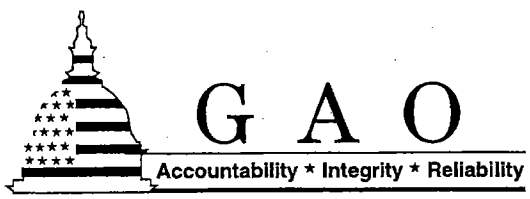
GAO

Report to the Ranking Minority Member, Committee on Health, Education, Labor, and Pensions, U.S. Senate

July 2006

EMPLOYMENT ARRANGEMENTS

Improved Outreach Could Help Ensure Proper Worker Classification



GAO-06-656

July 2006

EMPLOYMENT ARRANGEMENTS

Improved Outreach Could Help Ensure Proper Worker Classification

GAO Accountability · Integrity · Reliability

Highlights

Highlights of GAO-06-656, a report to the Ranking Minority Member, Committee on Health, Education, Labor, and Pensions, U.S. Senate

Why GAO Did This Study

Millions of U.S. workers participate in "contingent" employment, such as temporary or part-time work, and not in permanent or full-time jobs. The Department of Labor (DOL) enforces several labor laws to protect these and other workers, including the Fair Labor Standards Act (FLSA), which provides minimum wage, overtime pay, and child labor protections. In June 2000, GAO reported that contingent workers lagged behind standard full-time workers in terms of income, benefits, and workforce protections, and that some employees do not receive worker protections because employers misclassified them as independent contractors. GAO was asked to update this report by describing (1) the size and nature of the contingent workforce, (2) the benefits and workforce protections provided to contingent workers, and (3) the actions that DOL takes to detect and address employee misclassification. We analyzed DOL survey data on contingent workers and interviewed DOL officials.

What GAO Recommends

GAO recommends that DOL (1) provide additional contact information to facilitate the reporting of possible misclassification complaints, and (2) evaluate the extent to which misclassification cases found through FLSA investigations are referred to other agencies and take action to improve as needed. DOL generally agreed with both recommendations.

www.gao.gov/cgi-bin/getrpt?GAO-06-656.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Robert E. Robertson at (202) 512-7215 or robertsonr@gao.gov.

What GAO Found

Contingent workers constituted a relatively constant proportion of the total workforce from 1995 through 2005 and had diverse characteristics. While the population of the contingent workforce grew by an estimated 3 million workers during this time period, the proportion of contingent workers in the total workforce remained relatively constant at about 31 percent. In 2005, there were about 42.6 million contingent workers in the workforce. Contingent workers vary in terms of their demographic characteristics, industries, and occupations. For example, on average, contingent workers range in age from about 35 years for one category of temporary workers to about 48 years for self-employed workers. In addition, contingent workers are employed in a wide range of industries and occupations, including the services industry, construction, and retail trade.

A smaller proportion of contingent workers than of standard full-time workers has health insurance or pension benefits, or is protected by key workforce protection laws, including laws designed to ensure proper pay and safe, healthy, and nondiscriminatory workplaces. While 72 percent of standard full-time workers received employer-provided health insurance in 2005, the proportion of contingent workers who received employer-provided health insurance ranged from 9 to 50 percent, depending on the category of contingent worker. With regard to pension benefits, 76 percent of standard full-time workers reported working for an employer who offered a pension, whereas 17 to 56 percent of contingent workers reported working for an employer who offered a pension. One reason that contingent workers are less likely to receive protections is that some laws contain requirements that exclude certain categories of contingent workers.

DOL detects and addresses misclassification of employees by investigating complaints, but does not always forward misclassification cases to other federal and state agencies. Some workers do not receive worker protections to which they are entitled because employers misclassify them as independent contractors—a category of contingent workers excluded from many protections—when they should be classified as employees. DOL investigators detect and address employee misclassification primarily when responding to FLSA minimum wage and overtime pay complaints. DOL investigators examine whether a worker is an employee or an independent contractor to determine coverage under FLSA. DOL relies heavily on complaints from workers to enforce FLSA, but the FLSA workplace poster does not contain any information on employment classification or provide a telephone number for individuals to register complaints. Misclassification of employees may contribute to an FLSA violation or may violate laws enforced by other agencies, such as tax laws. DOL procedures require officials to share information with other federal and state agencies whenever investigators find possible violations of other laws. However, the district offices we contacted vary in how often they forward misclassification as a possible violation of other agencies' laws.

Contents

Letter		1
	Results in Brief	3
	Background	5
	Contingent Workers Constitute a Relatively Constant Proportion of the Workforce and Are Diverse	10
	A Smaller Proportion of Contingent Workers than Others Has Benefits or Is Covered by Key Workforce Protection Laws	14
	DOL Detects and Addresses Employee Misclassification through Investigations, but Offices We Studied Vary in How Often They Forward Misclassification Cases to Other Federal and State Agencies	26
	Conclusions	34
	Recommendations for Executive Action	35
	Agency Comments	36
Appendix I	**Objectives, Scope, and Methodology**	38
Appendix II	**Establishing the Employment Relationship of Workers**	43
Appendix III	**Size and Characteristics of the Contingent Workforce**	47
Appendix IV	**Key Laws Designed to Protect Workers**	51
Appendix V	**Comments from the Department of Labor**	56
Appendix VI	**GAO Contact and Staff Acknowledgments**	58
Related GAO Products		59

Tables

Table 1: Key Federal and State Agencies That Can Be Affected by Employee Misclassification 8
Table 2: Contingent Workers and the Total Employed Workforce (February 1995, February 1999, February 2005) 11
Table 3: Workers with Annual Family Incomes below $20,000 (February 2005) 14
Table 4: Changes in the Size of the Contingent Workforce 47
Table 5: Characteristics of Contingent Workers (February 2005) 48

Figures

Figure 1: Categories of Workers That GAO Considered Contingent 6
Figure 2: Composition of the Contingent Workforce (February 2005) 12
Figure 3: Workers with Health Insurance (February 2005) 16
Figure 4: Workers with Employer-Provided Pensions (February 2005) 19
Figure 5: Key Laws Designed to Protect Workers 22

Abbreviations

BLS	Bureau of Labor Statistics
CPS	Current Population Survey
DOL	Department of Labor
EMPLEO	Employment Education and Outreach
ERISA	Employee Retirement Income Security Act
ESA	Employment Standards Administration
ETA	Employment & Training Administration
FLSA	Fair Labor Standards Act
FOH	*Field Operations Handbook*
IRS	Internal Revenue Service
NLRA	National Labor Relations Act
NLRB	National Labor Relations Board

GAO
Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

July 11, 2006

The Honorable Edward M. Kennedy
Ranking Minority Member
Committee on Health, Education,
Labor, and Pensions
United States Senate

Dear Senator Kennedy:

Millions of workers in the U.S. economy participate in some form of "contingent" employment, such as temporary or part-time work. While definitions of the contingent workforce vary, broadly defined, contingent workers are workers who do not have standard full-time employment, that is, are not wage and salary workers working at least 35 hours a week in permanent jobs. Contingent work arrangements often have the potential to provide flexibility for employers and workers. However, such arrangements may also exclude some contingent workers from receiving key worker benefits and protections such as the guarantee of workers' rights to safe and healthful working conditions, a minimum hourly wage and overtime pay, freedom from employment discrimination, and unemployment insurance. The Department of Labor (DOL) enforces a wide range of labor laws that provide protections to workers, including the Fair Labor Standards Act (FLSA), which provides minimum wage, overtime pay, and child labor protections. Other federal and state agencies enforce laws that provide workers with additional workforce benefits and protections.

In June 2000, we reported that contingent workers, as broadly defined, constituted almost 30 percent of the workforce and that compared with standard full-time workers, contingent workers lagged behind in terms of income and benefits.[1] We also reported that some workers do not receive worker protections to which they are entitled because employers misclassify them as independent contractors—a category of workers that is excluded from many protections—when they should be classified as employees. In its last comprehensive misclassification estimate, the

[1] GAO, *Contingent Workers: Incomes and Benefits Lag Behind Those of Rest of Workforce*, GAO/HEHS-00-76 (Washington, D.C.: June 30, 2000).

Internal Revenue Service (IRS) estimated that 15 percent of employers misclassified 3.4 million workers as independent contractors in 1984, resulting in an estimated tax loss of $1.6 billion (or $2.72 billion in inflation-adjusted 2006 dollars[2]) in Social Security tax, unemployment tax, and income tax.

In this context, you asked us to update our work on contingent workers and review employee misclassification issues. Specifically, you asked us to examine (1) the size and nature of the contingent workforce, (2) the benefits and workforce protections provided to contingent workers, and (3) the actions that DOL takes to detect and address employee misclassification.

To respond to your request, we analyzed data from the Bureau of Labor Statistics' (BLS) Current Population Survey (CPS), which is used to survey people about their work and workplace benefits, and a CPS supplement developed to collect information on the contingent workforce. We used this CPS contingent workforce supplement to produce estimates of characteristics of contingent workers, their receipt of health insurance, and their participation in pension programs. To ensure reporting consistency, we used the same definition of contingent workers that we used in our 2000 report. This definition included eight categories of contingent workers: agency temporary workers (temps), direct-hire temps, on-call workers, day laborers, contract company workers, independent contractors, self-employed workers, and standard part-time workers.[3] We interviewed BLS officials and other researchers about contingent worker issues. We also reviewed key workforce protection laws to determine coverage of contingent workers. To obtain information on DOL's efforts to detect and address employee misclassification as part of FLSA enforcement, we reviewed DOL documents and interviewed DOL officials

[2] The $2.72 billion is intended to be an estimate of the magnitude of tax loss due to misclassification in 2006 dollars—not an updated estimate. The actual tax loss due to misclassification in 2006 may be higher or lower based on the tax rates, the level of independent contractors used in various sectors of the economy, and the types and levels of misclassification observed in 2006.

[3] Standard part-time workers are individuals who regularly work less than 35 hours a week for a particular employer and are wage and salary workers.

from headquarters, 3 of 5 regional offices, and 9 of 51 district offices.[4] We also reviewed literature and interviewed researchers about employee misclassification issues. We performed our work in accordance with generally accepted government auditing standards between July 2005 and June 2006. Appendix I provides detailed information on the scope and methodology of our work.

Results in Brief

Contingent workers constituted a relatively constant proportion of the total workforce from 1995 through 2005 and had diverse characteristics. While the population of the contingent workforce grew by an estimated 3 million workers during this time period, the proportion of contingent workers in the total workforce remained relatively constant at about 31 percent.[5] In 2005, there were about 42.6 million contingent workers in the workforce. Across categories, contingent workers vary in terms of their demographic characteristics. For example, on average, contingent workers range in age from about 35 years for direct-hire temps to about 48 years for self-employed workers. While about two-thirds of standard part-time workers are female, females constitute about one-third of contract company workers. Contingent workers are employed in a wide range of industries and occupations, including the services industry, construction, and retail trade.

A smaller proportion of contingent workers than of standard full-time workers has health insurance or pension benefits, or is protected by key workforce protection laws, including laws designed to ensure proper pay and safe, healthful, and nondiscriminatory workplaces. While 72 percent of standard full-time workers received employer-provided health insurance in 2005, the proportion of contingent workers who received employer-provided health insurance ranged from 9 to 50 percent, depending on the category of contingent worker. When other sources of

[4] We selected the regional and district offices using a nonprobability sample—a sample in which some items in the population have no chance, or an unknown chance, of being selected. Results from nonprobability samples cannot be used to make inferences about a population; thus, the information we obtained cannot be generalized to all regional and district offices.

[5] Estimates of the size and characteristics of the contingent workforce are based on CPS sample data and are subject to sampling error. For example, the 95 percent confidence intervals for percentages of the total workforce are within +/- 1 percentage point of the estimate itself. Appendix I contains information on the magnitude of sampling error for the CPS estimates contained in this report.

health insurance are taken into account, the proportional difference between contingent and standard full-time workers decreases substantially but is not eliminated. With regard to pension benefits, 76 percent of standard full-time workers reported working for an employer who offered a pension, and 64 percent reported being included in their employer's plan. In contrast, 17 to 56 percent of contingent workers reported working for an employer who offered a pension, and 4 to 37 percent reported being included in their employer's plan.

DOL detects and addresses misclassification of employees as independent contractors by investigating complaints, but does not always forward misclassification cases to other federal and state agencies. DOL investigators detect and address employee misclassification primarily when responding to FLSA minimum wage and overtime pay complaints. DOL investigators examine the employment relationship—whether a worker is an employee or an independent contractor—to determine whether workers are covered under FLSA. DOL relies heavily on complaints from workers to enforce FLSA, but the FLSA workplace poster—a principal means of communicating FLSA protections—does not contain any information on employment relationship or provide a telephone number for individuals to register complaints. While misclassification of an employee as an independent contractor is not a violation of FLSA, it may contribute to an FLSA violation if the employer does not pay the minimum wage or overtime required by the act. In addition, employee misclassification may contribute to a violation of laws enforced by other agencies, such as tax laws. DOL procedures require officials to share information with other federal and state agencies whenever investigators find possible violations of other laws. However, the district offices we contacted vary in how often they forward misclassification as a possible violation of other agencies' laws.

