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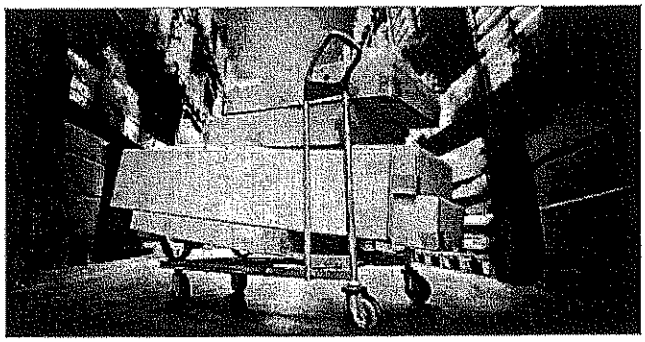

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Combating The Underground Economy

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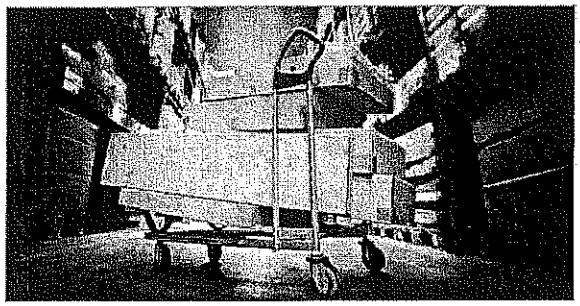

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Combating The Underground Economy

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By Kathleen Dunham

When one hears a term like "underground economy," one normally thinks of a third-world country or a business run by the mafia. But this term has been used officially by the State of California to refer to legitimate businesses that engage in practices that are designed to avoid payment of employment-related taxes and benefits to workers. According to California's Employment Development Department (EDD), these businesses "deal in cash and/or use other schemes to conceal their activities and their true tax liabilities from government licensing, regulatory, and tax agencies."

The EDD has targeted several industries that it has determined are part of this "underground economy." Among them is the courier and delivery industry. In an effort to crack down on these companies, the EDD created the Underground Economy Operations (UEO) "to reduce unfair business competition and protect the rights of workers." The State of California seeks to create a level playing field for those companies that voluntarily pay employment related taxes and benefits.

The EDD's Information Sheet points out that "when businesses operate in the underground economy, they gain an unfair competitive advantage over businesses that comply with the law. This causes unfair competition in the marketplace and forces law-abiding businesses to pay higher taxes." In addition to unfair business competition and workers' rights, the State of California is also concerned about the loss of tax revenues caused by the underground economy, and this concern has been heightened by the recent budget crisis in the state.

With regard to the courier and delivery industry crackdown, the EDD reported in 2007 that its UEO and other programs had targeted 381 cases, which resulted in 17,000 additional drivers found to be employees and an increase in tax liability against businesses in the amount of $30.8 million.

Among the devices used by the courier and delivery businesses to avoid paying employment-related taxes and benefits to workers is misclassifying employees as independent contractors. California courts have zeroed in on this practice, and the judicial trend in the last 15 years has been to find that the drivers are employees, and not independent contractors.

California is not alone in cracking down on courier and delivery companies that adopt such devices. The courts in a number of other states have been clamping down on these underground economy practices as well. In Massachusetts, the Court of Appeals in 2002 ruled that delivery drivers for a courier company were employees in spite of the fact that the company required each driver to sign a form contract that expressly labeled the drivers as "independent contractors." The Court of Appeals found this form contract to be unpersuasive, and even more strongly, called it a "subterfuge to avoid liability to the unemployment compensation fund." *Boston Bicycle Couriers Inc. v. Dep. Director of the Div. of Employment*, 56 Mass. App. Ct. 473, 484 (2002.)

In Arizona, a courier and taxi company called its drivers independent contractors and also transferred these drivers to a third-party middleman, taking the position that the middleman was actually the drivers' employer. The Court of Appeals of Arizona found that the drivers were employees, not independent contractors, and further found that they were employees of the company and not of the middleman. The court found that, in reality, the middleman "functioned as a conduit through which [the company's] policies and practices were distributed and enforced." *Central Management Company v. The Industrial Commission of Arizona* 162 Ariz. 187, 192 (1989).

