

Department of Legislative Services
 Maryland General Assembly
 2009 Session

FISCAL AND POLICY NOTE
Revised

Senate Bill 909
 Finance

(The President, *et al.*) (By Request - Administration)

Economic Matters

Workplace Fraud Act of 2009

This Administration bill establishes, for the purpose of enforcement only, a presumption that work performed by an individual paid by an employer creates an employer-employee relationship, subject to specified exemptions. It prohibits construction companies and landscaping businesses from failing to properly classify an individual as an employee, and establishes investigation procedures and penalties for noncompliance.

Fiscal Summary

State Effect: Special fund expenditures increase by \$259,000 in FY 2010 by the Department of Labor, Licensing, and Regulation (DLLR) for enforcement; expenditures are charged to the Workers' Compensation fund. Special fund revenues increase by the same amount due to the Workers' Compensation Commission's (WCC) assessment on insurers in the State. State expenditures (all funds) increase minimally due to a higher assessment charged by WCC to all insurers, including the State, to pay for the additional enforcement costs. Out-year costs reflect annualization, inflation, and diminished need for enforcement due to increased employer compliance. Potential significant general fund revenue increase in FY 2011 due to employer compliance with income tax withholding rules and from penalty provisions; these diminish over time due to increased employer compliance. The extent of all revenue increases cannot be reliably estimated.

(in dollars)	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014
GF Revenue	-	-	-	-	-
SF Revenue	\$259,000	\$440,600	\$362,100	\$377,400	\$393,600
SF Expenditure	\$259,000	\$440,600	\$362,100	\$377,400	\$393,600
GF/SF/FF Exp.	-	-	-	-	-
Net Effect	\$0	\$0	\$0	\$0	\$0

Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate effect

Unemployment Insurance Trust Fund Effect: Potential significant increase in revenues for the Unemployment Insurance Trust Fund beginning in FY 2011.

Injured Workers' Insurance Fund Effect: Potential significant increase in revenues beginning in FY 2011. Increase in expenditures for the Injured Workers' Insurance Fund (IWIF) due to the rise in the WCC assessment on all insurers in the State.

Local Effect: Potential significant increase in local income tax revenues. Minimal increase in expenditures due to the increased WCC assessment on all insurers in the State.

Small Business Effect: The Administration has determined that this bill has minimal or no impact on small business (attached). The Department of Legislative Services (DLS) disagrees with this assessment as discussed below. (The attached assessment does not reflect amendments to the bill.)

Analysis

Bill Summary: The bill applies to three areas of State government: labor and industry, workers' compensation, and unemployment insurance. Although the bill requires an employer in the targeted industries to comply with applicable rules in all three areas, only one set of penalties may be assessed against an employer who violates any of the bill's provisions.

An employer in an affected industry misclassifies an employee when an employer-employee relationship exists, but the employer has not classified the individual as an employee. An employer-employee relationship exists in an affected industry unless an employer can demonstrate that a worker is an exempt person, as defined by the bill, or independent contractor, as defined in the statute and subject to clarifying regulations issued by the Commissioner of Labor and Industry.

An employer in the two targeted industries must keep specified personnel records for at least three years. At the time of hire, an employer must provide each exempt person or independent contractor a written explanation of the implications of his or her classification.

The bill requires that units within DLLR and the Department of Budget and Management, the Secretary of State, the Comptroller, the Maryland Insurance Administration (MIA), and other State agencies share information concerning any suspected failure to properly classify an individual as an employee.

Any regulations to implement the bill may not be proposed as emergency regulations.

Penalties and Remedies for Misclassification within the Targeted Industries

The bill distinguishes between an employer who *improperly* misclassifies an employee and an employer who *knowingly* misclassifies an employee, and penalties are more severe for an employer who is guilty of knowingly misclassifying an employee.

