Statement for the Record by

Coalition to Preserve Independent Contractor Status

Hearing on

Leveling the Playing Field:

Protecting Workers and Businesses Affected by Misclassification

Before the United States Senate
Committee on Health, Education, Labor, and Pensions

June 17, 2010

The Coalition to Preserve Independent Contractor Status (the "Coalition") appreciates the opportunity to submit testimony concerning the important issue of worker classification. The Coalition consists of industry associations, businesses and independent contractors that share a common interest in preserving the legal status accorded independent contractors, and in the creation of economic opportunities for all individuals, whether they offer their services as independent contractors or employees.

The Coalition absolutely supports the proper classification of workers, and the proper and timely compliance by independent contractors with their federal, state and local tax reporting and payment obligations. Moreover, it supports government policies aimed at enhancing these objectives, provided that such policies do not undermine the rights of independent contractors and their clients to do business with each other.

In the current climate of record-high numbers of Americans out of work, the Coalition submits that one of the government's top priorities should be to support all facets of economic growth, regardless of whether they involve sectors in which individuals work as independent contractors or employees. The Congress should not thwart these opportunities by undermining the sound business relationships between independent contractors and their clients.

The Coalition opposes the enactment of S. 3254, the *Employee Misclassification Prevention Act,* because its provisions would increase the regulatory risks of doing business with independent contractors to an excessively high level.

We are concerned that if S. 3254 were enacted, companies that rely on the services of independent contractors would face additional burdens when engaging in those legitimate and legal business practices. Such burdens limit companies' flexibility to retain independent contractors, which would reduce their efficiency and ultimately threaten opportunities for not only independent contractors but also employees. The bill does not take into account the unique business models that individual companies rely on to remain competitive, and would be particularly detrimental in these challenging economic times.

S. 3254 is premised on the misguided assumption that there is widespread misclassification of contracted individuals, and it fails to acknowledge that individuals who operate as independent contractors generally do not wish to be classified as an employee. Status as a contractor affords both individuals and client companies the flexibility to agree to terms that are in the best interest of each party. The bill would unnecessarily add confusion and uncertainty to the long-standing administration of the Fair Labor Standards Act ("FLSA") and thus undermine economic growth.

The following outlines the specific reasons for our concerns with S. 3254.

1. The proposed financial sanctions for worker misclassification are disproportionate

Our principal concern with the bill involves the new financial sanctions it proposes for worker misclassification. The proposed sanctions, when added to the sanctions already imposed under current law, would expose a company to penalties that are highly disproportionate to the offense. The FLSA is already punitive in this regard, as it exposes a company that fails to pay minimum wage or overtime to actual damages plus liquidated damages plus attorneys' fees.[1] The bill would make those sanctions even more onerous when worker misclassification is involved, by increasing the double damages to treble damages and adding to that a penalty of up to $1,100 or $5,000 per misclassified worker. This would elevate the offense of worker misclassification to a higher magnitude than the *criminal* predicate acts[2] that form the basis for a civil penalty under the Racketeer Influenced and Corrupt Organizations Act ("RICO"), which imposes only treble damages plus attorneys' fees.[3]

Worse yet, the $1,100 per-misclassified-worker penalty and treble damages would be imposed in the form of *strict liability*. Levying these extreme monetary penalties on companies that have not demonstrated a willful intent to wrongly misclassify individuals as contractors under the FLSA is inappropriate. Currently, businesses are required to apply multiple factors contained in an *economic realities* test to properly classify individuals, which takes into account the unique circumstances of the engagement, the type of services provided as well as the scope of work performed under the terms of their contract. Such an overly broad capacity for expanded penalties would likely result in punitive damages for legitimate contracting practices.

While the threshold for imposing the higher $5,000 per-misclassified-worker penalty is more demanding, it still only requires that a misclassification be *repeated* or *willful*. This means that a firm that has been doing business for many years with many independent contractors might satisfy the *repeated* requirement, which would subject the firm, once again, to *strict liability* for the higher confiscatory financial sanctions. The effect of this penalty scheme would be to impose the harshest penalties on those firms that offer the most opportunities to independent contractors.