Other states finding that delivery drivers are employees and not independent contractors include Colorado, Illinois, New York, District of Columbia, Ohio and Texas. The federal government has also gotten involved. The Internal Revenue Service has issued rulings finding that delivery drivers are employees and not independent contractors. For example, in *Leb's Enterprises Inc.*, 85 AFTR2d Par. 2000-450, January 24, 2000, the U.S. District Court granted summary judgment to the government finding that drivers who transported vehicles from place to place are employees of the company and that the company was responsible for applicable employment taxes.

While the tide of court decisions and government agency rulings is in the direction of finding that delivery drivers are employees and not independent contractors, there are still forces that are attempting to hold back this tide. In 2007, the California State legislature passed SB 622, which would have authorized the Labor and Workforce Development Agency to assess civil penalties on employers found to be engaging in the willful misclassification of an employee as independent contractor.

While Gov. Schwarzenegger acknowledged that the bill was "intended to promote

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the worthy goal of ensuring that employees are not intentionally misclassified as independent contractors, thus deterring employers from conduct which may give them unfair economic advantages against their competitors," he nevertheless vetoed the bill, saying that "sufficient remedies already exist."

Schwarzenegger expressed a concern that the bill would create "an inhospitable business climate." The California Delivery Association has expressed serious concern about the targeting of the delivery industry by the California Employment Development Department, calling it "the most serious situation to confront our industry in recent memory." (CDA's "Important Information About EDD Audits," Dec. 30, 2003)

Nonetheless, the tide continues moving forward. Currently, SB 1490 is pending in the California State legislature, and, if passed, will require an employer who labels workers as independent contractors to provide information to those workers about what it means to be an independent contractor and what to do if they think they are misclassified.

The California Labor Federation has urged the passage of this law, stating on its website: "More and more companies have cut labor costs by misclassifying their employees as independent contractors. This type of arrangement absolves employers from having to provide basic protections such as workers' compensation, unemployment insurance, and healthcare. Too often, workers don't know what is at risk when they become independent contractors."

At the federal level, Senator Durbin and then-Senator Obama introduced a bill in 2007 known as the "Independent Contractor Proper Classification Act of 2007" (S. 2044). That bill is aimed at closing what it calls a "tax loophole" by, among other things, eliminating the ability of employers to rely on industry practice as a basis for using the loophole, and it also gives workers the right to petition the Secretary of the Treasury for a determination of their employee status. This bill is currently pending in the U.S. Senate's Committee on Finance.

Class action suits have also been utilized as a means of combating the underground economy. In *Gonzalez v. Freedom Communications Inc.*, (OCSC Case No. 03CC08756), a class of 5,000 newspaper delivery drivers claimed that Freedom Communications Inc. (which publishes the Orange County Register) had improperly misclassified them as independent contractors and had denied them benefits to which they were entitled as employees under the California Labor Code, including overtime and reimbursement of auto expenses. After five years of intense litigation and after two months at trial, the matter settled for a record $42 million. (*The author was a lead attorney on the case for the plaintiffs.*) Currently, there are similar class actions pending against The McClatchy Company and The Copley Press, which publishes the San Diego Union Tribune.

Another recent class action case, against Express Messenger Systems, resulted in a jury verdict that the drivers were independent contractors and not employees. In that case, the company utilized middlemen.

Based on currently pending state and federal legislation, on the trend of state and federal cases over the last 15 years, and on past and current enforcement action taken by government agencies, it is fair to assume that the government and the courts will continue to hone in on the underground economy and force companies to classify their workers correctly. The economic recession may intensify efforts to ensure proper classification of workers, as federal and state governments will be needing all companies to pay their share of employment-related taxes.