An employer found to have *improperly* misclassified an employee must, within 45 days, pay restitution to any employee not properly classified and come into compliance with all applicable labor laws. An employer is subject to a civil penalty of up to \$1,000 for each employee not in compliance, but the Commissioner of Labor and Industry cannot penalize employers who conform to applicable labor laws within 45 days. Penalties extend to successor corporations.

An employer is guilty of *knowingly* misclassifying an employee if the employer misclassifies the individual with actual knowledge, deliberate ignorance, or reckless disregard for the truth. For knowingly violating the bill's provisions, an employer is subject to a civil penalty of up to \$5,000 per misclassified employee, regardless of whether the employer enters into compliance within 45 days. Penalties extend to successor corporations if they have one or more of the same principals or officers as the employer against whom the penalty was assessed, unless those individuals did not, or with the exercise of reasonable diligence, could not know of the violation for which the penalty was imposed. Penalties can be doubled for employers who have previously violated the bill's provisions. An employer who has been found to have knowingly misclassified employees on three or more occasions may be assessed an administrative penalty of up to \$20,000 for each misclassified employee.

A person who assists, advises, or otherwise facilitates an employer to misclassify employees is subject to a civil penalty of up to \$20,000. A person who holds a professional license as a lawyer or an accountant who commits such a violation is not subject to civil fines, but instead is subject to sanctions by the regulatory body in the State responsible for oversight of these professions.

All revenues from imposition of the bill's civil penalty provisions by the Commissioner of Labor and Industry are paid into the general fund.

If an employer engaged in work with a public body fails to properly classify an employee, the Commissioner of Labor and Industry has to notify the public body. The public body is then required to withhold from payment an amount sufficient to pay each employee the full amount of wages due as well as pay any benefits, taxes, or other required contributions.

The bill specifies that if the court or an administrative unit determines that an individual or class of individuals is entitled to restitution as a result of an employer's knowing failure to properly classify employees, the court or administrative unit must award restitution to which the individual is entitled, and may award each individual an additional amount up to three times the amount – as much as triple damages. Otherwise, a misclassified employee is authorized to bring a civil action against the employer within three years of the violation; the court may award economic damages to the individual. If an individual was knowingly misclassified by an employer, he or she may be entitled to an *additional* award of up to three times the amount of any such damages. Reasonable counsel fees and other costs of the action may also be awarded. However, an individual may not bring a civil action against an employer if a final order of an administrative unit or of a court has already been issued.

An employer may not take action against an employee for bringing an action against the company. The Commissioner of Labor and Industry is authorized to investigate upon a complaint that an employer took retaliatory action against an employee. The employer must be given an opportunity to respond to the allegations. If the commissioner determines that retaliatory action was taken, the commissioner must file a complaint in circuit court to enjoin the violation, reinstate the employee, and take other appropriate action.

Similarly, a person is prohibited from making groundless or malicious complaints, or otherwise bringing an action or testifying in an action – in bad faith – related to the misclassification of employees. A person who commits such violations is subject to an administrative penalty of up to \$1,000 and disclosure of their identity to the employer.

Labor and Industry Investigations

The Commissioner of Labor and Industry must investigate the two specified industries as necessary to determine compliance with the bill and any regulations. Investigation of a misclassification complaint may be on the commissioner's own initiative, on receipt of a written complaint, or on referral from another unit of State government. The commissioner may enter a place of business or work site to observe work being performed, interview employees and contractors, and review records as part of this investigation. The commissioner may issue a subpoena for testimony and production of records. All required records must be kept by the employer for a period of three years. An employer that fails to produce records within 15 business days after the commissioner's request is subject to a fine of up to \$500 per day. If an individual fails to comply with a subpoena, the commissioner may file a complaint in circuit court requesting an order directing compliance.

The commissioner must issue a citation to an employer that fails to properly classify an employee. The commissioner is required to send the employer notice of the violation and the amount of the penalty. If a hearing is not requested within 15 days of the notice, the violation and penalties are considered the final order of the commissioner. Hearings are delegated to the Office of Administrative Hearings for a decision, which then becomes the final order of the commission. A party who is aggrieved by the commissioner's determination may seek judicial review as specified by the bill.