This report contains recommendations that DOL (1) revise its FLSA workplace poster to include additional contact information that would facilitate the reporting of potential employee misclassification complaints, and (2) evaluate the extent to which misclassification cases identified through FLSA investigations are referred to the appropriate federal or state agency, and take action to make improvements as necessary. In commenting on our draft report, DOL agreed with the first recommendation and agreed with the primary part of the second recommendation, but disagreed with one part of this recommendation. Regarding the second recommendation, DOL agreed with the value of sharing potential employee misclassification with appropriate federal and state programs, but did not agree with a part of the draft recommendation

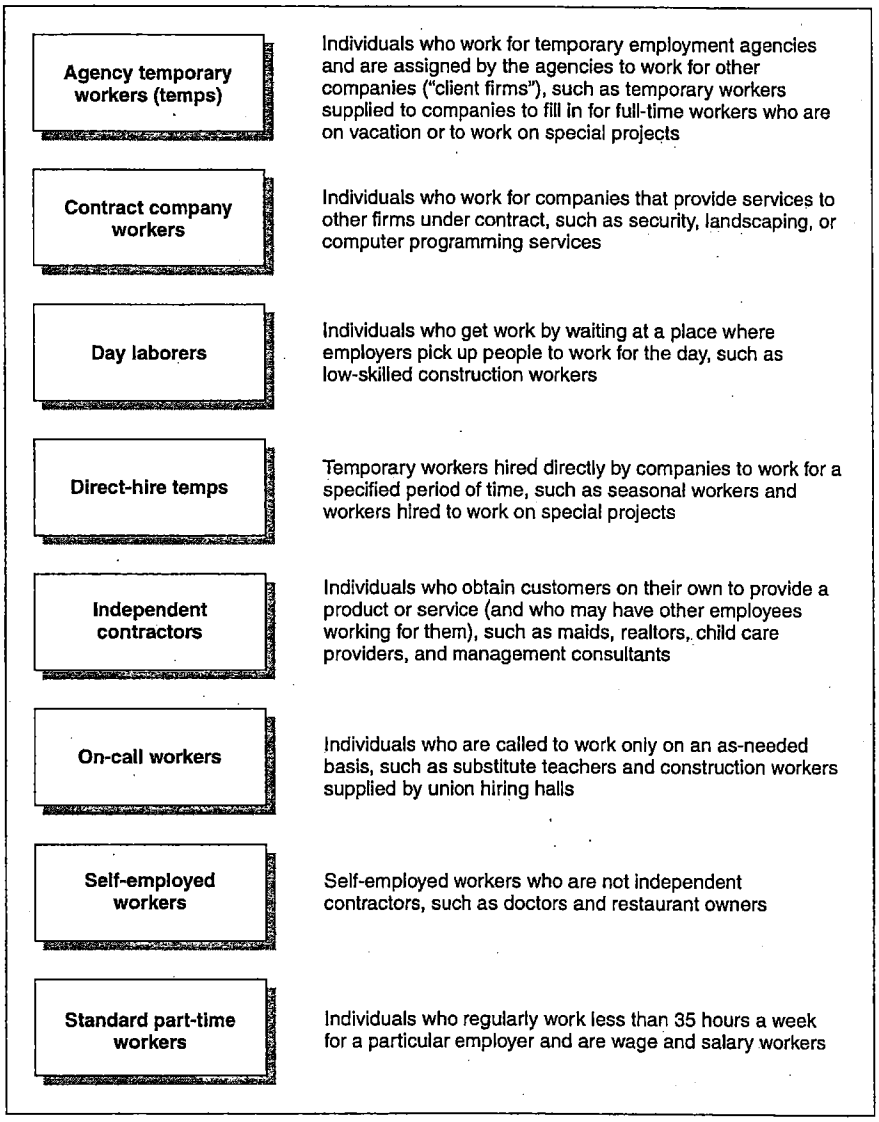
that referral of cases should include notifying the employer that the misclassification case has been forwarded to the appropriate agency. After considering DOL's position concerning this aspect of the draft recommendation, we deleted this part from the final recommendation. DOL also provided technical comments, which we incorporated in the report as appropriate. Our summary evaluation of the agency's comments is on page 36. DOL's comments are reproduced in appendix V.

Background

The term "contingent work" can be defined in many ways to refer to a variety of nonstandard work arrangements. Broadly defined, "contingent work" refers to work arrangements that are not long-term, year-round, full-time employment with a single employer. For example, an employer may hire workers when there is an immediate and limited demand for their services, without any offer of permanent or even long-term employment. Temporary workers, independent contractors, and part-time workers are examples of contingent workers. In 2000, we reported our definition of contingent workers that we also used in this report.[6] Figure 1 shows this definition, which includes eight categories of contingent workers.

[6] Although we used data from the Contingent Work Supplement, we used a definition of contingent worker different from the one used by BLS in its analysis of the data. As in our 2000 review of contingent workers, we did not restrict our definition to include only workers with relatively short job tenure, but rather provided information on a range of workers who could be considered contingent under different definitions. Although we believe that it is useful to consider the nature and size of the population of workers in jobs of limited duration as well as their access to benefits, we also believe that it is useful to provide information according to categories that are more readily identifiable and mutually exclusive. Appendix I provides a more detailed description of GAO's definition of contingent workers.

Figure 1: Categories of Workers That GAO Considered Contingent



Source: GAO/HEHS-00-76.

Research has shown that employers use contingent work arrangements for a variety of reasons. Employers may hire contingent workers to accommodate workload fluctuations, fill temporary absences, meet employee's requests for part-time hours, screen workers for permanent

positions, and save on wage and benefit costs, among other reasons.[7] Previous analyses of data from the CPS Contingent Work Supplement have indicated that workers also take temporary and other contingent jobs for a variety of personal and economic reasons. For example, workers in various types of contingent jobs indicated that they (1) preferred a flexible schedule to accommodate their school, family, or other obligations; (2) needed additional income; (3) could not find a more permanent job; or (4) hoped the job would lead to permanent employment.[8] Studies using data from the BLS National Longitudinal Survey of Youth show that events such as the birth of a child or a change in marital status affect the likelihood of entering different types of employment arrangements and prompt some workers to enter contingent work arrangements.[9]

Concerns arise when employers misclassify workers as independent contractors, who are in a category of contingent workers excluded from certain worker protections. Employee misclassification occurs when an employer improperly classifies a worker as an independent contractor when the worker should be classified as an employee. In 2000, we reported that because most key workforce protection laws cover only workers who are employees, independent contractors and certain other contingent workers, such as self-employed workers, are, by definition, not covered. (See app. IV for a more detailed description of these key laws.)

Misclassification of employees can affect the administration of many federal and state programs, such as payment of taxes and pension benefits. For example, if employers misclassify workers as independent

[7] See Susan N. Houseman, "Temporary, Part-Time, and Contract Employment in the United States: A Report on the W.E. Upjohn Institute's Employer Survey on Flexible Staffing Policies" (November 1996, revised June 1997), and Susan N. Houseman, "Why Employers Use Flexible Staffing Arrangements: Evidence from an Establishment Survey," *Industrial and Labor Relations Review* (October 2001):149-170.

[8] See Sharon R. Cohany, "Workers in Alternative Employment Arrangements," *Monthly Labor Review* (October 1996): 31-45; Anne E. Polivka, "Into Contingent and Alternative Employment: By Choice?," *Monthly Labor Review* (October 1996):55-74; Sharon R. Cohany, "Workers in Alternative Employment Arrangements: a Second Look," *Monthly Labor Review* (November 1998):3-21; Steven Hipple, "Contingent Work: Results from the Second Survey," *Monthly Labor Review* (November 1998):22-35; Steven Hipple, "Contingent Work in the Late-1990s," *Monthly Labor Review* (March 2001):3-27.

[9] Donna S. Rothstein, "Entry Into and Consequences of Nonstandard Work Arrangements," *Monthly Labor Review* (October 1996): 76-83, and Barbara A. Wiens-Tuers and Elizabeth T. Hill, "How Did We Get Here from There? Movement into Temporary Employment," *Journal of Economic Issues* (June 2002):303-311.

contractors, then they may not be paying the payroll taxes required to be paid for employees. At the federal level, misclassification can reduce tax payments, Medicare payments, and Social Security payments. At the state level, misclassification can affect payments into state tax, workers' compensation, and unemployment insurance programs. Table 1 shows key federal and state agencies that can be affected by employee misclassification issues.

Table 1: Key Federal and State Agencies That Can Be Affected by Employee Misclassification

Entity	Law	Areas potentially affected by employee misclassification
U.S. Department of Labor	Fair Labor Standards Act	Minimum wage, overtime, and child labor provisions
	Family and Medical Leave Act	Job-protected and unpaid leave
	Occupational Safety and Health Act	Safety and health protections
U.S. Department of Treasury–Internal Revenue Service	Federal tax law, including: Federal Insurance Contributions Act Federal Unemployment Tax Act Self-Employment Contributions Act	Federal income and employment taxes
U.S. Department of Health and Human Services	Title XVIII of the Social Security Act (Medicare)	Medicare benefit payments
DOL/IRS/Pension Benefit Guaranty Corporation	Employee Retirement Income Security Act	Pension, health, and other employee benefit plans
Equal Employment Opportunity Commission	Title VII of the Civil Rights Act	Prohibitions of employment discrimination based on race, color, religion, gender, and national origin
	Americans with Disabilities Act	Prohibitions of discrimination against individuals with disabilities
	Age Discrimination in Employment Act	Prohibitions of employment discrimination against any individual 40 years of age or older
National Labor Relations Board	National Labor Relations Act	The right to organize and bargain collectively
Social Security Administration	Social Security Act	Retirement and disability payments
DOL/state agencies	Unemployment insurance law	Unemployment insurance benefit payments
State agencies	State tax law	State income and employment taxes
	State workers' compensation law	Workers' compensation benefit payments

Source: GAO analysis of laws.

DOL may encounter employee misclassification while enforcing worker protection laws. DOL's mission is to promote the welfare of job seekers, workers, and retirees in the United States by improving their working conditions, advancing their opportunities for profitable employment, protecting their retirement and health care benefits, helping employers find workers, strengthening free collective bargaining, and tracking

changes in employment, prices, and other national economic measurements. In carrying out this mission, DOL enforces a variety of worker protection laws, including those guaranteeing workers' rights to safe and healthful working conditions, a minimum hourly wage and overtime pay, freedom from employment discrimination, and unemployment insurance.

In particular, DOL's Employment Standards Administration's (ESA) Wage and Hour Division enforces FLSA. The Wage and Hour Division—with staff located in 5 regional and 72 district, area, and field offices throughout the country—conducts investigations of employers who have $500,000 or more in annual sales volume.[10] In addition, the division conducts outreach efforts for employers and workers to ensure compliance with FLSA. District directors oversee investigators, who play a key role in carrying out FLSA enforcement. Investigators are trained to investigate a wide variety of workplace conditions and complaints and enforce a variety of labor laws in addition to FLSA.[11] Regional and district offices conduct outreach to employers and workers through brochures, workplace posters, presentations or training sessions for individuals or groups, and Web-based information.

FLSA—which provides minimum wage and overtime pay protections—requires that employers pay those employees covered by the act at least the minimum wage and pay overtime wages when they work more than 40 hours a week.[12] FLSA requires that an employer-employee relationship exist for a worker to be covered by the act's provisions. The act defines "employee" broadly as an individual employed by an employer. The U.S. Supreme Court has identified certain factors to be considered in determining whether a worker meets the FLSA definition of employee. Appendix II contains more information on establishing the employment relationship under FLSA.

[10] In addition, other types of employers—such as hospitals and schools—are covered by FLSA regardless of their annual sales volume.

[11] Complaints are a key component of DOL enforcement efforts under many federal labor laws. DOL enforcement generally relies on two types of information to identify potential violations: (1) complaints from individuals who believe they may have suffered a violation and (2) analysis of data to specifically target problematic industries or work sites.

[12] FLSA also includes record-keeping and child labor provisions.

Contingent Workers Constitute a Relatively Constant Proportion of the Workforce and Are Diverse

Contingent workers constituted a relatively constant proportion of the total workforce from 1995 through 2005 and had diverse characteristics. While the number of contingent workers grew by an estimated 3 million during this time period, the contingent proportion of the total workforce remained relatively constant. In 2005, there were about 42.6 million contingent workers in the workforce. The different categories of contingent workers vary in terms of demographic characteristics, industries, occupations, preferences for the type of job that they currently hold, and incidence of low family income.[13] Appendix III contains detailed information on changes in the size of the contingent workforce and characteristics of contingent workers.

Contingent Workers' Proportion of the Total Workforce Has Changed Little over the Past Decade

In 2005, an estimated 31 percent of the workforce could be considered to maintain a contingent work arrangement.[14] As shown in table 2, while the number of contingent workers grew from 39.6 million workers in 1995 to 42.6 million workers in 2005, contingent workers' share of the total workforce remained relatively constant over this time period.[15]

[13] GAO's 2000 review of contingent workers used $15,000 as the family income threshold for defining "low family income." This income level was selected because the BLS reports family income in $5,000 increments, and $15,000 was the income level closest to and below the 1999 federal poverty threshold for a family of four ($17,028). We selected $20,000 as the family income threshold for "low family income" for this report because it was the income level closest to the current federal poverty level. The 2004 federal poverty threshold for a family of four (the most current information published by the Bureau of the Census at the time this project was designed) was $19,307.

[14] Workforce characteristics are estimated from the CPS February 2005 Contingent Work Supplement. Percentage estimates based on the total workforce have 95 percent confidence intervals of within +/- 1 percentage point of the estimate itself. Appendix I contains additional information and confidence interval ranges for other CPS estimates presented in this report.

[15] Similarly, the proportions of the various categories of contingent workers changed little over this time period (see app. III).

Table 2: Contingent Workers and the Total Employed Workforce (February 1995, February 1999, February 2005)

Category of worker	February 1995		February 1999		February 2005	
	Estimated numbers of workers (in thousands)	Estimated percentage of the workforce	Estimated numbers of workers (in thousands)	Estimated percentage of the workforce	Estimated numbers of workers (in thousands)	Estimated percentage of the workforce
Contract company workers	652	0.5	769	0.6	813	0.6
Agency temps	1,181	1.0	1,188	0.9	1,217	0.9
On-call workers/day laborers	2,014	1.6	2,180	1.7	2,736	2.0
Direct-hire temps	3,393	2.8	3,227	2.5	2,972	2.1
Self-employed workers	7,256	5.9	6,280	4.8	6,125	4.4
Independent contractors	8,309	6.7	8,247	6.3	10,342	7.4
Standard part-time workers	16,813	13.6	17,380	13.2	18,360	13.2
Subtotal: contingent workers	**39,618**	**32.2***	**39,271**	**29.9***	**42,567**	**30.6**
Standard full-time workers	83,589	67.8	92,222	70.1	96,385	69.4
Total workforce	**123,207**	**100.0**	**131,493**	**100.0**	**138,952**	**100.0**

Source: GAO analysis of data from the CPS February 1995, 1999, and 2005 Contingent Work Supplements.

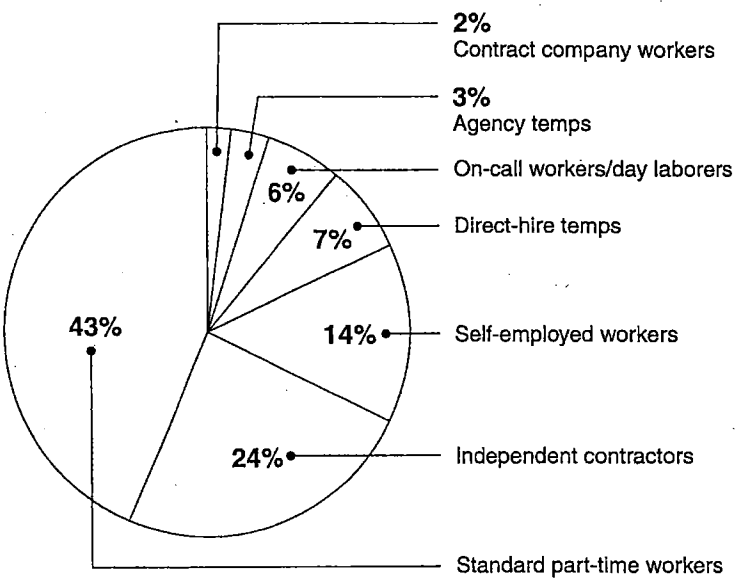
Note: We combined the on-call workers and day laborers categories because the definitions and characteristics of these workers are similar and the number of day laborers alone was not large enough to be statistically significant.