About the author: Kathleen Dunham is an experienced attorney with over 20 years in active practice in California. She practices at Callahan & Blaine in Santa Ana, Calif.

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The Underground Economy:

What the Government and Courts Are Doing to Combat It

by Kathleen Dunham, Esq.

When one hears a term like "underground economy," one normally thinks of a third-world country or a business run by the mafia. But this term has been used officially by the State of California to refer to legitimate businesses that engage in practices which are designed to avoid payment of employment-related taxes and benefits to workers. California's Employment Development Department (EDD) defines "underground economy" on its website as referring to businesses "that deal in cash and/or use other schemes to conceal their activities and their true tax liabilities from government licensing, regulatory, and tax agencies." The EDD has targeted several industries which it has determined are part of this "underground economy," and among them is the courier and delivery industry. In an effort to crack down on these companies, the EDD created the Underground Economy Operations (UEO) and its express mission "is to reduce unfair business competition and protect the rights of workers." (EDD website) The State of California seeks to create a level playing field for those companies who voluntarily pay employment related taxes and benefits; The EDD's *Information Sheet* points out that "When businesses operate in the underground economy, they gain an unfair competitive advantage over businesses that comply with the law.

This causes unfair competition in the marketplace and forces law-abiding businesses to pay higher taxes."

In addition to unfair business competition and workers' rights, the State of California is also concerned about the loss of tax revenues caused by the underground economy, and this concern has been heightened by the recent budget crisis in the State. The EDD's *California Employer* publication (First Quarter 2009 edition) stresses that problems created by the underground economy are particularly severe nowadays: "The state of our current economy makes it more important than ever to combat underground economies and provide a level playing field for California businesses." With regard to the courier and delivery industry crackdown, the EDD reported in 2007 that its UEO and other programs had targeted 381 cases, which resulted in 17,000 additional drivers found to be employees and an increase in tax liability against businesses in the amount of $30.8 million. (13th Report to the California Legislature dated June 2007, hereafter "Report", p. 19)

Let's examine briefly what devices are used by the courier and delivery businesses that fall into the underground economy. California's EDD describes one "scheme" as misclassifying employees as independent contractors. (Report, p. 19) The EDD observes that this is "a common practice." (Report p. 19) California courts have zeroed in on this practice of misclassifying employees as

independent contractors in the courier and delivery industry, and the judicial trend in the last fifteen years has been to find that the drivers are employees, and not independent contractors. These cases are numerous and include the following: *Air Couriers International et al. v. Employment Development Department* (2007) 150 Cal. App. 4th 923; *Estrada et al. v. FedEx Ground Package System, Inc.* (2007) 154 Cal. App. 4th 1; *JKH Enterprises Inc. V. Department of Industrial Relations* (2006) 142 Cal. App. 4th 1046; and *Toyota Motor Sales U.S.A. Inc. v. The Superior Court of Los Angeles* (1990) 220 Cal. App. 3d 864.

California is not alone in cracking down on courier and delivery companies that adopt devices to avoid paying employment-related taxes and benefits to workers. Numerous other states have been clamping down on this practice through court decisions. In Massachusetts, the Court of Appeals in 2002 ruled that delivery drivers for a courier company were employees in spite of the fact that the company required each driver to sign a form contract which expressly labeled the drivers as "independent contractors." The Court of Appeals found this form contract to be unpersuasive, and even more strongly, called it a "subterfuge to avoid liability to the unemployment compensation fund." (*Boston Bicycle Couriers Inc. v. Dep. Director of the Div. of Employment*, 56 Mass. App. Ct. 473, 484) In Arizona, a courier and taxi company called its drivers independent contractors and also transferred these drivers to a third party middleman; the