It is respectfully submitted that the bill's proposed financial sanctions would create a strict-liability trip wire for misclassification that would be so costly to businesses that few would continue doing business with any but the most exaggeratedly independent of the independent contractors*, i.e.*, those with multiple existing clients, a substantial capital investment in the business and a robust web presence or other evidence of significant business advertising. The individual freelancer who seeks to use a personal computer to earn extra money on a part-time basis, or who seeks to start a new freelance business and is searching for that first client, would likely find no company willing to take the risk. Even those independent contractors who have been in business for years, but who work principally for only a very few large clients, would

---

[1] See, 29 U.S.C. § 216(b).

[2] "RICO defines 'racketeering activity' to include violations of various predicate criminal statutes including mail and wire fraud. § 1961(1). *Hemi Group, LLC v. City of New York*, 130 S. Ct. 983, 995 (U.S. 2010).

[3] See, 18 USCS § 1964. "Congress intended RICO's civil remedies to help eradicate 'organized crime from the social fabric' by divesting 'the association of the fruits of ill-gotten gains.'" *Genty v. Resolution Trust Corp.,* 937 F.2d 899, 910 (3d Cir. 1991) (quoting *United States v. Turkette*, 452 U.S. 576, 585, 101 S. Ct. 2524, 2529, 69 L. Ed. 2d 246 (1981)).

likely find those clients less willing to continue those relationships, due to the risk that the individual could be found to be economically dependent on one of them. This bill poses a mortal threat to individuals who rely on contracting opportunities for their livelihood.

2. **Defining a non-employee to include entities whose owner is a service provider would penalize firms for adopting prudent policies designed to ensure compliance**

The bill's *per se* treatment as a non-employee for purposes of the proposed recordkeeping and notice requirements of any individual who offers services through an entity in which the individual owns an interest is an affront to the many companies that have taken prudent measures to ensure that they are doing business only with legitimate non-employees.

Firms that do business with large numbers of independent contractors commonly develop a systematic process for conducting due diligence on such contractors to ensure that they are truly self employed. Inasmuch as an important consideration in these determinations, particularly at the state level, is whether an individual is independently established as a separate trade or business, some firms have made the decision to do business only with vendors that operate in the form of an entity, as the existence of an entity offers compelling evidence of a *bona fide* trade or business.

Similarly, growing numbers of independent contractors, recognizing the increasingly hostile regulatory environment for independent contractors, have established legal entities to allay the fears among potential clients that doing business with them would expose the clients to a misclassification risk.

We are aware of what are sometimes referred to as pre-packaged incorporations, where a business, as part of its registration process for independent contractors, creates a legal entity for the contractor, but the bill does not seek to distinguish between those contrived arrangements and the legitimate arrangements discussed above. Rather, it disregards them all.

It is respectfully submitted that the important state laws that govern and recognize the separate legal status accorded a valid legal entity should not be disregarded, absent a compelling reason. The bill's proposed sweeping disregard of any such entity in which a service provider holds an ownership interest is overly broad, and should be rejected.

3. **Requiring companies to maintain records of hours worked by non-employees would be burdensome, counterproductive and disruptive to business relationships**

The bill would require companies to maintain records of hours worked by non-employees, without regard to whether their fees are determined on an hourly basis.

This new requirement would place non-employees at a competitive disadvantage relative to their larger competitors. While clients already likely maintain records of hours worked by vendors who render services on hourly engagements, clients likely do not maintain any such records for other engagements, where fees are determined on a basis *other than* hours worked.

Even with respect to hourly engagements, it is not likely that the records maintained for hours worked are necessarily determined in accordance with U.S. Department of Labor ("DOL") regulations governing the determination of compensable hours worked. If the proposal were construed to require compliance with such DOL regulations, the resultant burden imposed on non-employees and their clients – even with respect to hourly engagements – would be excessive and to no discernable purpose.

