



UNLAWFUL DENIAL OF WORKERS' COMPENSATION

Annual Report on Employee Misclassification &
Uninsured Employer Initiatives

BUREAU OF WORKERS' COMPENSATION

February 1, 2017



The past fiscal year (FY 2015/2016) was one of great change; more employees gained coverage, while even more non-compliant employers were discovered. More than \$3.7M in penalties were assessed.

Since the 2013 misclassification law became effective:



20,998

Employees Gained Coverage



1,493

Non-Compliant Employers Identified

Letter from the Administrator

Tennessee Bureau of Workers' Compensation

The Honorable Jack Johnson
Chairman, Senate Commerce
& Labor Committee
11 Legislative Plaza
Nashville, TN 37243

The Honorable Jimmy Eldridge
Chairman, House Consumer
& Human Resources Committee
208 War Memorial Building
Nashville, TN 37243

The bureau remains committed to reducing noncompliance with workers' compensation laws.

Dear Chairman Johnson and Chairman Eldridge:

In 2010, the General Assembly passed legislation that established an Employee Misclassification Advisory Task Force to make recommendations regarding employee misclassification in the construction services industry and to submit an annual report to your committees on or before February 1 of each year. The task force completed their legislatively mandated tasks, and the law that created the task force terminated in 2014. Recognizing the importance of these issues, the Bureau of Workers' Compensation (BWC) has continued to update your committees annually on employee misclassification, the failure to provide workers' compensation coverage, and the bureau's initiatives to reduce both.

The General Assembly's leadership in addressing misclassification in Tennessee led to the recognition of the state by the Migration Policy Institute for its efforts in this area. Stopping misclassification and ensuring that employers provide workers' compensation coverage are challenging goals that not all states have addressed as actively as Tennessee.

Many people and organizations have made valuable contributions to Tennessee's initiatives. The bureau is particularly grateful for the assistance of the agencies, businesses, and stakeholders who have served as members of the Employee Misclassification Advisory Committee. The progress noted in this report would have been impossible without their contributions.

While much has been accomplished, there is more work to do. The bureau remains committed to reducing noncompliance with laws that prohibit employee misclassification and require workers' compensation insurance coverage.

I hope you find this year's report informative. If your committees would like additional information on the bureau's efforts to increase compliance with workers' compensation laws, we will be happy to provide it.

Sincerely,



Abbie Hudgens, Administrator
Bureau of Workers' Compensation



Executive Summary

Too many employees are being unlawfully denied workers' compensation in Tennessee. This can be attributed to two main causes: employees are illegally classified as "independent contractors" and employers are not securing workers' compensation insurance even when mandated by statute.

Employee Misclassification is a serious obstacle to almost every segment of working society. When a construction services employer gains an unfair competitive advantage by not complying with state and federal laws, others unfairly bear a financial burden through increased workers' compensation premiums, lost business, denied benefits, and higher costs for social insurance programs. Workers, law-abiding employers, and insurance companies, as well as the Tennessee and federal governments are left to "foot the bill."

The General Assembly recognized the danger of allowing such practices to go unchecked and passed legislation in 2013 that targeted this problem. The legislation made it a violation of the workers' compensation law for construction services employers to classify employees incorrectly, established penalties for misclassification, and appropriated funds to pay the administrative costs required to investigate and penalize employers that violated the law.

While this legislation focused on the construction services industry, another statute (uninsured employers' fund) author-

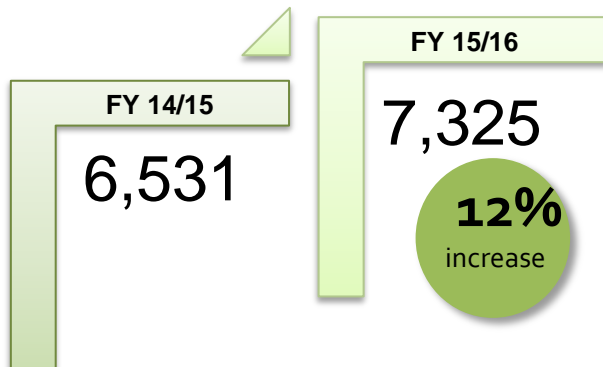
ized penalties in 2000 against employers in any industry who unlawfully failed to provide workers' compensation insurance coverage to employees. Together, these two statutes address the problem of shifting the responsibility for providing workers' compensation coverage from the appropriate employers to others.