If a determination is made that an employer failed to properly classify an individual, the commissioner must notify the Comptroller's Office, the Office of Unemployment Insurance, MIA, and WCC to assure the employer's compliance with their procedures. The requirement for compliance with applicable labor laws may include, with certain specifications, ordering the employer to enter into an agreement with a government unit for payments owed by the employer.

The commissioner must prepare an annual report for the Secretary of Labor, Licensing, and Regulation on the administration and enforcement of the bill. The report must include information on the complaints received, investigations conducted, citations issued, resolutions and adjudications by type, and violations found.

Unemployment Insurance

If the Secretary of Labor, Licensing, and Regulation determines that an employer has improperly classified an employee as an independent contractor, any unpaid contribution or reimbursement payments accrue interest at a rate of 2% per month after a 45-day grace period. If the Secretary determines that an employer knowingly improperly classified employees, the employer is subject to a civil penalty of up to \$5,000 per employee. An employer that has knowingly improperly classified an employee must pay contributions, at a level specified by the bill, for two years. These penalties are not limited to improper classification in the construction and landscaping industries. The Secretary must adopt regulations, as specified by the bill, to carry out these provisions. The Secretary must also adopt regulations pertaining to the applicability of the bill to work performed by individuals under a contract of hire.

Workers' Compensation

If WCC determines that an employer improperly classified an employee, the commission must order the employer to secure compensation coverage for the employee. If the commission determines that an employer knowingly failed to properly classify an employee, the commission may assess a civil penalty of up to \$5,000. This penalty is not limited to improper classification in the construction and landscaping industries.

Funding for additional staff within DLLR to enforce the bill's provisions occurs through an assessment on WCC. WCC has the authority to increase its assessment on insurers in the State to cover the costs associated with DLLR's enforcement of the bill's provisions.

Current Law: An employer who is found to have misclassified an employee must comply with unemployment insurance and workers' compensation requirements. The State has no established penalties for misclassification.

All employers in Maryland are required to provide workers' compensation coverage for their employees. An employer, or its insurer, is required to compensate covered employees upon a determination that an accidental personal injury suffered by an employee was the result of his or her employment.

Maryland employment and procurement law establishes standards that an employer must follow in providing payment and adequate rates of compensation for an employee. Additional insurance requirements provide wage protection for an individual who is injured or laid off. Other federal and State laws additionally provide family and medical leave, collective bargaining protections, and occupational safety standards that apply exclusively to employees.

An employer is further required to meet federal and State unemployment insurance requirements for employees. All private business employers and nonprofit organizations employing one or more persons are subject to Maryland Unemployment Insurance Law, with employer contributions generally based on taxable wages for covered employment.

In order to determine the proper classification of an individual, DLLR uses a measure termed the "ABC" test. An independent contractor must meet each of the three standards of this measure. The test's first standard relates to direction and control of a worker. An employer should not be responsible for training an independent contractor, setting his or her work hours, or providing direct orders on how work is performed. The test's second standard considers whether the work is outside the usual course of business for the employer, meaning that service performed by an independent contractor should be integrated into the employer's operation and is unrelated to the employer's business. The final standard relates to whether or not the worker is independently established. An independent contractor should have liability and workers' compensation insurance, a place of business, and a stake in the success or failure of the enterprise. WCC uses a different test, based on case law, to determine whether a worker is a covered employee. The criteria for determining the existence of a relationship include whether the employer has the power to hire the worker, terminate the worker, and control the worker's conduct. This common law test also considers how wages are paid and whether the work is part of the regular business of the employer.

Background: When a company hires an employee, it is responsible for paying half of that employee's Social Security and Medicare taxes, as well as premiums for workers' compensation and unemployment insurance coverage. Employers also typically withhold federal, State, and local income taxes. An employee is responsible for half of his or her Social Security and Medicare taxes, as well as any State and federal income tax in excess of the amounts withheld by the employer.