With respect to engagements for which fees are determined on a basis *other than* hours worked, to require firms to maintain records of hours worked by such vendors would serve no business purpose, create confusion over how the hours should be determined, and likely disrupt the parties' business relationship.

For example, in some industries, independent contractors have invested substantial resources in developing computer programs and other high-technology applications that permit the delivery of high-quality services with few hours' work, at least as determined on a client-by-client basis. A substantial fee might be charged for these services, which reflects not only the hours worked for a specific client but also the hours worked and other investment in developing the underlying system. To be sure, there are myriad examples of different types of arrangements in which a firm engages an independent contractor with specialized expertise to provide a service or produce a deliverable, or to sell products on a commissioned or buy-sell basis, where the agreed compensation has no relationship at all to the number of hours worked. To require an independent contractor to provide its clients with a record of hours worked on such engagements could create unnecessary tension with the client. For example, an independent contractor might find it uncomfortable charging a client a substantial fee for a deliverable that required only a few hours' work, even though the value of deliverable far exceeds the fee. Furthermore, while the client might have no interest in knowing the number of hours worked on such an engagement, once the client does know, it could be upset. Finally, if the DOL were to require these independent contractors to determine their hours in accordance with DOL regulations, the requirement would approach the absurd.

For the reasons outlined above, it is respectfully submitted that the bill's proposal to require a company to maintain records of hours worked by non-employees on engagements *other than* hourly engagements is inadvisable and should be rejected.

4. **Requiring companies to maintain records of the "accurate classification of the status" of non-employees is unnecessary**

The bill would require a company to maintain records showing an accurate classification of the status of each individual with whom the company does business as either an employee or a non-employee.

Companies commonly undertake due diligence to confirm the self-employed status of the independent contractors with whom they do business. Depending upon the industry, the type of services and other aspects of an independent-contractor engagement, the specific due-diligence criteria will differ. Companies that engage large numbers of independent contractors to provide similar types of services commonly do not maintain a specific due-diligence file for each individual. Requiring companies to do so would be unnecessary and would serve only to create

additional barriers to a contracting opportunity for self-employed individuals. Moreover, the burden it would impose on companies to create these records would significantly limit their flexibility to meet changing business needs and economic fluctuations.

Also, requiring a company to maintain such a due-diligence file only with respect to independent contractors would put independent contractors at a competitive disadvantage compared to larger firms, to which the requirement would not apply, and would hamper contractors' best value proposition for companies seeking to retain them. For example, if a company were seeking to outsource a discrete project, the burden of preparing a due-diligence file on an independent contractor for that one project might be sufficient to dissuade the company against offering the project to independent contractors, and instead to offer it only to larger vendors to which the due diligence requirement would not apply.

5. <u>Requiring companies to provide a specified notice to non-employees is burdensome and likely to lead to increased enmity and litigation between contracting parties</u>

The bill would require a company to provide non-employees with a notice to "inform the individual of the individual's classification," to direct the individual to a DOL website containing information "about the rights of employees under the law," and to advise the individual that his or her "rights to wage, hour and other labor protections depend on [the individual's] proper classification as an employee or non-employee."

The proposed notice requirement suggests that self-employed service providers are having their independent-contractor status imposed on them. For legitimate independent contractors, such a notice would be insulting and degrading; it also would accord them second-class standing relative to their larger competitors, as similar notices are not required for any other vendors.

Also, the content of the notice would create uncertainty and unnecessary confusion for independent contractors. The proposed notice suggests that contractors may be entitled to certain protections afforded only to employees. Currently, companies must determine the legal classification of individuals by utilizing a multifactor test of economic realities. The promulgation of the proposed notice does not take into account the many factors used to determine an individual's status for many individual service contracts and might be susceptible to being construed to mean that certain independent contractors are entitled to protections for which they do not qualify.