In 2013, legislation was passed to make it a violation of law to misclassify employees.

Since the misclassification law became effective, 275 formerly misclassified employees gained the protection of workers' compensation insurance and 20,723 employees gained coverage through the uninsured employer program. During the same period, the bureau identified 1,493 employers who did not provide legally required workers' compensation benefits to their employees.

In the most recent fiscal year (FY 2015/2016), the bureau had the following outcomes in its compliance program:

Employees Gained Coverage



- 7,325 employees gained workers' compensation insurance coverage, a 12% increase from 6,531 in FY 2014/2015.
- 3,881 investigations of employers took place.
- \$3,846,101 in penalties were assessed.
- \$1,311,815 was collected for misclassification and uninsured employer penalty assessments.
- 419 employers were assessed for noncompliance, a 12% increase from the 373 assessed in FY 2014/2015.
- Technological capabilities increased. SAS (fraud detection software) implementation was completed. The bureau also acquired CLEAR software that assists investigators to locate noncompliant employers who are often very mobile and difficult to locate.
- Bureau implemented a free "Notification of Early Cancellation" service.

Fulfilling the bureau's mission requires the elimination of employee misclassification.

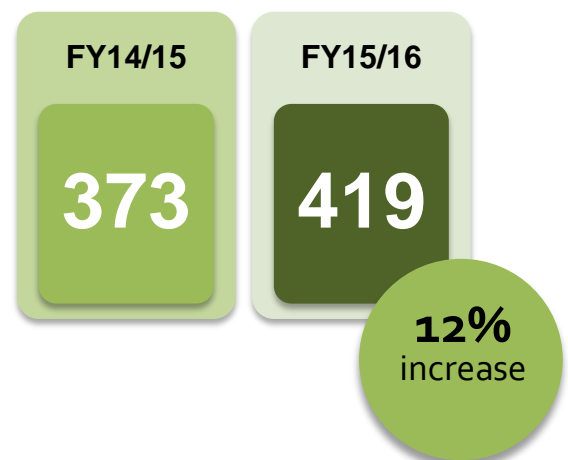
While these outcomes are encouraging, more can and should be done to increase compliance with these laws. The Employee Misclassification Advisory Committee and bureau identified and recommended during the year two pieces of legislation that could reduce employee misclassification further. One recommendation is to penalize inappropriate use of the Workers' Compensation Exemption Registry. The second is to require construction services employers to maintain simple documentation of their workers' compensation insurance on construction job sites.

Both recommendations are included in the Governor's legislative package for the 2017 session.

The bureau believes that there are still more opportunities to reduce noncompliance with workers' compensation laws. Misclassification occurs in most sectors of Tennessee's economy, not just construction. During FY 2016/2017, the bureau and the Employee Misclassification Advisory Committee will work together to develop recommendations to protect law-abiding businesses and workers in additional sectors of Tennessee's economy. In addition, the bureau will study the practice of employers who evade penalties by going out of business to avoid a penalty only to start providing the same product or service under a different name. These recommendations will be consistent with the goals of the original misclassification legislation, which were to provide a level playing field for employers and to provide workers' compensation coverage for workers in accordance with the law.

The mission of the bureau is to fulfill the promise of workers' compensation today...and tomorrow. To fulfill this mission, the bureau must eliminate misclassification and other employer practices that deny lawful workers' compensation coverage to employees.

Non-Compliant Employer Assessments



3,881 investigations were conducted.



Problems to Solve

Work-related injuries can be serious, even if workers receive all the benefits they are entitled to in a timely manner and without controversy.

Tennesseans who are injured on the job face hardships, even if they receive all the benefits of Tennessee's workers' compensation system with little difficulty. Imagine how devastating it would be for an injured worker to wake up in the hospital and discover that his or her "employer" was not going to provide workers' compensation benefits.

Imagine the frustration of a law-abiding dry wall contractor or other construction services owner who complies with workers' compensation laws and loses business to competitors who can bid lower because they did not comply with these laws. These scenarios occur too frequently in Tennessee.