By contrast, an independent contractor pays all of his or her Social Security and Medicare taxes and has no income taxes withheld but is still responsible for paying them in full. Independent contractors are not covered by workers' compensation or unemployment insurance, nor do they receive overtime compensation or benefits such as health insurance. They are treated by the law as temporary, freelance workers and are comparable to self-employed individuals.

A May 2007 report by the U.S. Government Accountability Office found that in 2005 there were 10.3 million independent contractors working nationwide. Independent contractors in these industries often work on a contingent basis to provide extra coverage to an employer on a temporary or part-time basis. That report confirmed that independent contractors do not generally have access to employer-based health insurance coverage and pension programs and are not covered by workers' compensation and unemployment insurance. Other protections, such as employee safety requirements, minimum wage and overtime compensation, and anti-discrimination protections, are generally unavailable to these contractors.

Misclassification in Maryland

Recent audits of Maryland employers generate widely divergent estimates of the rate at which employers misclassify employees. As reported in a recent national study of misclassification in the construction industry, random audits of Maryland construction companies by the U.S. Department of Labor found that 5% had misclassified their employees as independent contractors. This is substantially below the national average, which is estimated to be between 15% and 20%.

Over the last three years, DLLR's Division of Unemployment Insurance has conducted random and targeted audits of employers registered with the division to determine whether employees are correctly classified. Results of these audits displayed in **Exhibit 1** indicate that the rate of misclassification found through a combination of targeted and random auditing in Maryland may be as high as 20% to 25%.

Exhibit 1
Audits Conducted by the Division of Unemployment Insurance

	<u>2006</u>	<u>2007</u>	<u>2008</u>
Contributing Employers	137,037	139,103	140,334
Number Audited	2,875	2,988	3,293
Violations (all types)	1,179	979	1,269
Misclassifications (employers)	800	627	849
Workers Affected	6,477	4,090	7,048

Source: Department of Labor, Licensing, and Regulation

State Expenditures: Establishing a presumption of an employer-employee relationship likely increases the number of misclassification cases referred to DLLR for investigation. An individual who believes he or she has been knowingly misclassified – and has not received restitution – is more likely to file a complaint, especially since the bill allows the employee to collect quadruple damages and attorney’s fees if successful in court. The Employment Standards Unit within DLLR’s Division of Labor and Industry does not have enforcement staff available to investigate the higher number of cases likely to result from the bill.

As noted above, the Division of Unemployment Insurance (UI) conducts audits according to federal requirements that it audit 2% of contributing employers; it also conducts targeted audits as needed. Audit staff for the division are funded entirely by federal funds, with funding and staffing levels determined by the level of UI claims. As the number of claims has increased dramatically during the current recession, the division stands to increase its audit staff independent of the bill’s requirements. To the extent that the Employment Standards Unit bears the primary responsibility for investigating new complaints, the UI division can absorb any additional financial audit responsibilities with existing resources.

DLS assumes that the bill’s immediate effect on the number of misclassification complaints filed with DLLR is minimal, given its October effective date and the seasonal nature of the affected industries. However, caseloads are expected to increase during the ensuing spring and summer and then gradually decline as employer compliance increases. Both the construction and landscaping industries have experienced significant employment losses in the current recession. As a result, DLS expects DLLR to receive relatively few complaints immediately following the bill’s October effective date. Therefore, DLLR does not require additional staff until March 2010, when the weather improves and activity in the construction and landscaping sectors increase.

Following an initial surge in complaints investigated during spring and summer 2010, employer compliance likely increases, especially given that as many as one-quarter of investigations may result in citations. Moreover, DLLR reports that its Workplace Fraud Working Group has been developing strategies to provide outreach and education to employers, as well as coordinated enforcement. Together, these factors suggest that new complaints referred to DLLR begin a steady decline in fiscal 2011, and staffing levels decline in tandem.