Finally, for a company that does business with large numbers of independent contractors, the notice requirement would increase the cost of engaging new contractors and likely give rise to additional confusion and questions from the contractors once they receive the notice. The additional costs such a company would incur in complying with this new duty and in responding to the questions the notices would produce would reduce the company's efficiency. The effects of the resulting reduced efficiency would be passed on to customers in the form of higher prices.

The Coalition respectfully urges that this proposal not be enacted.

6. **Creating a presumption of employee status for failure to maintain records or provide requisite notice would be unfair**

The bill provides that a company's noncompliance with the proposed recordkeeping or notice requirements with respect to an individual would result in the individual being *presumed* an employee, which presumption could be rebutted only by establishing the individual's independent-contractor status by *clear and convincing* evidence, which is a demanding standard.

This proposal is insidious, as it would create a trap for the unwary. Companies would not intuitively suspect that the government imposes any such duty with respect to their dealings with vendors. Thus, the proposal likely would disproportionately affect small businesses that do not have an in-house legal department. The provision would provide the DOL with overwhelming leverage to convince companies that violate the notice and/or recordkeeping requirements to reclassify independent contractors to employee status, as the burden of meeting the *clear and convincing* standard under the economic realities test would be daunting.

The Coalition respectfully urges that this proposal be rejected.

7. **The proposed anti-retaliation provision would reward unethical conduct and create a new litigation hazard**

The bill would prohibit a company from discharging or in any other manner discriminating against an individual who opposes any practice, files a complaint or institutes a proceeding concerning an individual's status for purposes of the FLSA or federal employment tax purposes.

The proposed anti-retaliation provision would advance a policy of protecting individuals who misrepresent their status as being self-employed. An important component of the *economic realities* test is a consideration of the degree to which a putative independent contractor is economically dependent on the putative employer. A company cannot meaningfully evaluate this factor without obtaining information solely in the possession of an independent contractor, namely, the extent to which the contractor performs services for others. If a contractor provides materially false information, and as a consequence the contractor is misclassified, the client would have a legitimate reason to cease doing business with that contractor, but the bill would prohibit that.

Also, the proposal would provide an independent contractor who fails to meet contract terms with a new form of protection against the client terminating their engagement, *e.g.,* by filing an Internal Revenue Service ("IRS") Form SS-8[4] and seeking a determination by IRS of

[4] The Form SS-8 is the Internal Revenue Service ("IRS") form used to obtain a determination from IRS as to the status of an individual as an employee or independent contractor for federal taxes. To create another reason for individuals to submit Forms SS-8 would only add to an already overburdened IRS. A recently released audit report prepared by the Treasury Inspector General for Tax Administration ("TIGTA"), *Employment Tax Compliance Could Be Improved With Better Coordination and Information Sharing*, 2010-30-025 (March 23, 2010), found that the Form 8919 that the IRS created in response to a prior

their status as an employee or independent contractor. Under the bill, the filing of the Form SS-8 arguably would provide the individual with a basis for asserting that any subsequent termination by the client was in retaliation for that action.

Finally, the proposal would put individuals who operate as independent contractors at a disadvantage relative to larger competitors, because it would create a new litigation hazard associated with doing business with independent-contractor vendors that would not exist with other vendors.

For the foregoing reasons, the Coalition opposes this provision.

8. New mandate for states to enact laws imposing penalties for misclassifying workers

The bill would amend the provisions of the Social Security Act that impose conditions a state must satisfy to qualify for federal funding of its unemployment programs to require a state's laws to require states to enact laws that create new penalties for worker misclassification. This would result in additional layers of complexity for companies and independent contractors in an already complicated system of determining an individual's status under existing federal and state statutes.

Additionally, such a mandate would exacerbate the already excessive penalties proposed under S. 3254. Such provisions would do nothing to clarify existing company obligations for determining an individual's status as an employee or independent contractor for any purpose.

The Coalition would oppose this proposal for the foregoing reasons and also the reasons mentioned above under Section 1.