*Percentages do not add up to subtotal because of rounding.

Contingent Workers Are a Diverse Group

The categories of contingent workers differ considerably in terms of their share of the contingent workforce. In 2005, standard part-time workers constituted the largest category (43 percent) and contract company workers constituted the smallest category (2 percent) of the contingent workforce (see fig. 2).

Figure 2: Composition of the Contingent Workforce (February 2005)



Source: GAO analysis of data from the CPS February 2005 Contingent Work Supplement.

Note: Actual estimated percentages do not add to 100 percent because of rounding.

Contingent workers exhibit a wide range of demographic characteristics. For example, direct-hire temps (with a mean age of about 35 years[16]) were, on average, the youngest contingent workers in 2005, while self-employed workers (with a mean age of about 48 years[17]) were the oldest. An estimated 68 percent of standard part-time workers were female, while about 31 percent of contract company workers were female.[18] Self-employed workers had the highest percentage (81 percent) of white/non-Hispanic workers, while agency temps had the smallest percentage (50 percent) of white/non-Hispanic workers. Standard part-time workers had the highest percentage (21 percent) of workers with less than a high school degree, while self-employed workers and independent contractors had the lowest percentages (8 percent).

[16] The 95 percent confidence interval is from 34.1 to 36.3 years old.

[17] The 95 percent confidence interval is from 47.2 to 48.5 years old.

[18] The percentage estimates for individual categories of contingent workers have 95 percent confidence intervals of within +/- 10 percentage points, unless noted. See appendix I for additional information.

Contingent workers are employed in a wide range of industries and occupations. Regarding industry, in 2005, the percentage of part-time workers employed in retail trade (38 percent) was greater than in other industries, the percentage of agency temps in business services (28 percent) was greater than in other industries, the percentage of direct-hire temps in educational services (28 percent) was greater than in other industries, and the percentage of independent contractors in construction (22 percent) was greater than in other industries. Regarding occupation, in 2005, the percentage of self-employed workers in management (29 percent) was greater than in other occupations, the percentage of agency temps in office and administrative support (25 percent) was greater than in other occupations, and the percentage of contract company workers in construction and extraction (20 percent) was greater than in other occupations.

The extent to which contingent workers express a preference for a different type of employer or job also varies across the different categories of contingent workers. For example, in 2005, 59 percent of agency temps expressed a preference to work for a different type of employer. Similarly, 48 percent of on-call workers/day laborers indicated that they would prefer a job where they worked regularly scheduled hours. In contrast, 9 percent of independent contractors and 8 percent of self-employed workers indicated that they would prefer to work for someone else.

The proportion of contingent workers reporting low family incomes varies considerably across the different categories of contingent workers. As shown in table 3, while 16 percent of the overall contingent worker population reported family incomes below $20,000 in 2005, the incidence of low family income ranged from 8 percent for self-employed workers (the same percentage as for standard full-time workers) to 28 percent among agency temps. The relatively high incidence of low family income among some groups of contingent workers may reflect a number of factors, including lower levels of educational attainment, lower number of hours worked, or employment in low-wage sectors of the economy.

Table 3: Workers with Annual Family Incomes below $20,000 (February 2005)

Category of worker	Estimated number of workers with family incomes below $20,000	Estimated percentage of workers with family incomes below $20,000[a]
Self-employed workers	382,484	8
Contract company workers	85,210[b]	11
Independent contractors	952,924	11
Direct-hire temps	464,561	18
Standard part-time workers	2,963,389	19
On-call workers/day laborers	501,014	21
Agency temps	318,535[b]	28
Subtotal: contingent workers	**5,668,117**	**16**
Standard full-time workers	6,902,861	8
Total workforce	**12,570,978**	**11**

Source: GAO analysis of data from the CPS February 2005 Contingent Work Supplement.

[a]The percentages in this table are based on valid responses only.

[b]The 95 percent confidence interval for agency temps and for contract company workers are 318,535 +/- 70,692, and 85,210 +/- 36,585, respectively. The 95 percent confidence intervals for totals for other categories of contingent workers are within +/- 20 percent of the estimate itself.

A Smaller Proportion of Contingent Workers than Others Has Benefits or Is Covered by Key Workforce Protection Laws

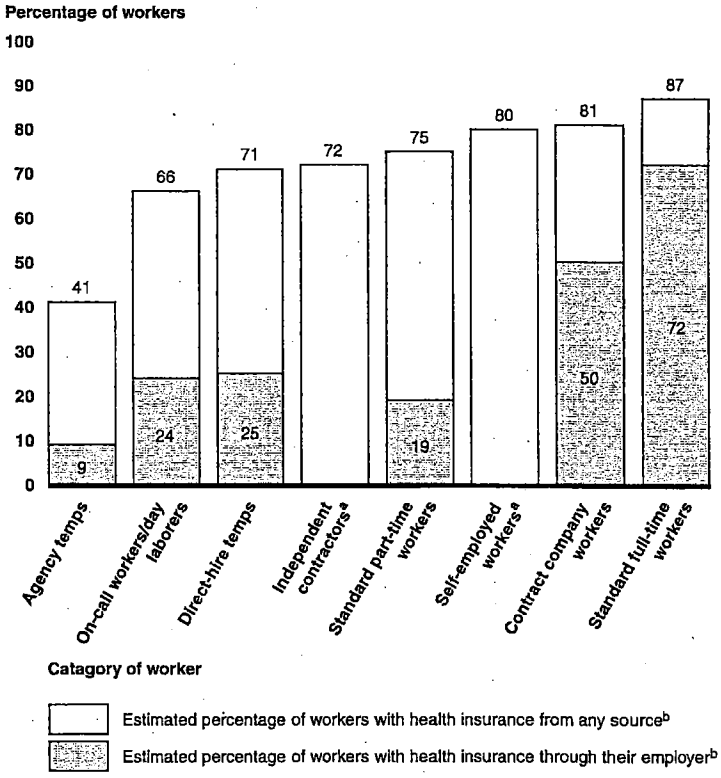
A smaller proportion of contingent workers than of standard full-time workers has health insurance or pension benefits, or receives protections offered by key workforce protection laws, including ones designed to ensure proper pay and safe, healthy, and nondiscriminatory workplaces. A smaller proportion of contingent workers than of standard full-time workers has employer-provided health insurance coverage. When other sources of health insurance are taken into account, the difference between contingent and standard full-time workers decreases, but it remains the case that a smaller proportion of contingent workers is insured. In addition, a smaller proportion of contingent workers than of standard full-time workers has employers who offer pension plans or is included in employer-provided plans. Finally, contingent workers are less likely than standard full-time workers to receive protections offered by key workforce protection laws. Some laws contain requirements that exclude certain categories of contingent workers or contain certain time-in-service requirements that make it difficult for them to be covered. In addition, in cases where contingent workers have more than one employer, it is difficult to determine which employer is responsible for providing workers with workforce protections. Appendix IV contains a detailed description of the key workforce protection laws.

A Smaller Proportion of Contingent Workers than Others Receives Health Insurance

The proportion of contingent workers receiving health insurance is smaller than the proportion of standard full-time workers receiving health insurance. Overall, an estimated 13 percent of contingent workers received health insurance through their employer in 2005, compared to 72 percent of standard full-time workers. As shown in figure 3, the share of contingent workers receiving employer-provided health insurance ranged from 9 percent for agency temps to 50 percent for contract company workers.[19]

[19] Workers who do not have employers are not included in the questions on employer provided health insurance in the CPS February 2005 Contingent Work Supplement. All workers in the "self-employed" category, and most workers in the "independent contractor" category, do not have employers and were excluded from our analysis of employer-provided health insurance.

Figure 3: Workers with Health Insurance (February 2005)



Source: GAO analysis of data from the CPS February 2005 Contingent Work Supplement.

[a] Most workers in these categories do not have an employer and were excluded in our analysis of employer-provided health insurance.

[b] For this figure, the population of contingent workers is defined as all those respondents who gave a valid response to the question "Do you receive health insurance from any source?" The percentages reported above are based on this population.

Although the proportion of contingent workers who received health insurance increased significantly when other sources of health insurance were taken into account, a smaller proportion of contingent workers than of standard full-time workers received health insurance from any source. Overall, about 73 percent of contingent workers received health insurance through any source in 2005, compared to 87 percent of standard full-time workers. The share of contingent workers who received health insurance through any source ranged from 41 percent among agency temps to 81 percent among contract company workers. As might be expected, a smaller proportion of workers with low family incomes received health

insurance than of workers of all income levels.[20] Overall, the highest percentage of contingent workers who had health insurance through a source other than their employer received it from their spouse's health insurance plan. Contingent workers also reported receiving health insurance through other family members' plans, plans offered through other or previous jobs, direct purchase, or participating in Medicare or Medicaid programs.

Workers may lack access to employer-provided health insurance for a number of reasons, including electing not to participate in an available plan, having an employer who does not offer a health insurance plan, or being ineligible for their employer's plan if one is offered. Just over half of workers—both contingent and standard full-time—who lacked employer-provided health insurance coverage in 2005 worked for an employer who offered health insurance to some of its employees. Not all workers reported being able to participate in their employer's health insurance plan. An estimated 38 percent of the contingent workers in this group reported that they could participate in their employer's health insurance plan if they wanted to, compared to 81 percent of standard full-time workers. Both contingent and standard full-time workers reported several reasons for not participating in health insurance plans offered by their employer, including having coverage through another plan and the expense of their employer's plan.

Some states and professional associations have developed health insurance programs that help contingent workers access health care. For example, Massachusetts recently passed legislation that will make health insurance available to all residents of the state, including contingent workers such as part-time workers, contractors, and self-employed workers. This new law provides for health insurance premium assistance for low-income workers as well as low-cost policies available for purchase in the private market. In addition, Maine recently created the Dirigo program, which provides low cost health insurance to self-employed workers and workers without employer-sponsored insurance. Similarly, New York's Healthy NY program helps uninsured workers, including self-employed workers, who earn too much to qualify for Medicaid access

[20] In 2005, 49 percent of contingent workers with low family incomes received health insurance from any source, as compared to 73 percent of contingent workers of all income levels. Similarly, 9 percent of contingent workers with low family incomes received employer-provided health insurance, as compared to 13 percent of contingent workers of all income levels.

comprehensive health insurance. Professional associations are also creating health plans to serve contingent workers. For example, the HR Policy Association—a nonprofit organization of senior human resources executives of Fortune 500 companies—recently brought major health insurers and large companies together to create the National Health Access program. This program provides a range of low-cost health plans to part-time, seasonal, and temporary workers, as well as independent contractors at participating companies who are ineligible for the companies' traditional health plans. While these public and private initiatives are relatively new and long-term outcomes have yet to be determined, the programs have succeeded in expanding health insurance options to some contingent workers.

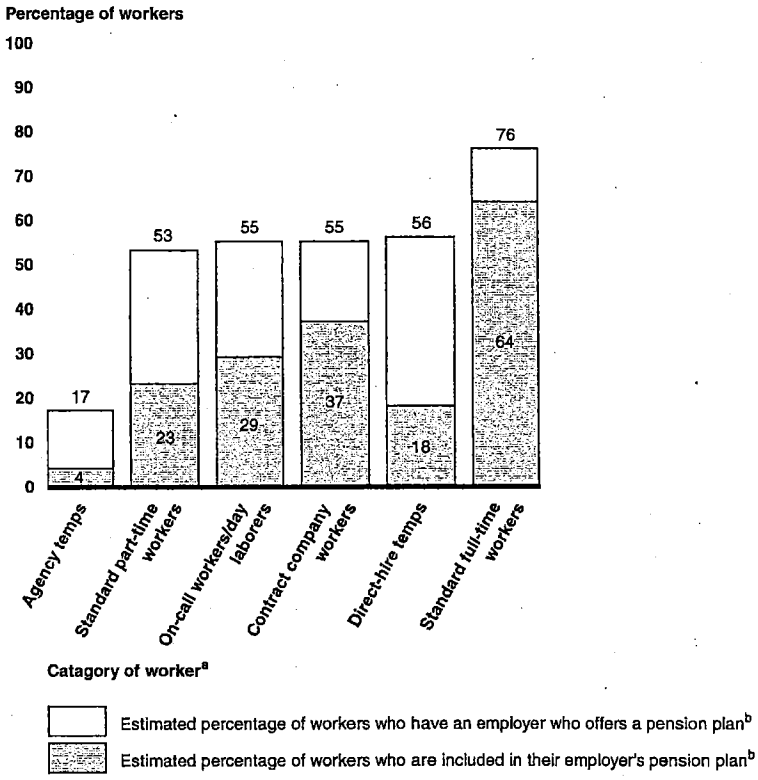
A Smaller Proportion of Contingent Workers than Others Has Access to Employer-Provided Pensions

A smaller proportion of contingent workers than of standard full-time workers has employers who offer pensions or is included in their employer's pension plans.[21] Overall, 38 percent of contingent workers reported having employers who offered a pension in 2005, compared to 76 percent of standard full-time workers. Similarly, while 17 percent of contingent workers reported being included in their employers' pension plan, 64 percent of standard full-time workers reported being included in such plans. As shown in figure 4, with the exception of agency temps, 53 to 56 percent of the contingent workers in other categories reported having employers who offered pension plans.[22] The percentage of contingent workers who were included in employer-provided pension plans ranged from 4 percent for agency temps to 37 percent for contract company workers.

[21] The CPS classifications regarding access to employer-provided pensions are sometimes described in different terms. For example, the CPS questionnaire asks workers if their employer "offers" a pension plan to any of its employees, and if they are "included" in this plan. In a past GAO report, GAO has used other terms to describe access to employer-provided pensions. For example, GAO has indicated that employers can "sponsor" a pension plan (similar to "offering" a plan) and workers can be "covered" by a plan (similar to being "included" in a plan). See GAO, *Pension Plans: Characteristics of Persons in the Labor Force without Pension Coverage*, GAO/HEHS-00-131 (Washington, D.C.: Aug. 22, 2000).

[22] Most workers in the self-employed and independent contractor categories do not have employers and were excluded from our analysis of employer-provided pensions.

Figure 4: Workers with Employer-Provided Pensions (February 2005)



Source: GAO analysis of data from the CPS February 2005 Contingent Work Supplement.

[a]Because workers in the self-employed category, and most workers in the independent contractor category, do not have employers, they were not included in this figure.