Therefore, special fund expenditures by DLLR increase by an estimated \$258,952 in fiscal 2010, which accounts for the fiscal effect being delayed until March 1, 2010. This estimate reflects the cost of hiring two permanent fraud investigators, one contractual fraud investigator, one office clerk, an office secretary, one contractual data programmer, and one assistant Attorney General. Administrative staff assists in tracking and scheduling inspections, database development, hearing and court appearances, and document production. This estimate includes salaries, fringe benefits, one-time start-up costs, and ongoing operating expenses as shown below.

Regular Positions	5
Contractual Positions	2
Salaries and Fringe Benefits	\$114,331
Database Development	75,000
Office Equipment and Start-up Costs	32,045
Other Operating Expenses	<u>37,576</u>
Total FY 2010 State Expenditures	\$258,952

Future year expenditures reflect full salaries with 4.4% annual increases, employee turnover (3% for permanent staff and 6.8% for contractual staff), and 1% annual increases in ongoing operating expenses. The two contractual positions expire at the end of fiscal 2012. DLS anticipates that the data programmer is no longer needed due to the full implementation of the computer and software systems and that increased compliance among employers in the State renders a third fraud investigator unnecessary.

The bill specifies that special funds to support these expenditures are derived from WCC. WCC funds its operations by assessing a tax on all workers' compensation insurers in the State. WCC may ensure it has sufficient funds to cover DLLR's enforcement by increasing its assessment on all insurers in the State. Accordingly, State expenditures (all funds) increase as a result the WCC assessment on all workers' compensation insurers in the State. The total assessment on all insurers in the State was \$21.4 million in fiscal 2008. As an insurer, the State's share of the 2008 assessment was 4.8%. Assuming

a similar rate in fiscal 2010 and *for illustrative purposes only*, the State's share of the additional assessment is \$12,430. In addition to expenditures for added enforcement, WCC anticipates an increase in claims for workers' compensation, as well as investigations of potential misclassification of employees. It is unclear whether the operational impact on WCC can be handled with existing resources or whether additional increases in assessments would be needed to cover WCC costs.

State Revenues: General fund revenues and, to a more limited extent, special fund revenues increase minimally due to the bill's penalty provisions. DLLR advises that its enforcement efforts initially focus on compliance, and that penalties are applied only in a small percentage of cases. DLS assumes that, upon being cited and informed that they have 45 days to comply with the law, 95% of violators choose to comply. Moreover, DLS expects very few investigations of new complaints to be completed in fiscal 2010, given that they will likely not begin until the final quarter of the fiscal year. In fiscal 2011, general fund revenues from the civil penalty provisions, including the failure to provide records, may increase by as much as \$300,000, but decline in future years as compliance increases in conjunction with outreach and education. For purposes of this analysis DLS assumes administrative penalties are also paid to the general fund.

In addition to the penalty revenue, the Comptroller may realize additional income tax revenue as a result of the bill, to the extent that enforcement requires more employers to comply with income tax withholding requirements. DLS cannot reliably estimate the extent to which enforcement efforts uncover misclassification by affected employers. Available data from DLLR and the U.S. Department of Labor indicates that between 5% and 25% of employers in the affected industries misclassify at least some employees and, therefore, would have to withhold income taxes from their compensation. Based on available data and *for illustrative purposes only*, DLS assumes that 14% of employers misclassify employees. Based on this assumption, and on estimated wages for the construction and landscaping industries in Maryland, general fund revenues may increase by between \$5 million and \$10 million annually due to additional tax compliance in these industries. Revenues may increase from additional tax compliance in other industries to the extent that enhanced enforcement spills over into other industries.