Solving the problems above is the goal of the bureau's compliance program. The problem in the first paragraph describes employers who do not provide workers' compensation coverage to employees at all. Generally, every employer in the state that has five (5) or more employees must provide workers' compensation insurance coverage or be self-insured. Employers in the construction and coal mining trades are not subject to the five-employee minimum and must provide coverage on all their employees even if they employ only one person.

Employee misclassification is described in the second paragraph. It occurs when construction service providers improperly avoid insurance premiums by misclassifying employees as independent contractors, underreporting payroll, or misrepresenting the type of work their employees perform.

The consequences of these two problems are serious, and include:

- Unfair advantage of noncompliant construction services employers over law-abiding employers;
- Lost medical benefits for injured workers;
- Lost wage-replacement benefits for injured workers while they are recovering from work-related injuries;
- Lost overtime pay for workers;
- Lost social security benefits, fair labor standards protections, unemployment benefits, family medical leave, and other employee protections;
- Insurance companies lose workers' compensation insurance premiums;
- Tennessee loses unemployment insurance premiums;
- Avoidance of federal employment taxes;
- Increased costs to TennCare, social security, disability insurance and charitable programs.

These problems are not confined to one area of Tennessee. They exist in all three grand divisions of the state. The illustrations on the next page show the number, dollar amounts of penalty assessments and collections in each of the three grand divisions for both employee misclassification and failure to provide insurance (UEF) in FY 2015/2016. The difference between assessments and collections demonstrates that even when a violation is uncovered and a penalty is assessed, an employer may be as noncompliant in paying a penalty as it was in following the law.

- *Unfair advantage over law-abiding employers;*
- *Loss of benefits for injured employees;*
- *Avoidance of insurance premiums and unemployment taxes;*
- *Increased costs for social welfare programs.*

EMPLOYEE MISCLASSIFICATION ASSESSMENTS



UNINSURED EMPLOYER ASSESSMENTS



The difference between assessments and collections demonstrates that even when a violation is uncovered and a penalty is assessed, an employer may be as noncompliant in paying a penalty as it was in following the law

* Collections



Addressing Problems

The goal of the Compliance Program of the Bureau of Workers' Compensation is to reduce or eliminate these problems.

The goal of the Bureau of Workers' Compensation's Compliance Program is to reduce and/or eliminate these problems. Two statutes authorize the bureau's compliance activities:

(1) T.C.A. §50-6-411 prohibits construction services employers from misclassifying employees to avoid insurance premiums by "concealing any information pertinent to the computation and application of an experience rating modification factor or by materially understating or concealing" pertinent information.

(2) T.C.A. §50-6-412 authorizes penalties for an employer's failure to comply with statutory insurance requirements related to providing workers' compensation to employees.

The employee misclassification initiative began with legislation in 2010 that created the Employee Misclassification Advisory Task Force. The legislation required the task force to study misclassification issues and report its findings to the Senate Commerce and Labor Committee and the House Consumer and Human Resources Committee.

The task force had meetings for three years and made recommendations in its annual reports. The legislature considered the recommendations and passed legislation that went into effect July 1, 2013 (T.C.A. §50-6-411), which prohibited misclassification and established penalties for violations of the statute. It also included provisions for referrals to the "Tennessee bureau of investigation or the appropriate district

attorney general" for "action deemed necessary under any applicable criminal law."

The law that created the task force terminated in June 2014, since the task force completed its mission. Recognizing that additional problems remained, many of the former task force members, along with additional stakeholders, volunteered to be members of the Employee Misclassification Advisory Committee. The new committee is an active and valuable part of the continued initiative to eliminate practices that deprive employees of legally-required workers' compensation coverage and subject lawful employers to unfair competition. (A list of current members of the Advisory Committee in Exhibit I of the Appendix to this report.)

The law that created the task force terminated in June 2014 since its mandate had been accomplished, but an active volunteer committee continues its work.