[b]For this figure, the population of contingent workers is defined as all those respondents who gave a valid response to the question "Do you work for an employer who offers a pension plan?" The percentages reported above are based on this population.

Among contingent workers with employers who offered pension plans, the most frequently reported reasons for not being included in the plan were those related to eligibility. For example, these workers reported that they were not allowed to join the plan, they had not worked enough hours or weeks, or they had not worked long enough to be eligible.

In addition to employer-provided pension plans, other types of tax deferred retirement accounts (such as individual retirement accounts and Keogh plans) may offer workers an opportunity to save for retirement. A larger proportion of self-employed workers and independent contractors

than of other categories of contingent workers reports having other types of tax deferred retirement accounts.[23] For example, 45 percent of self-employed workers and 42 percent of independent contractors, compared to 16 percent of standard full-time workers, reported having such accounts in 2005.

Contingent workers with low family incomes have less access to employer-provided pension benefits than workers of all income levels. Overall, 29 percent of contingent workers with low family incomes reported having employers who offered pension plans in 2005; 7 percent of contingent workers with low family incomes reported being included in such plans. Contingent workers with low family incomes commonly reported that they were not included in their employer's pension plan for reasons related to eligibility; for example, they were not allowed to join the plan, they had not worked enough hours or weeks, or they had not worked long enough to be eligible.

[23] Most workers in the independent contractor category were self-employed.

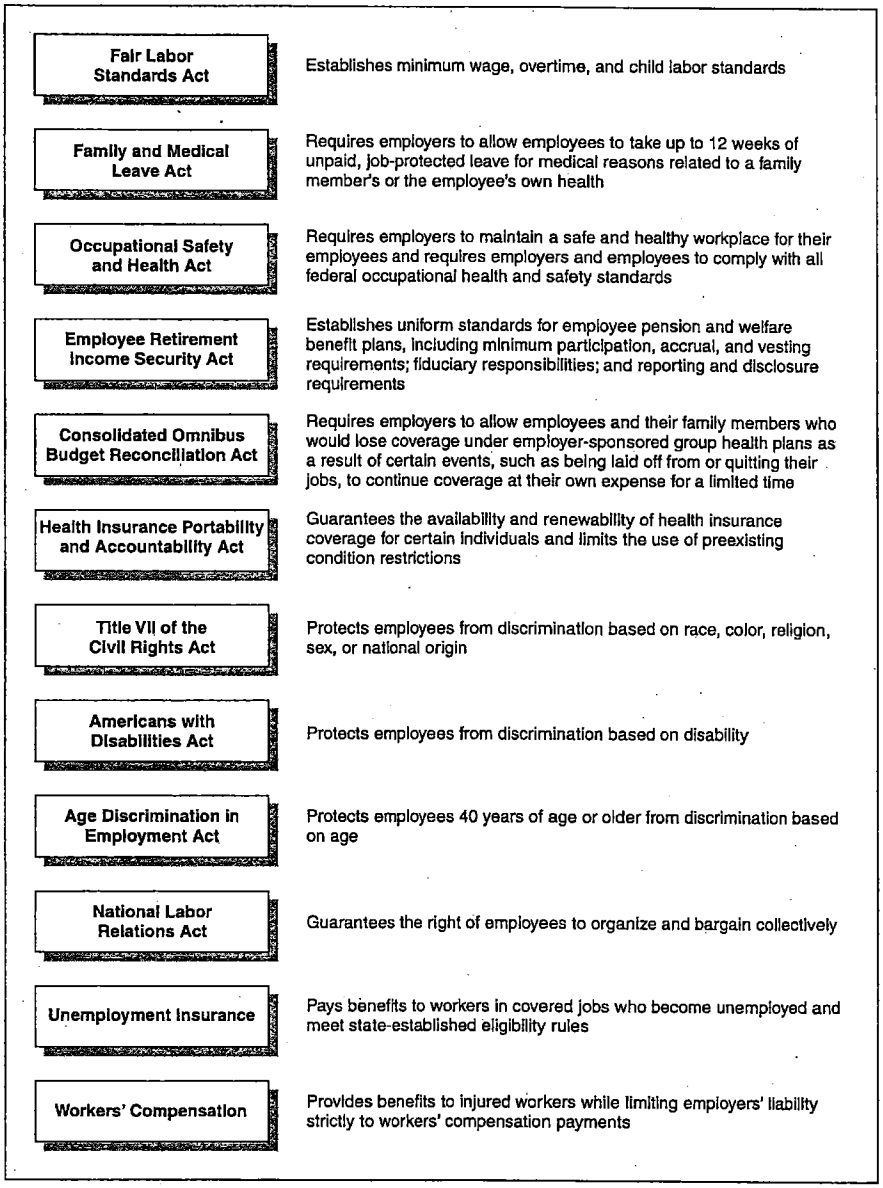
Some Categories of Contingent Workers Are Not Covered by Key Laws Designed to Protect Workers

Contingent workers who are employees are generally protected under key laws designed to protect workers, but certain categories of contingent workers—such as independent contractors and self-employed workers—may be excluded from coverage under these laws. While most of the key worker protection laws do not distinguish between types of employees (i.e., contingent and standard full-time employees), some laws contain requirements that exclude certain categories of contingent workers or contain certain time-in-service requirements that make it difficult for them to be covered.[24] In addition, because these laws are based on the traditional employer-employee relationship, they generally cover only workers who are employees; independent contractors and self-employed workers, therefore, are not covered. According to the 2005 Contingent Work Supplement, 10.3 million individuals are independent contractors; these individuals would not be covered by these workforce protection laws.

When employers have misclassified workers as independent contractors, workers may need to go to court to establish their employee status and their eligibility for protection under the laws. In addition, DOL may bring a lawsuit on behalf of the worker or group of workers to require that the employer provide the benefit or protection under the law. As shown in figure 5, the key workforce protection laws cover a wide range of issues.

[24] All of the key laws designed to protect workers have some exclusions, such as exclusions for small businesses, that apply to both contingent workers and standard full-time workers. We did not, however, examine whether contingent workers are disproportionately affected by these exclusions.

Figure 5: Key Laws Designed to Protect Workers



Source: GAO analysis of laws.

Certain categories of contingent workers, such as temporary, on-call, and part-time workers, are not covered by some of the laws designed to protect workers. For example, the Family and Medical Leave Act requires workers to have worked for the same employer at least 12 months and a minimum of 1,250 hours during the past 12 months to be covered. These conditions decrease the likelihood that workers who are temporary, on-call, or part-time will be covered. Although employers are not required to provide pension or health care plans to their employees, when plans are offered, the Employee Retirement Income Security Act (ERISA) has rules that govern which employees must be included in the plans in order to qualify for special tax treatment. For example, ERISA allows employers to exclude workers who have worked less than 1,000 hours in a 12-month period from entering their pension plans. ERISA also allows employers to exclude employees who have worked for the company less than 3 years as well as part-time and seasonal employees from the count of employees who must be included in self-insured medical plans and group term life insurance plans. As a result, some temporary, on-call, and part-time workers may not be included in their employers' benefit plans. These exclusions are intended to strike a balance between providing benefits to workers and not be unduly burdening employers. For example, the exclusions in ERISA were enacted to recognize that it may be impractical or too costly for employers to include all short-term employees in their pension plans.

Some laws have exemptions for portions of certain industries or types of employers that may disproportionately affect contingent workers. For example, FLSA exempts all agricultural employers from the overtime pay requirement and exempts agricultural employers who do not use more than 500 days of labor in any calendar quarter from the minimum wage requirement. These exemptions affect some categories of contingent workers more than standard full-time workers because a greater proportion of these contingent workers is in the agriculture industry; for example, an estimated 11 percent of self-employed workers, 2 percent of on-call workers and day laborers, 2 percent of independent contractors, and 1 percent of direct-hire temporary workers are employed in agriculture, compared with 1 percent of standard full-time workers.

Similarly, the nature of contingent work makes it difficult for some contingent workers to meet state eligibility requirements for unemployment insurance. Temporary and part-time workers may not meet the minimum earnings requirements, which vary by state, and these workers may have difficulty meeting the rules governing job loss because they have less flexibility when the circumstances of their jobs change.

For example, temporary workers who choose this type of work in order to meet family obligations or to attend school might be more likely to quit if their employer changed the job location or required them to work different hours. Nevertheless, they would be ineligible for unemployment insurance benefits in many states because they voluntarily quit without good cause.[25] In addition, contingent workers can find it difficult to meet continuing eligibility requirements.[26]

Some contingent workers, such as temporary or contract workers, may also find it difficult to meet the requirements of the National Labor Relations Act (NLRA) for joining an existing bargaining unit or forming a new bargaining unit. For example, under the act, temporary workers wanting to join an existing collective bargaining unit at a work site must first demonstrate that they have a "sufficient community of interest" with the permanent workers in the bargaining unit.[27] In 2004, the National Labor Relations Board (NLRB) overturned a decision made in 2000, and required consent from both the user and supplier employer before temporary employees could join an existing bargaining unit.[28] The 2004 decision made it more difficult for temporary and leased employees to join unions and bargain collectively. Contingent workers may also find it difficult to form new collective bargaining units. For example, temporary workers and day laborers may find it difficult to form bargaining units because they do not work at one location or with one employer long enough to identify with a particular group of workers and organize a union. In addition, some worker advocacy groups maintain that contract company workers have difficulty forming new collective bargaining units because employers that use contract company workers may cancel contracts and contract with other companies when workers attempt to unionize.

[25] Applicants are generally disqualified from receiving benefits when job loss is due to voluntary separation without good cause, although the definition of "good cause" varies from state to state.

[26] According to a report by the National Employment Law Project ("Part Time Workers and Unemployment Insurance," March 2004), unemployed workers who limit their search for new work to only part-time jobs are denied unemployment benefits in many states because workers are not available for full-time employment. Since 2001, 24 states and the U.S. Virgin Islands maintain restrictive rules regarding part-time unemployment insurance eligibility.

[27] A "sufficient community of interest" includes factors such as common supervision, working conditions, and interest in the unit's wages, hours, and conditions of employment.

[28] *M.B. Sturgis*, 331 NLRB 1298 (2000) and *H.S. Care L.L.C.*, 343 NLRB No.76 (2004).

Incorrect Employment Relationship May Result in Lack of Worker Protections

In some cases it is difficult to determine which employer is responsible for providing workers with workforce protections because some contingent workers have more than one employer. In these cases, employers may be (1) an intermediary, such as a temporary employment agency, contract company, or leasing company; (2) the client firm that obtains the workers through the intermediary; or (3) both the intermediary and the client firm. Because it is often difficult in these cases to determine which employer is liable to provide workers with workforce protections, litigation may be necessary to resolve this issue.

Even in cases where there is only one employer involved, employers sometimes classify workers improperly, primarily by designating some workers as independent contractors when, in fact, they are more appropriately considered employees. Moreover, employers have economic incentives to misclassify employees as independent contractors because employers are not obligated to make certain financial expenditures for independent contractors that they make for employees, such as paying certain taxes (Social Security, Medicare, and unemployment taxes), providing workers' compensation insurance, paying minimum wage and overtime wages, or including independent contractors in employee benefit plans.

In addition, the tests used to determine whether a worker is an independent contractor or an employee are complex, subjective, and differ from law to law. For example, the NLRA, the Civil Rights Act, FLSA, and ERISA each use a different definition of an employee and various tests, or criteria, to distinguish independent contractors from employees.[29] (See app. II for more information on employment relationship.)

[29] See app. IV for descriptions of the tests used under each law.

DOL Detects and Addresses Employee Misclassification through Investigations, but Offices We Studied Vary in How Often They Forward Misclassification Cases to Other Federal and State Agencies

DOL detects and addresses employee misclassification when enforcing the FLSA minimum wage and overtime pay provisions. As part of its FLSA investigation process, DOL examines the employment relationship—whether a worker is an employee or an independent contractor—to determine which workers are covered. Investigators use various methods to test the employment relationship of workers, including interviewing employers and workers, reviewing payroll and related documents, and touring work sites. While misclassification alone is not an FLSA violation, it may contribute to FLSA violations or violations of other laws, such as tax violations. DOL's outreach efforts provide some information to employers and workers on employee misclassification issues. DOL procedures require officials to share information with other federal and state agencies whenever investigators find possible violations of other laws. However, the district offices that we contacted vary in how often they forward misclassification cases as a possible violation of other agencies' laws.

Investigators Determine Workers' Employment Relationship

DOL relies on complaints as a primary way to identify potential violations for investigation.[30] All FLSA investigations of minimum wage and overtime pay complaints begin with an examination of workers' employment relationship because FLSA applies only to employees, not to independent contractors. If investigators determine that a worker is an employee and not an independent contractor, they continue with their FLSA investigation to determine whether the employer has provided the minimum wage and overtime pay required by the act.

DOL's *Field Operations Handbook* (FOH) provides investigators with statutory interpretations and investigation procedures regarding the employment relationship required for FLSA to apply. It also describes the Supreme Court factors and explains how to apply them to test employment relationship. For example, the Supreme Court factors address whether the worker uses his or her own tools or equipment and whether the worker can decide which hours to work. Appendix II contains more information on the employment relationship. According to DOL officials,

[30] Complaints are a key component of DOL enforcement efforts under FLSA. DOL enforcement of FLSA generally relies on two types of information to identify potential violations: (1) complaints from individuals who believe they may have suffered a violation and (2) analysis of data to specifically target problematic industries or work sites.

investigators rely on their professional judgment when applying the Supreme Court factors. Investigators receive classroom training and on-the-job mentoring on the Supreme Court factors and techniques for applying the factors. In their training, they are taught to identify all the relevant factors and make a full, balanced assessment of the facts of each case.[31]

Investigators may identify possible employee misclassification at different points during the investigation. According to DOL officials, misclassification issues may come up during the initial conference with the employer or during an investigator's review of records to determine whether an employer had classified workers as employees or independent contractors. At the initial conference with the employer, investigators ask employers about the nature of their work, annual dollar volume of business, the number of workers, and how workers are paid, and they request payment documents, such as payroll records, time cards, and W-2 forms. While it is standard practice for investigators to review payroll and other records related to wages and employment, investigators do not necessarily review contracts or 1099 forms used to pay independent contractors unless they have a reason to suspect possible misclassification.