company took the position that the middleman was actually the drivers' employer. The Court of Appeals of Arizona found that the drivers were employees, not independent contractors, and further found that they were employees of the company and not of the middleman. The Court found that, in reality, the middleman "functioned as a conduit through which [the company's] policies and practices were distributed and enforced." (*Central Management Company v. The Industrial Commission of Arizona* (1989) 162 Ariz. 187, 192) Other states which have found that delivery drivers are employees and not independent contractors include Colorado, Illinois, New York, District of Columbia, Ohio, and Texas. (See, *e.g., Gustafson v. Bell Atlantic Corporation* (2001) S. Dist. N.Y. 171 F. 2d. 311); Chicago *Messenger Service v. Jordan, the Dept. of Employment Security* (2005) 356 Ill. App.3d. 101; *Speedy Messenger & Delivery Service v. Industrial Claim Appeals Office from the State of Colorado* (2005) 129 P.3d. 1094; *AFM Messenger Service Inc. v. The Dept. of Employment Security* (2001) 198 Ill.2d. 380; *Corporate Express Delivery Systems v. National Labor Relations Board* (2002) (Dist. of Columbia Cir.) 292 F. 3d. 777; *In the Matter of CDK Delivery Service Inc.* (1989) 151 A.D. 2d 932; *Hatchcock v. Acme Trucklines* (2001) (5th Cir.) 262 F. 3d. 522; and *Holiday v. Vacation Land Federal Credit Union* (2004), N. Dist. of Ohio, West Div. 2004 U.S. Dist. LEXIS 5655.)

The federal government has also gotten involved. The Internal Revenue Service has issued rulings finding that delivery drivers are employees and not independent contractors. For example, in *Leb's Enterprises Inc.*, 85 AFTR2d Par. 2000-450, January 24, 2000, the U.S. District Court granted summary judgment to the Government finding that drivers who transported vehicles from place to place are employees of the company and that the company was responsible for applicable employment taxes.

While the tide of court decisions and government agency rulings is in the direction of finding that delivery drivers are employees and not independent contractors, there are still forces which are attempting to hold back this tide. In 2007, the California State legislature passed SB 622 which would have authorized the Labor and Workforce Development Agency to assess civil penalties on employers found to be engaging in the willful misclassification of an employee as independent contractor. While Governor Schwarzenegger acknowledged that the Bill was "intended to promote the worthy goal of ensuring employees are not intentionally misclassified as independent contractors, thus deterring employers from conduct which may give them unfair economic advantages against their competitors," he nevertheless vetoed it saying that "sufficient remedies already exist." Mr. Schwarzenegger expressed a concern that the Bill would create "an inhospitable business climate." The California Delivery Association has

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Nonetheless, the tide continues moving forward. Currently, SB 1490 (Padilla) is pending in the California State legislature, and, if passed, it will require an employer who labels a worker as an independent contractor to provide information to their independent contractors about what it means to be an independent contractor and what to do if they think they are misclassified. The California Labor Federation has urged the passage of this law, stating in their website: "More and more companies have cut labor costs by misclassifying their employees as independent contractors. This type of arrangement absolves employers from having to provide basic protections such as workers' compensation, unemployment insurance, and healthcare. Too often, workers don't know what is at risk when they become independent contractors." At the federal level, Senator Durbin and then-Senator Obama introduced a bill in 2007 known as the "Independent Contractor Proper Classification Act of 2007" (S. 2044). That bill is aimed at closing what it calls a "tax loophole" by, among other things, eliminating the ability of employers to rely on industry practice as a basis for using the loophole, and it also gives workers the right to petition the Secretary of the

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Express Messenger Systems, Inc. (2009) 171 Cal. App. 4th 72)

Based on currently-pending state and federal legislation, on the trend of state and federal cases over the last 15 years, and on past and current enforcement action taken by government agencies, it is fair to assume that the government and the courts will continue to hone in on the underground economy and force companies to correctly classify their workers. The economic recession may intensify efforts to ensure proper classification of workers, as federal and state governments will be needing all companies to pay their share of employment-related taxes.

Kathleen Dunham, Esq.
Callahan & Blaine
Co-Counsel on *Gonzalez v. Freedom Communications Inc.*
Named one of the Top 100 Women Litigators in California for 2009 (by the Los Angeles and San Francisco Daily Journal)