The second part of the bureau's compliance program is the Uninsured Employer Fund ("UEF"). Legislation in 2000 established the UEF program. The provisions of this program are contained in T.C.A. §50-6-412 and T.C.A. §50-6-801. In accordance with the statute, the bureau identifies employers who are required to provide workers' compensation coverage under the law but fail to do so and assesses penalties that vary according to whether and when the employer comes into compliance. To address both compliance issues, the program employs nine investigators across the state. Assisting them are four administrative and legal staff members in the Nashville office. Investigators, along with their assigned territories and administrative staff, are listed in Exhibit II of the Appendix.

The outcomes from compliance efforts in FY 2015/2016 are encouraging. Statistics are not the only measure of a program's success, but the statistics below provide a snapshot of the results in FY 2015/2016.

The number of employers investigated for misclassifying employees or failing to provide workers' compensation coverage increased to 3,881, a 47.6% increase from 2,629 in the prior year.

Misclassification penalties increased by 62.4%

Of those investigated, 419 employers were found to have either misclassified their employees or failed to provide them with required coverage, a 12.3% increase from the 373 identified in FY 2014/2015.

Penalty assessments for misclassification or being an uninsured employer rose from \$2,368,321 in FY 2014/2015 to \$3,846,101, a 62.4% increase.

Collections for the two programs rose from \$1.28 million in FY 2014/2015 to \$1,311,815, a 2.4% increase.

Methods to Increase Compliance

The compliance program utilizes many tools to identify noncompliant employers. Not every method is useful for every investigation. Often, the most effective approach is old-fashioned "boots on the ground." However, the bureau investigators have resources that assist them.

Information

Referrals and tips from individual citizens continue to be one of the most useful tools to combat both types of noncompliance. During FY 2015/2016, the bureau received thirty-nine "tip forms." The tip form is available to the public on the bureau's website. Seven resulted in an assessment.

Technology

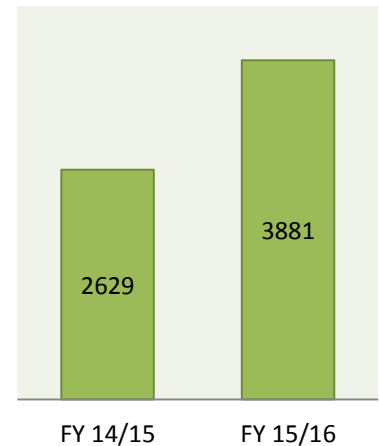
A legislative appropriation for fraud detection software allowed the bureau to acquire SAS software that analyzes several large datasets such as insurance coverage, unemployment insurance, and licensing board data for leads to potential noncompliance. The SAS vendor team, in collaboration with the Department of Labor and Workforce Development's IT division and the bureau's compliance program staff, worked for over 16 months to develop and implement the system.

In addition to SAS, the bureau obtained CLEAR software from Thomson Reuters. CLEAR makes it easier to locate people, assets, businesses, and affiliations. Many noncompliant employers are very mobile, making it difficult to contact them without resources like CLEAR. This software increases the accuracy of communications, including service of process for litigation.

Communications

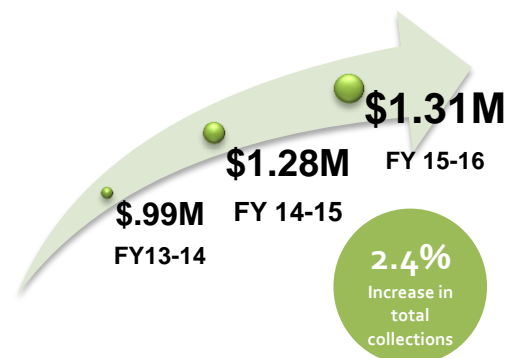
The bureau reached out to stakeholders during the fiscal year to raise awareness about misclassification. Compliance staff conducted training sessions for 14 groups, including the Home Builders Association, insurance agencies, insurance companies, Department of Revenue, and Workforce Employer Outreach Committee (WEOC). Over 250 people attended these sessions.

Employers Investigated



Television coverage provided information to the public about misclassification this year. The negative consequences of this issue were the subject of a report by Nashville's WSMV-TV news anchor Demetria Kalodimos on February 17, 2016. Ms. Kalodimos interviewed the director of the bureau's compliance program about unfair construction services competition in Nashville when contractors submit lower bids because they have reduced their costs illegally through misclassification.