Investigators may have reason to suspect misclassification stemming from the complaint that initiated the case or their knowledge of potential misclassification in that industry. In these cases, the investigator would ask employers about whether they contract any work and how they classify their workers. For example, according to DOL officials, if an investigator was conducting an investigation of a large drywall employer, then the investigator would probably spend a large amount of time pursuing independent contractor issues because misclassification has been a problem in the past with construction contractors subcontracting work to drywallers, roofers, electricians, and carpenters. In other cases where the investigator has no knowledge about potential misclassification, the employer's responses at the initial conference may raise questions. For

[31] In 2005, DOL began an "Off-the-Clock" initiative to identify employers who do not compensate workers for all the hours that they work and who may not keep accurate wage and employment records for their workers (also referred to as "off the books"). Although the focus is off-the-clock work, this effort may help detect employee misclassification. This initiative includes training, outreach, and investigation. The investigator training includes a section on employment relationship, with questions and scenarios about how to determine whether a worker is an independent contractor or an employee.

example, if the employer had millions of dollars in annual business but only two employees, then the investigator would likely ask further questions about the employment relationship of any other workers. In addition, DOL officials told us that investigators compare payroll records with the work process identified by the employer to see if there are any gaps. For example, investigators would need to follow up with employers who describe work processes that required many workers but had no employees listed on the payroll. Such a scenario could indicate that employers had misclassified workers as independent contractors who were not listed on the payroll.

Investigators may learn about employment relationship when interviewing workers to verify the employer's payroll and time records or to identify workers' duties in order to determine whether FLSA applies. According to DOL officials, an investigator would not ask directly whether the worker is an independent contractor or an employee; instead, an investigator would ask questions to determine whether the worker is an employee or an independent contractor. For example, an investigator would ask whether workers set their own work hours or use their own equipment on the job—indications that workers may be independent contractors, not employees.

Investigators may obtain additional information on employment relationship while touring an employer's establishment. During a tour, investigators can compare their observations about employment relationship in the work environment to the information from the records and interviews with employers and workers. Specifically, investigators can observe control issues, such as whether workers are supervised and provided with supplies and equipment. For example, if an apartment rental complex treats its maintenance workers as independent contractors, then the investigator would observe who provides the plumbing supplies and paint—the employer or the workers—to help determine whether workers are independent contractors or employees. Also, a tour can identify potential misclassification issues for an investigator to follow up on. For example, if the payroll records show that the employer has 10 employees but the investigator sees 15 workers during the tour, then the investigator will conduct further interviews and record review to determine whether these other 5 workers are employees or independent contractors.

Because employee misclassification is not a violation of FLSA, investigators are not required to discuss misclassification identified during FLSA investigations with employers or to include it in their investigation report. According to DOL officials, however, an investigator may discuss

misclassification with the employer during the investigation and may note instances of misclassification in the investigation report. In discussing a misclassification case with the employer, the investigator would explain that the workers should be classified as employees, not independent contractors, and that the employer may be violating other laws administered by other agencies, such as tax laws or workers' compensation laws. Specifically, investigators would explain to the employer how they applied the Supreme Court factors in determining that the workers were employees, not independent contractors. DOL officials said that investigators would provide employers with publications and fact sheets on employment relationship if they identified misclassification during an investigation. In addition, the investigators may mention employee misclassification in their final investigation report that summarizes the facts of the investigation. According to DOL officials, if the investigators included misclassification in the case report, it would be mentioned as an underlying reason for a minimum wage or overtime violation. However, investigation reports do not always include the reason for the violation.

Employee Misclassification, though Not an FLSA Violation, May Contribute to FLSA or Other Violations

Employee misclassification alone is not a violation of FLSA, but may contribute to FSLA minimum wage and overtime pay violations or violations of tax, workers' compensation, or unemployment insurance laws.[32] DOL investigations have identified FLSA violations associated with employee misclassification. For example, one misclassification case involved a valet parking company located in Arizona that provided services to local restaurants, sports venues, hotels, and theaters. In 2004, this company paid $66,947 in minimum wage and overtime pay back wages to 262 employees who had been misclassified as independent contractors. When reviewing the employment relationship, the DOL investigator found that the services provided by these workers were integral to the business, and that the employer had imposed strict policies and procedures to follow and told them when they would work, where they would work, what their pay rate would be, and what uniforms they would wear. The investigator determined that the workers were not required to use initiative, judgment, or foresight to be successful as independent

[32] According to DOL officials, in some cases, misclassification may be considered an FLSA record-keeping violation, but there are no penalties for record-keeping violations under FLSA.

contractors; did not have any investment in facilities or equipment; and were not operating to make a profit.

Another misclassification case involved a chicken-processing company based in California that contracted out its deboning operations to a subcontractor. In 2005, DOL investigators found that the subcontractor had misclassified as independent contractors the employees he hired to work at this deboning plant. The subcontractor violated FLSA when he failed to meet payroll for 2 weeks, pay minimum wages and overtime pay, and keep adequate payroll records. The subcontractor also illegally deducted the cost of aprons, gloves, hair nets, and other required equipment from workers' paychecks. When the subcontractor went bankrupt, the contractor agreed to cover the back wages due—$40,000 owed to 59 workers—although the contractor was not legally required to do so.

DOL officials told us that their investigators have encountered cases where employers classified workers as independent contractors instead of employees to avoid paying proper wages under federal and state wage laws or to avoid providing benefits under other laws, such as workers' compensation and unemployment insurance laws. For example, in 2004, a joint DOL-State of California investigation found that a services company located in California had misclassified employees and not paid overtime in accordance with FLSA. The affected workers provided janitorial services to a major department store chain located in California, Arizona, Nevada, Texas, and New Mexico. According to DOL officials, the company contracted out the janitorial work to individuals who were not legitimate contractors in that, among other things, they did not control the location or hours of work. These "contractors" then hired others to do the janitorial work. As a result of this arrangement, the services company avoided paying minimum wage, overtime, and other benefits, such as workers' compensation. In response to the investigation, the company agreed to pay $1.9 million in back wages to 775 employees. Throughout the investigation, DOL worked with the state to ensure compliance with state wage laws, workers' compensation programs, and unemployment insurance programs.

DOL's Outreach Efforts Provide Some Information on Employee Misclassification Issues

As part of general FLSA outreach efforts to employers and workers, DOL provides some information on establishing the employment relationship. While these outreach efforts primarily focus on how to comply with provisions of FLSA—minimum wage, overtime pay, and child labor—they also include some information on the employment relationship.

Specifically, information on employment relationship issues is available to employers and workers through brochures, pamphlets, fact sheets, and Web-based information. According to DOL officials, outreach efforts conducted specifically for industries likely to use independent contractors may also address the topic of employee misclassification.

The DOL Web site contains several sources of information on the FLSA employment relationship. DOL's Wage and Hour Division posts its *Employment Relationship under FLSA* (WH Publication 1297) and fact sheets that provide information on determining the employment relationship in applying provisions of FLSA. For example, *Fact Sheet 13: Employment Relationship under the Fair Labor Standards Act (FLSA)* outlines the Supreme Court's factors for determining an employment relationship under FLSA and is available in several languages, including Chinese, Korean, Spanish, Thai, and Vietnamese. It also identifies common problems: (1) construction contractors hire so-called independent contractors, who in reality should be considered employees because they do not meet the Supreme Court tests for independence and (2) individuals who work at home are often improperly considered independent contractors. Another DOL Web site resource is Employment Laws Assistance for Workers and Small Businesses (elaws) FLSA Advisor, an interactive system that allows employers and workers to determine whether a worker would be considered an employee or an independent contractor. These Web site outreach sources contain contacts—such as the Wage-Hour toll-free telephone line and links to district office telephone numbers—to obtain additional information about employment relationship issues.

Another form of outreach that DOL provides is its workplace poster. FLSA regulations require that every employer that has employees subject to the act's provisions post a notice explaining the act in a prominent and accessible place at the work site.[33] While DOL relies heavily on complaints from workers to enforce FLSA, the FLSA workplace poster does not provide a telephone number for workers or others to call to register complaints. Instead, the poster directs inquiries for additional information to the nearest Wage and Hour Division office listed in the telephone directory under "United States Government, Labor Department." Also, the FLSA workplace poster does not include any information on the

[33] DOL's Wage and Hour Division prescribes the content of the FLSA workplace poster (WH Publication 1088).

employment relationship. As a result, individuals seeking to report possible employee misclassification complaints have no easy method to do so.

DOL district offices conduct locally based general FLSA outreach efforts for employer and worker groups that do not target employee misclassification, but they provide some information on establishing the employment relationship. DOL officials told us that they distribute employment relationship publications and fact sheets to industries that use independent contractors—such as the construction and garment industries—and may be more likely to misclassify employees. According to DOL officials, this outreach to industries using independent contractors may also address the topic of employee misclassification. Also, in DOL's Western Region, a recent outreach effort to educate Hispanic employers and workers about general workplace rights and responsibilities has identified cases of employee misclassification from calls to a hotline. Specifically, the Employment Education and Outreach (EMPLEO)—an alliance of federal and state agencies, Mexican and Central American consulates, and private nonprofit groups—provides a toll-free hotline staffed by Spanish-speaking volunteers, not associated with the government, who forward calls to the appropriate agency for response.

DOL Offices We Studied Vary in How Often They Forward Misclassification Cases to Other Federal and State Agencies

Employers' misclassification of workers as independent contractors may in some circumstances violate tax, unemployment insurance, and workers' compensation laws. According to the *Field Operations Handbook*, DOL regional or district officials are required to share information with other appropriate federal and state agencies whenever investigators conducting FLSA investigations find instances of possible violations of other laws. At the same time, however, the FOH cautions investigators not to interpret laws outside their authority. We discussed whether DOL forwards misclassification cases identified during an FLSA investigation. The DOL officials we spoke to in 9 district offices could not provide the number of misclassification cases they referred to other agencies because they do not track this information. However, their responses indicated that district offices vary in how often they implement the procedures to refer cases to other agencies. Some of the DOL district offices told us that they notified IRS and state agencies when they found misclassification, while others told us that they had little or no contact with other agencies regarding misclassification issues. These district offices also reported that it was

rare for them to receive misclassification referrals from other federal or state agencies.[34]

DOL requires its regional or district officials to notify other agencies about possible violations identified during DOL investigations. The procedures state that investigators should note conditions that appear to be possible violations of other federal or state laws or regulations. They also state that for matters that are not within the authority of the Wage and Hour Division, investigators should confine their investigative activities to obvious conditions that they observe, or are brought to their attention, to avoid any impression that the Wage and Hour Division is overstepping its investigation authority. Further, the procedures instruct investigators not to interpret any law other than those administered by the Wage and Hour Division. They also direct investigators to report to district office management any possible violations of other laws or regulations. The Wage and Hour Division provides a form (WH-124) for regional or district office officials to use to notify other federal or state agencies about possible violations of laws or regulations administered by those agencies.

According to DOL officials, investigators do not have the authority or the expertise to look for violations of other laws. DOL officials told us that because investigators focus on identifying minimum wage, overtime pay, and child labor violations during FLSA investigations, checking for compliance with laws enforced by other agencies is not a priority. DOL officials also noted that interagency collaboration on employee misclassification referrals is difficult because different laws have different tests of establishing the employment relationship.

The DOL district offices we contacted varied in how often they implemented the procedures to refer possible violations, including misclassification, to other federal or state agencies. According to the DOL officials in these offices, in most cases, district offices are responsible for contacting other agencies. While some districts told us that they notified IRS and state agencies about misclassification cases, other districts told us

[34] Beginning in 2005, DOL's Employment & Training Administration (ETA) has been involved in efforts to coordinate with other agencies about misclassification: (1) ETA has coordinated with IRS to assist states in obtaining IRS 1099 information to identify misclassification in state unemployment insurance tax audits and (2) ETA is participating on an interagency Questionable Employment Tax Practices team with IRS, federal tax administrators, and state workforce agencies to develop a memo of understanding, share information, and coordinate compliance activities. The team is planning to address several issues, including misclassification.

that they had no contact with states or other federal agencies about misclassification issues. Some district officials told us that they notified IRS when investigators found instances of misclassification that appeared to involve tax law violations, but rarely received any response from IRS after submitting their referral.[35] Other districts told us that they had little contact with IRS regarding misclassification.[36] For example, one district official said his district generally does not receive any feedback from IRS. He said that his district would have more incentive to refer cases if IRS would inform the district when it received DOL referrals and if the district knew that IRS would act on the referrals.

Similarly, some DOL officials told us that their contact with state agencies could include misclassification, while others said they had little contact with states about these issues. For example, one regional official cited coordination with the state agencies that are responsible for employment tax and registration of contractors in the construction industry. He said that this state agency imposes fines on individuals who are not registered as contractors and that this sometimes involves misclassification.[37]

District officials in the offices we contacted said they rarely receive referrals about misclassification from other federal or state agencies. While one district official said that other state agencies in the region refer some complaints that occasionally include misclassification issues, most officials said their districts have not received any misclassification referrals from IRS or other federal or state agencies.

Conclusions

Contingent workers constitute an important and diverse sector of the U.S. workforce. Yet while contingent work arrangements offer flexibility to both employers and workers, they also provide contingent workers with fewer workforce protections than are available to other workers. Contingent workers also received fewer benefits. Many contingent

[35] The IRS officials we contacted about this could not comment on the specifics of referrals at the district level.

[36] Also, some districts have made referrals and conducted general outreach to IRS when DOL has identified that employers are paying workers in cash, and most likely are not paying taxes. However, this practice is not necessarily employee misclassification.

[37] One district has coordinated with state agencies that enforce tax, workers' compensation, unemployment insurance, and Social Security laws about workers paid in cash and probably not paying taxes. However, this practice is not employee misclassification.

workers may not be covered under employer-sponsored health and benefit plans and may not be able to afford these benefits on their own—a situation that could have long-term adverse consequences for workers and government programs. To the extent that contingent workers neither receive health or pension benefits nor qualify for unemployment or workers' compensation, they may have to turn to needs-based programs, such as Medicaid, to make ends meet. To the extent that this occurs, costs formerly borne by employers may be shifted to federal and state public assistance budgets. To help address the lack of health insurance coverage, some state and professional associations have developed programs that help contingent workers access health care. Although these initiatives are relatively new and long-term outcomes have yet to be determined, they may serve as promising practices for the future.

DOL investigators identify instances of employee misclassification when responding to minimum wage and overtime pay complaints. However, because the FLSA workplace poster does not provide an easy method for workers to report complaints, DOL may be missing opportunities to address other instances of potential misclassification. Improving the workplace poster would reinforce DOL's complaint-based strategy and would help further protect the wages of employees who may be misclassified.

While DOL investigators conducting FLSA investigations are required to share information with other federal and state agencies whenever they find instances of possible violations of other laws, DOL district offices we studied varied in how often they forwarded misclassification cases to other agencies. DOL does not know the extent to which district offices refer misclassification cases to other agencies. DOL cautions investigators not to interpret laws outside their authority, but referring misclassification cases identified through FLSA investigations would not require DOL to interpret other agencies' laws. In addition, referring this information may assist other federal and state agencies in addressing misclassification. Furthermore, when DOL does not refer cases of misclassification, other agencies lose opportunities to fulfill their fiduciary duties in conserving government funds.