Unemployment Insurance Trust Fund Effect: Revenues for the Unemployment Insurance Trust Fund within DLLR's Division of Unemployment Insurance likely reflect no change in fiscal 2010 due to the limited number of enforcement investigations. Enhanced enforcement by DLLR beginning in fiscal 2011 results in more employers complying with mandated contributions to the trust fund. Revenues increase by as much as \$4 million in fiscal 2011 and 2012. Assuming continued compliance, revenues increase by as much as \$6 million and \$7 million, respectively, in fiscal 2013 and 2014 due to higher levels of voluntary and enforced compliance.

Although unemployment insurance claims may increase under the bill, any such increase is not expected to be significant. Under current law, a misclassified employee who files a claim may receive unemployment insurance benefits provided that the division finds that the employer improperly classified the employee. In such cases, the employer is then responsible for unpaid unemployment insurance taxes.

Injured Workers' Insurance Fund Effect: IWIF indicates that a reduction in misclassified workers results in an increase in premiums for insurers in the State. IWIF does not have statistics on this point but is aware of a number of cases involving misclassification, primarily in the construction industry. *For illustrative purposes only*, IWIF collects about \$60 million per year in annual premiums from the construction industry; assuming about 14% misclassification in the industry, IWIF estimates that it loses approximately \$8.5 million per year. The extent to which IWIF collects some of that foregone revenue depends on how many employers currently misclassify employees or pay employees in cash, which cannot be reliably estimated.

IWIF expenditures increase due to the rise in the assessment on all insurers in the State, including IWIF, for the additional WCC staff needed for the enforcement effort. As an insurer, IWIF's share of the 2008 assessment was 8.6%. Assuming a similar rate in fiscal 2010 and, *for illustrative purposes only*, IWIF's share of the additional assessment is \$22,270.

Although workers' compensation claims may increase under the bill, any such increase is not expected to be significant. Under current law, a misclassified employee who files a claim due to injury on the job may receive workers' compensation benefits provided that WCC finds that the employer improperly classified the employee. In such cases, the employer is then responsible for the workers' compensation benefits owed to the employee.

Local Fiscal Effect: Local tax revenue may also increase significantly with increased compliance with classification requirements. Local expenditures increase minimally due to the increased WCC assessment on all insurers in the State to cover DLLR's enforcement costs.

Small Business Effect: Small businesses that are found to misclassify their employees must pay unemployment insurance, workers' compensation, and payroll taxes on behalf of misclassified employees. They are also subject to civil and administrative penalties if they knowingly or repeatedly misclassify employees. Expenditures by all small businesses increase minimally to comply with recordkeeping requirements and for higher WCC assessments. Small businesses that currently comply with all classification requirements may become more competitive relative to those that do not currently comply and therefore have lower labor costs.

Additional Information

Prior Introductions: None.

Cross File: HB 819 (The Speaker, *et al.*) (By Request - Administration) - Economic Matters.

Information Source(s): Office of the Attorney General; Department of Budget and Management; Department of General Services; Maryland Insurance Administration; Injured Workers' Insurance Fund; Comptroller's Office; Judiciary (Administrative Office of the Courts); Department of Labor, Licensing, and Regulation; Office of Administrative Hearings; Subsequent Injury Fund; Secretary of State; Uninsured Employers' Fund; Workers' Compensation Commission; Department of Legislative Services

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Analysis by: Michael T. Vorgetts

Direct Inquiries to:
(410) 946-5510
(301) 970-5510

ANALYSIS OF ECONOMIC IMPACT ON SMALL BUSINESSES

TITLE OF BILL: Workplace Fraud Act of 2009

BILL NUMBER: Senate Bill 909

PREPARED BY: Department of Labor, Licensing and Regulation

PART A. ECONOMIC IMPACT RATING

This agency estimates that the proposed bill:

WILL HAVE MINIMAL OR NO ECONOMIC IMPACT ON MARYLAND
SMALL BUSINESS

OR

WILL HAVE MEANINGFUL ECONOMIC IMPACT ON MARYLAND
SMALL BUSINESSES

PART B. ECONOMIC IMPACT ANALYSIS

To the extent that small businesses are complying with the current law, there will be no impact.