Total Penalty Collections



Insurance Coverage Information

There is a new way to combat failure to provide coverage on the bureau's website. In March 2016, the "Notification of Early Cancellation" tracking service went into effect. Now individuals may register for each insurance policy they want to track to ensure a firm maintains workers' compensation insurance.

Once a policy is registered, a notification will be sent to the individual if the policy is cancelled. This service enables general contractors and others to verify that subcontractors are maintaining required insurance. This service is available at no cost to users. It has been well received by contractors and insurance agents.

Sweeps

A sweep is a coordinated effort of many of the bureau investigators at one time in one area where widespread fraud is suspected. The most recent sweep

occurred in Sevier County on January 11 and 12, 2017. The investigators initiated 274 investigations. Over 100 possible violations were identified. In addition, compliance staff educated homeowners on the dangers of hiring contractors without verifying that the contractors have proper insurance. For example, they met with a homeowners' association where 90 homes were destroyed by fires. Three of the homeowners had already lost money to contractors who never returned to do the work after receiving payment.

As a result, the homeowners' association put information provided by the investigators on their website explaining the importance of verifying that contractors are insured. The investigators also established contacts with the local law enforcement officials.

This sweep was a preliminary one. The bulk of the rebuilding in Gatlinburg will commence in the spring, and the investigators will conduct at least one more sweep when the rebuilding begins.



BWC Compliance Field Investigators recently conducted a sweep in Sevier County, Tennessee that resulted in identifying possible violations and educating homeowners.



Compliance investigator Rene Gallardo interviews an employer on the sweep in Gatlinburg in January 2017.



November's wildfires damaged hundreds of structures in Sevier county; sweeps uncovered over 100 likely violations.

Recommendations for Next Steps

Workers' Compensation Exemption Registry

Investigations have indicated that some workers were being placed on the registry without their knowledge. This practice allows employers to submit incorrect underwriting information to insurance companies and pay lower premiums. It also means that those workers will be denied workers' compensation benefits if they are injured while working for that employer.

The employer who uses the exemption unlawfully gains a competitive advantage against law-abiding employers. It also means taxes that should have been paid on premiums are not going to the Second Injury Fund. Unemployment insurance premiums are not paid, and federal taxes are not collected when the exemption registry is misused.

Data from last year's investigations suggested that more than 2,000 registrants were incorrectly registered as independent contractors, operating their own businesses. To combat this unscrupulous use of the registry, a part of the Governor's legislative package proposes that a penalty be established for any person who knowingly enters or directs a party to enter false or unauthorized information on construction services employers' applications to the registry.

Proof of Workers' Compensation Insurance at Construction Sites

Another recommendation that would reduce the incidence of misclassification is a requirement that construction services employers have proof of workers' compensation coverage at their place of business and at construction job sites. Providing such proof of insurance coverage is also part of the administration's legislative package.

The purpose of this proposed legislation is to overcome the problem of verifying insurance coverage at some construction sites. In highly mobile business, a visit to the construction site may be the only way that bureau investigators can contact contractors who have no fixed office in the state. Verifying coverage immediately is necessary to ensure that the employers are complying with the insurance requirements of the construction project and providing appropriate coverage to employees.

Proof of coverage at the job site will lessen administrative burdens for compliant employers. Some investigations would end immediately if evidence of appropriate insurance coverage was at the construction site. It would also allow investigators more time to pursue noncompliant employers.

Considerations for the Future

The bureau and the advisory committee recognize that the practice of misclassification occurs in sectors of Tennessee's economy other than construction services. There are no simple answers to dealing with misclassification in other industries; however, the bureau and the advisory committee will continue to discuss this issue and develop proposals for legislation.

Another issue identified as a concern is the loophole that allows employers to evade penalties by going out of business under one name and immediately starting up the same business under a different name. This practice allows an employer to continue unlawful employment practices without consequences. The bureau and advisory committee will study potential methods to close this loophole in the coming year.



Conclusion

The Bureau of Workers' Compensation has had continued success in its efforts to enforce the misclassification law and the law requiring compliance with workers' compensation.

Since the implementation of these laws, thousands of employees have gained workers' compensation benefits, and many construction employers in Tennessee are now able to operate on a more level playing field.