Recommendations for Executive Action

To facilitate the reporting of FLSA complaints, we recommend that the Secretary of Labor instruct the Wage and Hour Division to revise the FLSA workplace poster to include national, regional, and district office telephone numbers and a Web site address that complainants may use to report alleged employee misclassification issues.

To facilitate addressing employee misclassification across federal and state programs, we recommend that the Secretary of Labor instruct the Wage and Hour Division to evaluate the extent to which misclassification cases identified through FLSA investigations are referred to the appropriate federal or state agency potentially affected by employee misclassification, and take action to make improvements as necessary. In addressing its referral mechanism, the Wage and Hour Division officials should consider building upon efforts by district offices currently engaging in referrals.

Agency Comments

We provided a draft of this report to DOL for comment. Overall, DOL agreed with the first recommendation and agreed with the primary part of the second recommendation, but disagreed with one part of this recommendation. DOL's written comments are reproduced in appendix V.

DOL's ESA agreed with the first recommendation on revising the workplace poster to provide additional contact information to facilitate the reporting of possible misclassification complaints. ESA noted that the Wage and Hour Division is in the process of revising its workplace poster to add the division's toll-free phone number.

Regarding the second recommendation, on referring misclassification cases to other agencies, DOL agreed with the value of sharing potential employee misclassification with appropriate federal and state programs. The agency commented that the Wage and Hour Division will review its processes to determine the appropriateness of referral of such cases to other agencies. However, DOL did not agree with a part of the draft recommendation that referral of cases should include notifying the employer that the misclassification case has been forwarded to the appropriate agency. The agency stated that such notification could place the Wage and Hour Division staff in the untenable position of having to defend a referral based upon interpretations of laws, which the division staff has no expertise or authority to interpret or enforce. After considering DOL's position concerning this aspect of the draft recommendation, we deleted this part from the final recommendation.

DOL's BLS also provided technical comments, which we incorporated in the report as appropriate.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this report. At that time, we will send copies of this report to the Secretary of Labor and other interested parties. We will also make copies available to others upon request. In addition, the report will be available at no charge on GAO's Web site at http://www.gao.gov.

If you or your staff have any questions about this report, please contact me at (202) 512-7215 or robertsonr@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who have made major contributions to this report are listed in appendix VI.

Sincerely,

Robert E. Robertson
Director, Education, Workforce,
and Income Security Issues

Appendix I: Objectives, Scope, and Methodology

The objectives of our study were to determine (1) the size and nature of the contingent workforce, (2) the benefits and workforce protections provided to contingent workers, and (3) the actions that the Department of Labor (DOL) takes to detect and address employee misclassification.

To obtain information on the contingent workforce, we analyzed data from the Bureau of Labor Statistics (BLS). Specifically, we reviewed BLS's Current Population Survey (CPS), which is used to survey people about their work and benefits, and a CPS supplement that BLS developed to collect information on the contingent workforce. We defined "contingent workers" according to the methodology used in our 2000 review of the contingent workforce, examining eight categories of workers who could be considered contingent: agency temporary workers (temps), direct-hire temps, on-call workers, day laborers, contract company workers, independent contractors, self-employed workers, and standard part-time workers.[1] Standard full-time workers were defined as all workers who do not fall into one of the contingent worker categories. We reported descriptive statistics on the characteristics of contingent workers and standard full-time workers, their receipt of health insurance, and their participation in pension plans. We did not conduct multivariate analyses to determine the causal relationships explaining contingent workers' incidence of low family income, receipt of health insurance, or participation in pension plans. We also interviewed BLS officials and other researchers about contingent worker issues.

To estimate the size of the contingent workforce and describe how it has changed over the past decade, we used data collected in the CPS as well as data collected in a special supplement to the survey—the Contingent Work Supplement—in February 1995, 1999, and 2005.[2] To describe the demographic characteristics of the contingent workforce and the extent to which these workers have access to health insurance and pension benefits, we used data collected in the CPS and the Contingent Work Supplement in February 2005.

[1] GAO, *Contingent Workers: Incomes and Benefits Lag Behind Those of Rest of Workforce*, GAO/HEHS-00-76 (Washington, D.C.: June 30, 2000).

[2] The years 1995, 1999, and 2005 were selected to examine changes in the size of the contingent workforce over the past decade in order to reflect the changes that occurred during the time period covered in our 2000 review of contingent workers (1995-1999) as well as those occurring since that time (1999-2005).

The CPS is designed and administered jointly by the Bureau of the Census (Census) and BLS. It is the source of official government statistics on employment and unemployment in the United States. The survey is used to collect information on employment as well as such demographic information as age, sex, race, marital status, educational attainment, and family structure. The survey is based on a sample of the civilian, noninstitutionalized population of the United States. Using a multistage stratified sample design, about 60,000 households are selected on the basis of area of residence to be representative of the country as a whole and of individual states. A more complete description of the survey, including sample design, estimation, and other methodology, can be found in the CPS documentation prepared by Census and BLS.[3]

The Contingent Work Supplement was designed by BLS to obtain information from workers on whether they hold contingent jobs, defined by BLS as jobs that are expected to last only a limited period of time.[4] In addition, information is collected on several alternative employment relationships, namely working as independent contractors and on call, as well as working through temporary help agencies or contract firms. All employed persons except unpaid family members are included in the supplement. For persons holding more than one job, the questions refer to the characteristics of their main job—the job in which they work the most hours. Similar surveys have been conducted in February of 1995, 1997, 1999, 2001, and 2005. For a more complete description of the supplement see the technical documentation prepared by Census and BLS.[5]

For our data reliability assessment, we reviewed agency documents on the CPS and conducted electronic tests of the files. On the basis of these reviews, we determined the required data elements from the CPS were sufficiently reliable for our purposes.

Because the CPS is a probability sample of the population based on random selection, the sample is only one of a large number of samples that

[3] See Technical Paper 63RV: "Current Population Survey—Design and Methodology," issued March 2002.

[4] See Anne E. Polivka, "Contingent and Alternative Work Arrangements, Defined," *Monthly Labor Review* (Oct.1996), pp. 3-9 for a description of how BLS defines and estimates the contingent workforce.

[5] Current Population Survey, February 2005: Contingent Work Supplement File Technical Documentation CPS-05.

might have been drawn. Since each sample could have provided different estimates, confidence in the precision of the particular sample's results is expressed as a 95 percent confidence interval (for example, +/- 4 percentage points). This is the interval that would contain the actual population value for 95 percent of the samples that could have been drawn. As a result, we are 95 percent confident that each of the confidence intervals in this report will include the true values in the study population.

For the CPS estimates in this report, we use the CPS general variance methodology to estimate the sampling error and report it as confidence intervals. Percentage estimates based on the total workforce have 95 percent confidence intervals of within +/- 1 percentage point of the estimate itself, unless otherwise noted.[6] Percentage estimates for individual categories of contingent workers have confidence intervals of within +/- 10 percentage points of the estimate unless otherwise noted. Estimates of totals exceeding 1 million workers have 95 percent confidence intervals of within +/- 10 percent of the estimate itself unless otherwise noted. Estimates of totals exceeding 400,000 workers have 95 percent confidence intervals of within +/- 20 percent of the estimate itself unless otherwise noted. The 95 percent confidence intervals for other estimates are presented with the estimates themselves in the body of the report. Consistent with CPS documentation guidelines, we do not produce estimates from the February 2005 supplement for populations of less than 75,000.

In addition to the reported sampling errors, the practical difficulties of conducting any survey may introduce other types of errors, commonly referred to as nonsampling errors. For example, differences in how a particular question is interpreted, the sources of information available to respondents, or the types of people who do not respond can introduce unwanted variability into the survey results. For the CPS, data are often collected from one household member for all household members. Nonsampling error could occur if a proxy responder was unable to provide correct pension or insurance information for household members not at home at the time of the interview.

Although we used data from the Contingent Work Supplement, we used a definition of contingent worker different from the one used by BLS in its

[6] For example, an estimated 30.6 percent of the 2005 workforce are contingent workers; the 95 percent confidence interval for this estimate would be within 29.6 and 31.6 percent.

analysis of the data. As in our 2000 review of contingent workers, we did not restrict our definition to include only workers with relatively short job tenure, but rather provided information on a range of workers who could be considered contingent under different definitions. Although we believe that it is useful to consider the nature and size of the population of workers in jobs of limited duration as well as their access to benefits, we also believe that it is useful to provide information according to categories that are more readily identifiable and mutually exclusive.[7] The categories we used to define the contingent workforce included direct-hire temporaries (workers hired directly by employers to work in temporary jobs), even though the Contingent Work Supplement did not contain a question that directly asked for this information.[8] We also combined on-call workers and day laborers because the definitions and characteristics of these workers are similar and the number of day laborers alone was not large enough to be statistically significant. Information on leased workers was not included in our 2000 review of contingent workers because of a lack of data on these workers. For this reason, leased workers were not included in the definition of the contingent workforce used in this report.

To obtain information about the workforce protections that are offered to contingent workers, we reviewed key workforce protection laws, related court cases, and other studies on contingent workers.

To obtain information on DOL's actions to detect and address employee misclassification as part of FLSA enforcement, we reviewed FLSA and its corresponding regulations. We also reviewed DOL documents related to FLSA, including policies and procedures on conducting investigations, information on investigator training, and outreach efforts. We interviewed

[7] See Susan N. Houseman, *Flexible Staffing Arrangements*, August 1999, and Anne E. Polivka, Sharon R. Cohany, and Steven Hipple, "Definition, Composition, and Economic Consequences of the Nonstandard Workforce," in *Nonstandard Work: The Nature and Challenges of Changing Employment Arrangements*, Industrial Relations Research Association Series 2000, edited by Francoise Carre, Marianne A. Ferber, Lonnie Goldman, and Stephen A. Herzenberg, for examples of the research used to model the different categories of contingent workers.

[8] The category of direct-hire temps was constructed using several questions from the supplement. We included workers who indicated that although they did not work for a temporary employment agency, their job was temporary or they could not stay in their jobs as long as they wished for one of the following reasons: (1) they were working only until a specific project was completed, (2) they were temporarily replacing another worker, (3) they were hired for a fixed period of time, (4) their job was seasonal, or (5) they expected to work for less than a year because their job was temporary.

officials from the Wage and Hour Division headquarters office, 3 of the 5 regional offices, and 9 of the 51 district offices—3 district offices in each region. We selected a nonprobability sample of district and regional offices to target offices located in large cities and that provided geographic coverage across each region. Because this was not a probability sample, we did not generalize the results of our regional and district interviews to the regions and districts we did not contact. In each office, we interviewed regional and district management-level officials using a standard set of questions in order to obtain information related to employee misclassification as part of FLSA enforcement. The interview questions asked about (1) the extent and source of employee misclassification, (2) investigations related to employee misclassification, and (3) training and outreach efforts related to employee misclassification. We contacted the following offices:

- Northeast Regional Office
  - New York City District Office
  - Richmond District Office
  - Southern New Jersey District Office
- Midwest Regional Office
  - Columbus District Office
  - Detroit District Office
  - Springfield District Office
- Western Regional Office
  - East Los Angeles District Office
  - Phoenix District Office
  - Seattle District Office

In addition, we reviewed literature and interviewed researchers from four academic institutions and two nonprofit groups about employee misclassification issues.

We performed our work in accordance with generally accepted government auditing standards between July 2005 and June 2006.

Appendix II: Establishing the Employment Relationship of Workers

Establishing the employment relationship of workers under the Fair Labor Standards Act (FLSA) and the Employee Retirement Income Security Act (ERISA) can be complex and may result in litigation. FLSA requires that an employer-employee relationship exist for a worker to be covered by the act's provisions.[1] FLSA—which provides minimum wage and overtime pay protections—requires that employers pay those employees covered by the act at least the minimum wage and pay overtime wages when they work more than 40 hours a week.[2] The act defines "employee" broadly as an individual employed by an employer. The U.S. Supreme Court has identified certain factors that should be considered in determining whether a worker is an employee or an independent contractor under FLSA. In general, a worker who meets the FLSA definition of employee is one who is economically dependent on the business he or she serves. In contrast, an independent contractor is one who is engaged in a business of his or her own. The test used to determine whether an employment relationship exists for FLSA purposes is referred to as the economic realities test.[3] The court has indicated that in applying this economic realities test under FLSA, such determinations must consider the circumstances of the whole activity and cannot be based on isolated factors or a single characteristic. In enforcing FLSA, DOL uses the following factors:

- **The extent to which the worker's services are an integral part of the employer's business**
  - Examples: Does the worker play an integral role in the business by performing the primary type of work that the employer performs for their customers? Does the worker perform a discrete job that is one part of the business' overall process of production? Does the worker supervise any of the company's employees?

- **The permanency of the relationship**
  - Example: How long has the worker worked for the same company?

[1] 29 U.S.C. 201 et. seq.

[2] FLSA also includes record-keeping and child labor provisions.

[3] *Rutherford Food Corp. v. McComb*, 331 U.S. 722, 730 (1947).

- **The amount of the worker's investment in facilities and equipment**
  - Examples: Is the worker reimbursed for any purchases, materials, or supplies? Does the worker use his or her own tools or equipment?
- **The nature and degree of control by the employer**
  - Examples: Who decides on what hours to be worked? Who is responsible for quality control? Does the worker work for any other company(s)? Who sets the pay rate?
- **The worker's opportunities for profit and loss**
  - Examples: Did the worker make any investments such as insurance or bonding? Can the worker earn a profit by performing the job more efficiently or exercising managerial skill or suffer a loss of capital investment?
- **The amount of initiative, judgment, or foresight in open market competition with others required for the success of the claimed independent contractor**
  - Examples: Does the worker perform routine tasks requiring little training? Does the worker advertise independently through the Yellow Pages or business cards? Does the worker have a separate business site?