9. Permit DOL to share information on worker misclassification with IRS

The bill would permit the DOL's Wage and Hour Division to share information concerning worker misclassification with the IRS. States and the federal government already participate in extensive sharing of information about the classification of workers. Moreover, detailed information already is required from companies from several federal agencies. It has yet to be demonstrated that additional systems of information sharing between federal agencies will result in more effective enforcement of current laws. Until it is demonstrated by both the DOL and the IRS that the capability exists to streamline a system of enhanced information sharing, additional efforts will only serve to further burden an already beleaguered system used to enforce employment classification requirements. Furthermore, a determination needs to be made as to what type of information would be collected by the DOL and whether that information would be helpful to the IRS.

TIGTA audit report is contributing to a substantial increase in the volume of Form SS-8 submissions that is overwhelming IRS staff who respond to them.

For the foregoing reasons, the Coalition opposes this proposal.

10. <u>Require new DOL webpage containing information about the disparity of rights accorded employees versus independent contractors</u>

The proposed creation of a new DOL website emphasizing the regulatory distinction between employees and independent contractors would have the effect of deemphasizing the fundamental *business* differences between these two very different means of pursuing a livelihood. At a minimum, such a website should also mention the business differences.

Furthermore, the proposed website that would emphasize how independent contractors are denied protections accorded to employees not only would suggest that the two options are merely differences by degree, as opposed to being two fundamentally different approaches to income production, but it also would tacitly discourage individuals from pursuing self employment. From a public policy perspective, such a message from a government agency is morose. To be sure, rather than encouraging enterprising citizens to pursue their entrepreneurial dreams and grow the economy, the message would encourage individuals to secure refuge in the safety of employment, with all of the attendant government protections accorded that status.

The Coalition opposes this proposal.

11. <u>The general effect of the bill would be to fundamentally re-characterize independent contractors from small businesses to hybrid employees</u>

An overarching concern with S. 3254 is that it would diminish the fundamental distinctions under the FSLA between employees and independent contractors, and inject an element of adversity between the contracting parties. The employee-type protections that the bill would impose on companies that do business with independent contractors, *e.g.,* the anti-retaliation provisions and the recordkeeping and notice requirements, would have the effect of converting independent contractors into a new status of *hybrid-employee*. This would be a decidedly negative change for those individuals who seek to establish their own business and compete head-to-head with larger firms.

Also, the new litigation hazards that the bill would create for companies doing business with independent contractors, and the exorbitant financial sanctions the bill would impose on a company for misclassifying workers, would tend to dissuade companies from doing business with independent contractors. Moreover, the proposed new notice requirements and DOL website content would tend to cause individuals to possibly question whether their decision to pursue self employment was a prudent decision; and for individuals newly investigating the possibility of pursuing this path, the government's message to them would not be encouraging.

The cumulative effect of the bill's proposals would likely cause a material reduction in the amount of business conducted by independent contractors and a corresponding reduction in the number of individuals who operate as independent contractors. The Coalition respectively submits that such a policy is a threat to economic growth and threatens the livelihood of individuals who wish to remain independent contractors.

The Coalition submits that the government should assist in the efforts of companies to create economic opportunities for employees and independent contractors alike through policies that encourage entrepreneurship; and it should recognize the benefits of opportunities afforded to individuals that are legitimately classified as independent contractors. Especially at a time when our economy attempts to recover from the magnitude of job losses not seen since the Great Depression, government policies should not place additional burdens any form of legitimate economic activity.

The Coalition would appreciate the opportunity to work with the Committee to develop proposals that help ensure the proper classification of individuals as employees or independent contractors while preserving the rights and prospects of legitimate independent contractors.

Respectfully submitted,

Russell A. Hollrah
Executive Director
Coalition to Preserve Independent Contractor Status
1850 K Street, N.W.
International Square
Suite 390
Washington, D.C. 20006
Telephone: (202) 659-0878
Facsimile: (202) 659-0879
iccoalition.org