Since the implementation of the misclassification law, more investigators have been hired; stakeholders have been educated; fraud-detection software has been implemented; and the public has been provided with a service that allows them to check whether a contractor is maintaining the correct coverage. Each year, even more noncompliant employers are identified, and more employees gain protection for injuries on the job.

Unfortunately, there are still law-abiding employers who must compete for contracts with employers who cut 20% or more from their bids by avoiding compliance with the state's laws on workers' compensation. There are still workers who become injured and discover that their employers will not provide them workers' compensation benefits.

There are still workers who are illegally classified as independent contractors and denied benefits unfairly. There are still workers who are forced to sign applications for the Workers' Compensation Exemption Registry as a condition of employment. There are new schemes to hide payroll for subcontractors. There are still construction companies that underreport payroll to avoid insurance premiums, unemployment taxes, and federal payroll taxes.

As long as these abuses continue, the Bureau of Workers' Compensation will continue to work to reach the goals of the misclassification legislation, which are to provide equal opportunities for law-abiding employers and to provide lawful workers' compensation coverage for workers. These tasks are in keeping with the mission of the bureau, which is to fulfill the promise of workers' compensation today...and tomorrow.



There are still law-abiding employers who must compete for contracts with employers who can cut costs by avoiding compliance with the state's laws on workers' compensation.

Appendix

Exhibit I: Employee Misclassification Advisory Committee

Abbie Hudgens

Bureau of Workers' Compensation Administrator

Daniel Bailey

Assistant General Counsel, Tennessee
Department of Labor and Workforce
Development

Jim Brown

NFIB/Tennessee State Director, National
Federation of Independent Business

Nathan Burton

Director of Business Services, Secretary of State's
Office

Martha Campbell

Deputy Attorney General, Office of Attorney
General and Reporter

Dr. William Canak, Ph.D.

Professor of Sociology and Anthropology
Middle Tennessee State University

Matthew Capece, Esq.

Representative of the General President and
Joiners of America United Brotherhood of
Carpenters

Ashley Arnold Gold

General Counsel for Insurers of Tennessee

Kevin Hale

Hale Insurance

Mark Howell

Director, Employer Accounts Operations
Tennessee Department of Labor and Workforce
Development

Bradley Jackson,

CEO, the Tennessee Chamber of Commerce and Industry

Carolyn Lazenby

Executive Director, Board for Licensing Contractors

James Milam

Assistant District Attorney of Davidson County, District
Attorneys General Conference

Bob Pitts

Consultant, Associated Builders and Contractors

Alex Rieger

Assistant Attorney General, Office of Attorney
General and Reporter

Larry Scroggs

Administrator, Advisory Council on Workers'
Compensation

Mike Shinnick

Workers' Compensation Manager, Department of
Commerce and Insurance

Randall Thomas

Premium Auditor, The Travelers Companies, Inc.