In some cases, employers misclassify workers as independent contractors when they should be classified as employees. Under FLSA, the courts have examined the issue of misclassification by applying the economic realities test and making case-by-case determinations as to whether the workers are employees and thereby covered by the act. For example, a federal district court recently determined that over 500 delivery workers for supermarket and drugstore chains had been misclassified as independent contractors.[4] The court ruled that the companies that had hired these workers to make deliveries controlled their placement and pay, provided them with delivery carts to rent and uniforms to purchase, required little skill to perform the job, and that the work performed constituted an integral part of the companies' business. Therefore, the court ruled that they were employees and entitled to overtime wages under FLSA. In another case, DOL brought suit on behalf of cable installers against cable television providers and cable installation companies for overtime

[4] *Ansoumana v. Gristede's Operating Corp.*, 255 F. Supp. 184 (2003).

compensation under FLSA. In this case, the court ruled that the employer did not exhibit the type of control needed to characterize the relationship as employee-employer, that the workers provided their own van and other equipment, and that the job required skilled labor. On the basis of these factors, the court denied the claim and held that the cable installers were properly classified as independent contractors and not entitled to protection under FLSA.[5]

The complexity of issues involving joint employment and misclassification of employees is illustrated by litigation involving the Microsoft Corporation. In the late 1980s, Microsoft began to hire what the company classified as independent contractors to fill many of its full-time employment vacancies. After the Internal Revenue Service (IRS) determined that these workers were common law employees in 1989 and 1990, Microsoft terminated the employment relationship, set up an employment agency, and converted these workers into temporary agency employees. The workers sued Microsoft, and in 1996 the court ruled that they were employees of the company rather than independent contractors or temporary agency employees.[6] The court then considered whether or not the employees were eligible for the employer's saving and stock purchase plan benefits under ERISA. The determining factor was the language included in Microsoft's plan, which expressly made any common law employee on the U.S. payroll eligible for benefits. However, while the court determined that the workers were common law employees, it directed Microsoft to determine what rights these workers, as common law employees, had under Microsoft's ERISA plan. Eventually the parties entered into a settlement agreement in which Microsoft paid $96.9 million.

Other cases have held that although workers may have been misclassified, they still did not qualify for benefits under ERISA plans because they did not qualify under the language of the plan that excluded certain types of employees, such as temporary or leased employees.[7] Some employers amended their ERISA plans in response to the Microsoft decision to limit participation to workers that the employers classified as employees, whether or not the excluded workers may later be determined to be

[5] *Herman v. Mid-Atlantic Installation Services, Inc.*, 164 F.Supp2d 667 (2000).

[6] *Vizcaino v. Microsoft Corp.*, 97 F.3d 1187 (9th Cir. 1996).

[7] *Wolf v. Coca Cola*, 200 F.3d 1337 (11th Cir.2000); *Bronk v. Mountain States Tel. & Tel., Inc.*, 140 F. 3d 1335 (10th Cir.1998); *Abraham v. Exxon Corp.*, 85 F.3d 1126 (5th Cir.1996).

employees by the IRS or courts. The IRS has approved the use of such language in ERISA plans.[8]

[8] The IRS issued an unnumbered Technical Advice Memorandum on July 28, 1999, approving a clause excluding from participation in the plan individuals whom the employer had engaged and treated as independent contractors, even if they were later found to be employees.

Appendix III: Size and Characteristics of the Contingent Workforce

This table provides the following information on contingent workers: growth rates (percentage changes) and changes in the share of the total workforce (percentage point changes) for 1995-1999, 1999-2005, and 1995-2005.

Table 4: Changes in the Size of the Contingent Workforce

	Feb. 1995—Feb. 1999		Feb. 1999—Feb. 2005		Feb. 1995—Feb. 2005	
Category of worker	Percentage change (number of workers)	Percentage point change (percentage of total workforce)	Percentage change (number of workers)	Percentage point change (percentage of total workforce)	Percentage change (number of workers)	Percentage point change (percentage of total workforce)
Agency temps	+ 0.6*	- 0.1*	+ 2.4*	0.0*	+ 3.0*	- 0.1*
Direct-hire temps	- 4.9*	- 0.3	- 7.9*	- 0.4	- 12.4	- 0.7
On-call workers/ day laborers	+ 8.2*	+ 0.1*	+ 25.5	+ 0.3	+ 35.8	+ 0.4
Contract company workers	+ 17.9*	+ 0.1*	+ 5.7*	0.0*	+ 24.7	+ 0.1*
Independent contractors	- 0.7*	- 0.4	+ 25.4	+ 1.1	+ 24.5	+ 0.7
Self-employed workers	- 13.5	- 1.1	- 2.5*	- 0.4	- 15.6	- 1.5
Standard part-time workers	+ 3.4*	- 0.4*	+ 5.6	0.0*	+ 9.2	- 0.4*
Subtotal: contingent workers	**- 0.9***	**- 2.3**	**+ 8.4**	**+ 0.7**	**+ 7.4**	**- 1.6**
Standard full-time workers	+ 10.3	+ 2.3	+ 4.5	- 0.7	+ 15.3	+ 1.6
Total workforce	**+ 6.7**	------	**+ 5.7**	------	**+ 12.8**	------

Source: GAO analysis of data from the CPS February 2005 Contingent Work Supplement.

Note: An asterisk (*) denotes that the change over this period was not statistically significant for this category of worker at the 95 percent confidence level.

Table 5: Characteristics of Contingent Workers (February 2005)

(Percentage unless indicated otherwise)

	Agency temps	Direct-hire temps	On-call workers and day laborers	Contract company workers	Independent contractors	Self-employed workers	Standard part-time workers	Standard full-time workers
AGE								
16-19 years	3	11	7	1	1	0	20	1
20-24 years	17	21	15	11	3	1	17	8
25-34 years	30	25	22	25	15	13	15	24
35-54 years	37	29	39	47	54	55	30	52
55-64 years	11	9	11	14	19	21	10	13
65 and older	3	5	7	2	9	9	8	2
Mean age (years)	37.4	35.2	38.9	40.3	46.4	47.9	36.2	40.8
GENDER								
Men	47	49	53	69	65	63	32	56
Women	53	51	47	31	35	35	37	68
RACE/ORIGIN								
White, non-Hispanic	50	63	68	62	80	81	76	69
Black, non-Hispanic	22	9	8	15	5	4	9	11
Hispanic	21	18	19	16	9	7	11	14
Other, non-Hispanic	8	9	5	7	5	9	5	6
EDUCATION								
Less than high school diploma	18	15	20	17	8	8	21	9
High school diploma, no college	29	21	29	22	28	28	27	31
Some college	32	33	28	29	29	26	35	28
College degree	19	17	16	18	22	23	12	21
Graduate school	2	14	6	14	13	15	5	11
DIVISION								
New England	4	6	3	3	5	3	6	5
Middle Atlantic	8	11	12	15	11	12	15	14
E. North Central	17	14	14	10	15	15	19	15
W. North Central	5	8	7	4	8	9	8	7
South Atlantic	19	17	15	30	19	17	16	19
E. South Central	7	6	7	4	5	5	5	6
W. South Central	12	9	13	15	10	11	9	11
Mountain	6	6	7	6	9	8	6	7
Pacific	22	23	23	13	19	19	15	15

	Agency temps	Direct-hire temps	On-call workers and day laborers	Contract company workers	Independent contractors	Self-employed workers	Standard part-time workers	Standard full-time workers
INDUSTRY								
Business services	28	4	5	5	7	5	4	3
Auto and repair services	0	1	1	0	4	4	1	1
Personal services								
—Private households	2	2	1	0	2	0	1	0
—Other personal services	1	1	2	2	5	6	3	2
Arts, entertainment, recreation services	0	3	4	1	3	2	3	1
Professional services								
—Hospitals	2	4	6	3	0	0	5	5
—Health services	7	3	6	5	3	7	7	5
—Educational services	1	28	18	8	2	2	10	10
—Social services	1	2	2	0	3	4	4	2
—Other professional services	5	9	4	5	15	8	6	7
Agriculture	0	1	2	0	2	11	0	1
Mining	0	0	1	0	0	0	0	1
Construction	3	9	14	17	22	6	3	7
Durable goods manufacturing	17	3	2	8	2	4	1	10
Nondurable goods manufacturing	12	2	3	6	1	3	2	5
Transportation and warehousing	2	2	7	2	4	3	3	5
Communications, information, Internet	2	2	2	4	2	1	2	3
Utilities and sanitation	1	1	1	2	0	0	0	1
Wholesale trade	6	2	2	3	2	5	1	4
Retail trade								
—Other retail trade	2	6	6	3	9	17	22	11
—Eating and drinking establishments	1	5	5	2	1	4	16	4
Banking and other finance	2	1	1	2	2	2	2	4
Insurance and real estate	2	2	2	5	8	7	2	4
Forestry and fisheries	0	0	0	0	1	1	0	0
Justice, public order, and safety	0	1	3	2	0	0	0	3
Admin of human resource programs	1	1	0	3	0	0	0	1
National security, international affairs	0	1	0	6	0	0	0	1
Other public administration	2	2	0	7	0	0	0	2

	Agency temps	Direct-hire temps	On-call workers and day laborers	Contract company workers	Independent contractors	Self-employed workers	Standard part-time workers	Standard full-time workers
OCCUPATION								
Management	2	5	3	4	16	29	3	10
Business and financial operations	6	3	2	6	6	2	2	5
Computer and mathematical science	3	2	1	13	2	1	1	3
Architecture and engineering	2	1	1	6	2	0	1	2
Life, physical, and social science	1	2	0	1	1	1	0	1
Community and social service	0	2	1	1	0	0	1	2
Legal	0	1	0	0	2	3	0	1
Education, training, and library	2	17	14	2	2	1	7	6
Arts, design, entertainment, sports, media	1	4	4	3	7	3	2	1
Health care practitioner and technical	3	3	7	2	3	6	6	5
Health care support	5	2	3	3	1	0	4	2
Protective service	0	1	3	12	0	0	1	3
Food preparation and serving	1	5	6	3	0	1	16	4
Building, grounds cleaning, and maintenance	5	3	6	7	5	3	4	3
Personal care and service	4	6	3	1	7	8	5	2
Sales and related occupations	2	6	5	2	17	21	18	10
Office and administrative support	25	15	9	5	3	5	18	15
Farming, fishing, and forestry	1	2	2	0	1	0	0	1
Construction and extraction	4	7	15	20	15	4	2	6
Installation, maintenance, and repair	3	4	4	2	4	3	1	4
Production	17	4	3	2	2	4	3	8
Transportation and material moving	13	5	10	3	4	3	6	7

Source: GAO analysis of data from the CPS February 2005 Contingent Work Supplement.

Appendix IV: Key Laws Designed to Protect Workers

This appendix provides a more detailed description of the key laws designed for workers' protection and their applicability to members of the contingent workforce. By definition, these laws apply only to employees—independent contractors and self-employed workers are not covered. However, no definitive test exists to distinguish whether a worker is an employee or an independent contractor. In determining whether an employment relationship exists under federal statutes, courts have developed several criteria. These criteria have been classified as the economic realities test, the common law test, and a combination of the two sometimes referred to as a hybrid test.

The economic realities test looks to whether the worker is economically dependent upon the principal or is in business for himself. The test is not precise, leaving determinations to be made on a case-by-case basis. The test consists of a number of factors, such as the degree of control exercised by the employing party over the worker, the worker's opportunity for profit or loss, the worker's capital investment in the business, the degree of skill required for the job, and whether the worker is an integral part of the business.

The traditional common law test examines the employing party's right to control how the work is performed. To determine whether the employing party has this right, courts may consider the degree of skill required to perform the work, who supplies the tools and equipment needed to perform the work, and the length of time the worker has been working for the employing party.

When the tests are combined in some type of hybrid, a court typically weighs the common law factors and some additional factors related to the worker's economic situation, such as how the work relationship may be terminated, whether the worker receives leave and retirement benefits, and whether the hiring party pays Social Security taxes.

Each of the laws is discussed in more detail below, including the tests used under each to determine whether a worker is an employee or an independent contractor.

Family and Medical Leave Act of 1993 (29 U.S.C. 2601)

The Family and Medical Leave Act of 1993 provides various protections for employees who need time off from their jobs because of medical problems or the birth or adoption of a child. The act requires employers to allow employees to take up to 12 weeks of unpaid leave for medical reasons related to the employee or a family member or to care for a newborn or

newly adopted child without reduction of pay or benefits when he or she returns to work. It also requires employers to maintain the same health care coverage for employees while they are on leave that was provided when they were actively employed. To be eligible for this coverage, employees must have been employed for 12 months by an employer that employs 50 or more employees who work 20 or more calendar weeks in a year and must have worked at least 1,250 hours during the past 12 months.

To determine whether a worker is a covered employee under the law, the courts have applied the economic realities test.

Employee Retirement Income Security Act (29 U.S.C. 1001)

The Employee Retirement Income Security Act establishes uniform standards for employee pension and welfare benefit plans, including minimum participation, accrual, and vesting requirements; fiduciary responsibilities; and reporting and disclosure requirements. The act does not require employers to provide pension or welfare benefits to employees; it applies to any employer or employee organization engaged in commerce or any industry affecting commerce that maintains a covered employee benefit plan.

Contingent workers are covered by the act only if the employer allows them to participate in a pension or welfare benefit plan. Which employees are included in a plan depends on how the plan documents are drafted and interpreted. If an employer wishes to exclude some or all types of contingent workers from participating in a plan, the employer must clearly define the excluded groups of workers, and that definition must be properly applied. Otherwise, contingent workers whom the employer intended to exclude may be covered.

To determine whether a worker is a covered employee under the law, the courts have applied the common law test.

Fair Labor Standards Act (29 U.S.C. 201)

The Fair Labor Standards Act establishes minimum wage, overtime, and child labor standards for employees. The act covers all employees of employers engaged in commerce or the production of goods that meet a dollar-volume-of-business requirement. The act also covers all employees engaged in commerce or the production of goods for commerce; all employees engaged in domestic service covered by the law; all employees of a hospital, residential care institution, or school; and all federal, state, and local government employees.

To determine whether a worker is a covered employee under the law, the courts have applied the economic realities test.

National Labor Relations Act (29 U.S.C. 151)

The National Labor Relations Act guarantees the right of employees to organize and bargain collectively. The act applies to all employers and employees in their relationships with labor organizations whose activities affect interstate commerce. The act does not differentiate by firm size.

The coverage issue regarding temporary workers is whether they have a right to join the same bargaining units as permanent employees with whom they work. Generally, agency temps who work at one site on a fairly regular basis over a sufficient period of time can join the existing collective bargaining unit of permanent employees if the agency (or agencies, if more than one is involved) and the employer that hired the workers from the agency consent to this arrangement. However, temporary workers often do not work at one work site long enough to have an interest in joining a union.

To determine whether a worker is a covered employee under the law, the courts have applied the common law test.

Unemployment Insurance

The unemployment insurance system is a joint federal-state system funded by both federal and state payroll taxes. It was established by the Social Security Act of 1935 and was intended to provide temporary relief through partial wage replacement for workers who lose jobs for economic reasons, such as layoffs, and to help stabilize the economy during recessions. The system pays benefits to workers who become unemployed and meet state-established eligibility rules. To determine whether a worker is a covered employee under the law, most states use a different type of test than is used for other laws. This test is called the ABC test: workers are considered employees unless (a) they are free from direction and control over performance of the work; (b) the service is performed either outside the usual course of the business for which it is performed or is performed outside of all places of business of the enterprise for which it is performed; and (c) the individual is customarily engaged in an independent trade, occupation, profession, or business.

Workers' Compensation

State and federal workers' compensation programs provide benefits for wage loss and medical care to injured workers and, in some cases, their families. At the same time, employers' liabilities are limited strictly to

workers' compensation payments. Benefits paid depend on the nature and extent of the injuries and the ability of injured workers to continue working. For employees whose injuries are not serious, the only benefits received are of a medical nature. Employees with more serious injuries or illnesses may also be entitled to wage-loss benefits; vocational rehabilitation benefits; and schedule payments for the permanent loss, or loss of use of, parts or functions of the body. In addition, survivors of an employee may receive death benefits if the employee's death resulted from a job-related injury or illness. To determine whether a worker is a covered employee under the law, most states use the common law test.

Occupational Safety and Health Act (29 U.S.C. 651)

The Occupational Safety and Health Act requires employers to maintain a safe and healthful workplace and provides employees with certain rights and responsibilities. Courts use either the economic realities test or the common law test to determine whether someone is an employee under the act. According to the law, the party responsible for ensuring safety is the employer that is in direct control of the workplace and the actions of those who work there, including contingent workers such as agency temps and contract company workers who are supplied by another party. Thus, if an accident occurs at the workplace, the employer that created the hazard, not the temporary help firm or contract company, is responsible.

Title VII of the Civil Rights Act (42 U.S.C. 2000e), the Americans with Disabilities Act (42 U.S.C. 12101), and the Age Discrimination in Employment Act (29 U.S.C. 621)

Title VII of the Civil Rights Act, the Americans with Disabilities Act, and the Age Discrimination in Employment Act protect all employees and job applicants from various forms of discrimination, such as discrimination based on race, national origin, gender, disability, or age. The Civil Rights Act and the Americans with Disabilities Act apply to employers that have 15 or more employees for each of 20 or more calendar weeks in a year. The Age Discrimination in Employment Act applies to employers that have 20 or more employees for each working day in each of 20 or more calendar weeks.

Further, each of these laws explicitly covers temporary employment agencies. Title VII of the Civil Rights Act explicitly prohibits employment agencies from discriminating on the basis of race, color, religion, gender, or national origin in classifying or referring people for employment. The Americans with Disabilities Act explicitly includes employment agencies in the definition of entities covered by the law. The Age Discrimination in Employment Act explicitly prohibits employment agencies from discriminating on the basis of a person's age (if over 40) in classifying or referring a person for employment.

To determine whether a worker is a covered employee under federal antidiscrimination statutes, the courts have used all three tests—the common law test, the economic realities test, and the hybrid test. Independent contractors receive some protection from discrimination. Under a provision of the Civil Rights Act that protects contractual rights, independent contractors are protected against racial discrimination in both the termination of a contract and the creation of a hostile work environment. In joint employment situations, one employer may be liable for the discriminatory acts of the other employer if the employer that is being held liable controls some substantial aspect of the employee's compensation or terms and conditions of employment.

Consolidated Omnibus Budget Reconciliation Act (29 U.S.C. 1161)

Continuation of group health plan coverage is generally required under this act for employees who otherwise would lose coverage as a result of certain events, such as being laid off by their employers. Individuals may continue coverage under their former employers' group health plans at their own expense. Depending on the qualifying event, the duration of required coverage ranges from 18 to 36 months. In general, when a covered employee experiences termination or reduction in hours of employment, the continued coverage of the employee and the employee's spouse and dependents must continue for 18 months. The act applies to all group health plans, except those maintained by employers with fewer than 20 employees. Workers who were considered employees under the group health plans are also employees for purposes of this act.

Health Insurance Portability and Accountability Act of 1996 (Pub. L. No. 104-191)

This act guarantees the availability and renewability of health insurance coverage for certain individuals. It limits, and in most cases eliminates, the waiting time before a plan covers a preexisting condition for group health plan participants and beneficiaries who move from one job to another and from employment to unemployment. The act also creates federal standards for insurers, health maintenance organizations, and employer plans, including employers who self-insure. The act does not require employers to offer health insurance to its employees or, if they offer health insurance, to cover part-time, seasonal, or temporary employees. The act increases the tax deduction for health insurance for self-employed workers, including independent contractors, to 100 percent of premiums and provides new tax incentives to encourage individuals and employers to purchase long-term-care insurance.

Appendix V: Comments from the Department of Labor

U.S. Department of Labor

Assistant Secretary for
Employment Standards
Washington, D.C. 20210

JUN 14 2006

Mr. Robert E. Robertson
Director, Education, Workforce, and
Income Security Issues
United States Government Accountability Office
Washington, D.C. 20548

Dear Mr. Robertson:

Thank you for the opportunity to comment on the draft report entitled *"Employment Arrangement: Improved Outreach Could Help Ensure Proper Worker Classification"* (GAO-06-655) (Job Code 130460).

The report contains two recommendations to address employee misclassification. Our comments follow a restatement of each recommendation.

Recommendation 1

To facilitate the reporting of FLSA complaints, we recommend that the Secretary of Labor instruct the Wage and Hour Division to revise the workplace poster to include national, regional and district office phone numbers and a Web site address that complainants may use to report alleged employee misclassification issues.

Response

The WHD is in the process of revising its workplace poster to add the WHD's toll-free number, 1-866-4US-WAGE (1-866-487-9243). Calls to the number are handled by call center staff who screen information, provide general guidance to employees and refer complainants to the appropriate WHD office. The call center currently has Spanish-speaking customer service representatives and an interpreter service that supports 150 languages. The WHD will also add the agency's web site address to the poster, which can be used to report alleged violations, including those that may be related to employee misclassification issues.

Recommendation 2

To facilitate addressing employee misclassification across federal and state programs, we recommend that the Secretary of Labor instruct the Wage and Hour Division to evaluate the extent to which misclassification cases identified through FLSA investigations are referred to the appropriate federal or state agency potentially affected by employee misclassification, and take action to make improvements as necessary. Referral of cases should include notifying the employer that the misclassification case has been forwarded to the appropriate agency. In

addressing its referral mechanism, the Wage and Hour Division officials should consider building upon efforts by district offices currently engaged in referrals.

Response

The WHD agrees with the value of sharing potential employee misclassification with appropriate federal and state programs. However, automatic referrals to multiple agencies that may make little or no use of the information provided may not be an efficient use of federal resources.

The WHD will review its internal processes to determine the extent and appropriateness of referring employee misclassification cases to other federal or state agencies. In evaluating the effectiveness of the current referral mechanism, WHD will consider building upon efforts by district offices currently engaged in referrals.

However, WHD does not agree with the recommendation that employers be notified when the WHD refers potential misclassification cases involving laws not enforced by the WHD to another agency. Such notification could place WHD staff in the untenable position of having to defend a referral based upon interpretations of laws, which WHD has no expertise or authority to interpret or enforce. As GAO notes, WHD investigators are specifically cautioned to "not interpret laws outside their authority." Further, there is a strong possibility that the receiving agency will not react to the referral (which is correctly stated in the GAO report).

We appreciate the opportunity to provide comments in advance of the publication of the final report.

Sincerely,

FOR

Victoria A. Lipnic

2

Appendix VI: GAO Contact and Staff Acknowledgments

GAO Contact

Robert E. Robertson, (202) 512-7215 or robertsonr@gao.gov.

Staff Acknowledgments

In addition to the contact named above, Brett S. Fallavollita, Linda L. Siegel, Janice L. Peterson, and Jason R. Campbell contributed significantly to all aspects of this report. Daniel A. Schwimer reviewed the coverage of contingent workers under laws designed to protect workers; Richard P. Burkard provided legal support; Paula J. Bonin, Evan B. Gilman, Mark F. Ramage, and Joan K. Vogel assisted in analyzing the BLS data; Thomas D. Short assisted with IRS issues; and Jonathan S. McMurray assisted in report development.

Related GAO Products

Department of Labor, Wage and Hour Division: Defining and Delimiting the Exemptions for Executive, Administrative, Professional, Outside Sales, and Computer Employees. GAO-04-735R. Washington, D.C.: May 5, 2004.

Worker Protection: Labor's Efforts to Enforce Protections for Day Laborers Could Benefit from Better Data and Guidance. GAO-02-925. Washington, D.C.: September 26, 2002.

Private Pensions: Improving Worker Coverage and Benefits. GAO-02-225. Washington, D.C.: April 9, 2002.

Health Insurance: Proposals for Expanding Private and Public Coverage. GAO-01-481T. Washington, D.C.: March 15, 2001.

Health Insurance: Characteristics and Trends in the Uninsured Population. GAO-01-507T. Washington, D.C.: March 13, 2001.

Pension Plans: Characteristics of Persons in the Labor Force without Pension Coverage. GAO/HEHS-00-131. Washington, D.C.: August 22, 2000.

Contingent Workers: Incomes and Benefits Lag Behind Those of Rest of Workforce. GAO/HEHS-00-76. Washington, D.C.: June 30, 2000.

Fair Labor Standards Act: White-Collar Exemptions Need Adjustments for Today's Work Place. GAO/T-HEHS-00-105. Washington, D.C.: May 3, 2000.

Fair Labor Standards Act: White Collar Exemptions in the Modern Work Place. GAO/HEHS-99-164. Washington, D.C.: September 30, 1999.

Employment-Based Health Insurance: Medium and Large Employers Can Purchase Coverage, but Some Workers Are Not Eligible. GAO/HEHS-98-184. Washington, D.C.: July 27, 1998.

Private Health Insurance: Continued Erosion of Coverage Linked to Cost Pressures. GAO/HEHS-97-122. Washington, D.C.: July 24, 1997.

Tax Administration: Issues in Classifying Workers as Employees or Independent Contractors. GAO/T-GGD-96-130. Washington, D.C.: June 20, 1996.

Tax Administration: Issues Involving Worker Classification. GAO/T-GGD-95-224. Washington, D.C.: August 2, 1995.

Tax Administration: Estimates of the Tax Gap for Service Providers. GAO/GGD-95-59. Washington, D.C.: December 28, 1994.

Tax Administration: Improving Independent Contractor Compliance with Tax Laws. T-GGD-94-194. Washington, D.C.: August 4, 1994.

Tax Administration: Approaches for Improving Independent Contractor Compliance. GGD-92-108. Washington, D.C.: July 23, 1992.

Workers at Risk: Increased Numbers in Contingent Employment Lack Insurance, Other Benefits. GAO/HRD-91-56. Washington, D.C.: March 8, 1991.

Tax Administration: Information Returns Can Be Used to Identify Employers Who Misclassify Workers. GAO/GGD-89-107. Washington, D.C.: September 25, 1989.

GAO's Mission

The Government Accountability Office, the audit, evaluation and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through GAO's Web site (www.gao.gov). Each weekday, GAO posts newly released reports, testimony, and correspondence on its Web site. To have GAO e-mail you a list of newly posted products every afternoon, go to www.gao.gov and select "Subscribe to Updates."

Order by Mail or Phone

The first copy of each printed report is free. Additional copies are $2 each. A check or money order should be made out to the Superintendent of Documents. GAO also accepts VISA and Mastercard. Orders for 100 or more copies mailed to a single address are discounted 25 percent. Orders should be sent to:

U.S. Government Accountability Office
441 G Street NW, Room LM
Washington, D.C. 20548

To order by Phone: Voice: (202) 512-6000
TDD: (202) 512-2537
Fax: (202) 512-6061

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: www.gao.gov/fraudnet/fraudnet.htm
E-mail: fraudnet@gao.gov
Automated answering system: (800) 424-5454 or (202) 512-7470

Congressional Relations

Gloria Jarmon, Managing Director, JarmonG@gao.gov (202) 512-4400
U.S. Government Accountability Office, 441 G Street NW, Room 7125
Washington, D.C. 20548

Public Affairs

Paul Anderson, Managing Director, AndersonP1@gao.gov (202) 512-4800
U.S. Government Accountability Office, 441 G Street NW, Room 7149
Washington, D.C. 20548

PROOF OF SERVICE

Ayala, et al., v. Antelope Valley Newspapers, et al.
Court of Appeal Case No. B235484
Supreme Court Case No. S206874

I am employed in the County of Orange, State of California. I am over the age of 18 and not a party to the within action. My business address is 3 Hutton Centre Drive, Ninth Floor, Santa Ana, California 92707.

On **April 29, 2013,** I served the foregoing document(s) entitled:

DECLARATION OF MICHAEL J. WRIGHT IN SUPPORT OF MOTION FOR JUDICIAL NOTICE VOL. I OF II EXHIBITS 1 - 4

on the interested parties in this action by placing [ ] the original **[X]** a true copy thereof enclosed in a sealed envelope addressed as follows:

SEE ATTACHED SERVICE LIST

[X] **BY FEDEX:** I deposited such envelope at Santa Ana, California for collection and delivery by Federal Express with delivery fees paid or provided for in accordance with ordinary business practices. I am "readily familiar" with the firm's practice of collection and processing packages for overnight delivery by Federal Express. They are deposited with a facility regularly maintained by Federal Express for receipt on the same day in the ordinary course of business.

[X] **BY MAIL:** I deposited such envelope in the mail at Santa Ana, California. The envelope was mailed with postage thereon fully prepaid. I am "readily familiar" with the firm's practice of collection and processing correspondence for mailing. It is deposited with the United States Postal Service on that same day in the ordinary course of business. I am aware that on motion of party served, service is presumed invalid if postal cancellation date or postage meter date is more than one (1) day after date of deposit for mailing in affidavit.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct. Executed on **April 29, 2013**, at Santa Ana, California.

Elena Richards

Ayala, et al., v. Antelope Valley Newspapers, et al.
Court of Appeal Case No. B235484
Supreme Court Case No. S206874

SERVICE LIST

Sue J. Stott
PERKINS COIE
4 Embarcadero Center, Suite 2400
San Francisco, CA 94111
(415) 344-7000
(415) 344-7050 Fax
sstott@perkinscoie.com

Attorneys for Defendant-Respondent
ANTELOPE VALLEY
NEWSPAPERS, INC.
By FedEx

Eric D. Miller
PERKINS COIE
1201 Third Avenue, Suite 4900
Seattle, WA 98101-3099
(206) 359-8000
(206) 359-7338 Fax
emiller@perkinscoie.com

Attorneys for Defendant-Respondent
ANTELOPE VALLEY
NEWSPAPERS, INC.
By FedEx

California Court of Appeal
Second Appellate District, Division 4
Ronald Reagan State Building
300 S. Spring Street
2nd Floor, North Tower
Los Angeles, CA 90013

By U.S. Mail