Sarah Waters

Grassroots Manager, National Federation of
Independent Business

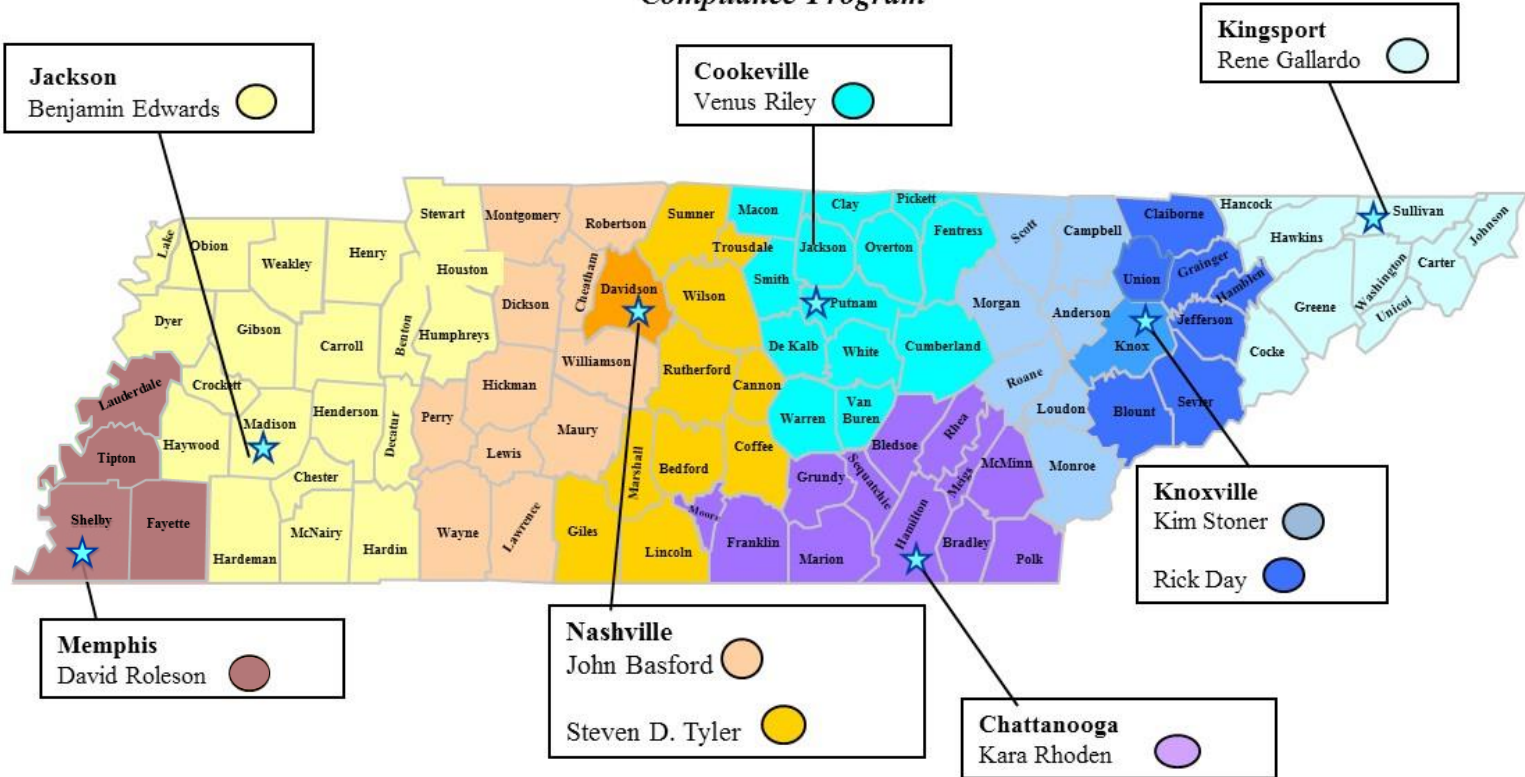
Russ Winkler

Special Agent in Charge, Tennessee Bureau of
Investigation

Exhibit II: Investigator Territories and Staff

Investigator Territories

*Bureau of Workers' Compensation
Compliance Program*



Compliance Staff

April Nix Bowden

615-253-1711
April.Nix@tn.gov

Shara Hamlett

615-253-6261
Shara.Hamlett@tn.gov

Carol Duncan

615-532-1319
Carol.D.Duncan@tn.gov

Patricia Thompson

615-741-0493
Patricia.Thompson@tn.gov

Kara Rhoden

423-634-2141
Kara.Rhoden@tn.gov

John Basford

615-253-5615
John.Basford@tn.gov

Steven D. Tyler

615-741-1242
Steven.D.Tyler@tn.gov

David Roleson

901-543-2475
David.Roleson@tn.gov

Kim Stoner

865-594-5331
Kimberly.Stoner@tn.gov

Rick Day

865-594-5188
Rick.Day@tn.gov

Benjamin Edwards

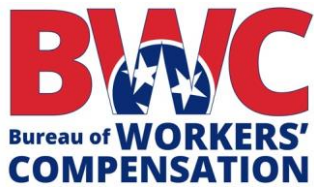
731-426-0416
Benjamin.Edwards@tn.gov

Venus Riley

931-520-4294
Venus.Riley@tn.gov

Rene Gallardo

423-245-4785
Rene.Gallardo@tn.gov



220 French Landing Drive, Suite 1-B
Nashville, TN 37243
Tel: 615-741-2395
Fax: 786-582-6556

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