Summary of Testimony – HB 2400
April 23, 2008

Pennsylvania Compensation Rating Bureau (PCRB)

Timothy L. Wisecarver, President
Bruce Decker, Senior Vice President

Introduction: The PCRB is the licensed rating organization for workers compensation business other than Coal Mine coverages in the Commonwealth of Pennsylvania, and has served in that role since 1915. PCRB is a non-profit, private corporation supported by members comprised of all insurers licensed to underwrite workers compensation insurance in Pennsylvania, including the State Workers Insurance Fund. PCRB makes annual rating value filings with the Pennsylvania Insurance Department and, subject to regulation and approval by the Insurance Department, PCRB maintains uniform classification and experience rating plans as well as rules and parameters associated with various other mandatory and optional pricing programs. PCRB has approximately 120 employees, the substantial majority of which are located in the Bureau's offices in Philadelphia.

Background: "Independent contractors", as distinguished from "employees" are not subject to coverage provisions of Pennsylvania's Workers compensation Act. As such, independent contractors would presumably not be required to obtain insurance, they would not be included in the payroll exposure base of any entity or entities with which they do business, and they would not be eligible for workers compensation benefits if and when they were injured or taken ill in the course of their business endeavors. However, when disputes have arisen (most commonly in the context of someone who has been injured attempting after-the-fact to secure workers compensation benefits), the prevailing criteria used to differentiate between independent contractor status and that of an "employee" has been the right of direction and control over the work done by the person in question. If and when the right of direction and control lies with the entity for which work is being done, courts find that the injured person was an employee of the entity being served. Where no right of direction and control is found to reside with the entity being served, courts find the injured person to be an independent contractor.

In essence, it is not "what" someone is doing as much as "how" they are doing it that determines who may be an employee and who may be an independent contractor. In fact, case law includes instances in which general practices of the person seeking benefits have been acknowledged to be consistent with the status of "independent contractor" but specific circumstances noted in close proximity to the moment of injury were determined to have vested short-term right of direction and control over the injured party by the entity for which work was being done, leading to a finding of employee status and eligibility for benefits. This transitory nature of the legal test makes it impossible to preordain who WILL BE employees and/or independent contractors in their future endeavors, and raises the prospect that some individuals may move rather fluidly between these statuses as time, projects and/or assignments undertaken and related conditions change.

Insurance carriers, being mindful (sometimes from first-hand experience) of the liability that can emanate from activities of individuals perceived by their insured risks as "independent contractors" have increasingly taken the approach that such persons not possessed of their own certificate of workers compensation insurance are presumptively "employees", and have included payments to such persons as part of the payroll basis for workers compensation premium determinations. These decisions typically happen at audit, after the expiration of the policy, and can impose large, unexpected and disputed additional premium amounts.

In PCRB's view, the issue to which HB 2400 is rightfully addressed is the ongoing uncertainty about who is eligible for benefits (and should thus be covered under an applicable commercial workers compensation insurance policy or an approved self-insurance plan) and who is not eligible for benefits (and should thus NOT be covered under an applicable commercial workers compensation insurance policy or an approved self-insurance plan). It is worthwhile noting that the problems briefly mentioned above are not limited to Pennsylvania, but rather attend almost every workers' compensation jurisdiction to some degree. PCRB knows of no jurisdiction that has applied a construct or solution embraced without controversy or exception as having fully and fairly resolved the disputes and ambiguities which abound in this area.

Potential Solutions: PCRB has previously considered the question of independent contractor status, and has identified four potential conceptual approaches to improving the clarity and certainty of the system with respect to the above issues. Very briefly, those alternatives have been:

- "All In" – In this system, independent contractors would be defined to be subject to mandatory provisions of the Workers' Compensation Act and the entity or entities for which such individual perform services would be obliged to provide workers compensation insurance or benefits for them. No election out of this mandatory coverage would be allowed.

- "All In with Option to Elect Out" – Here the starting point is the system described above, but the difference is that individuals may elect out of coverage using forms and procedures provided and overseen by a regulatory agency such as the Department of Labor & Industry, or they may provide their own workers' compensation coverage by purchasing a policy in their own name.

- All Out with Option to Elect In" – This approach would define independent contractors as not being subject to the Workers Compensation Act, but would allow them to elect coverage using forms and procedures provided and overseen by a regulatory agency such as the Department of Labor & Industry and provided that they concurrently purchase insurance in their own name.

- "All Out" – In this method the Workers Compensation Act would exclude independent contractors without exception or the option to obtain coverage.

Each of the above approaches would have perceived strengths and weaknesses, discussion of which would exceed the time available for today's hearing. PCRB has

some narrative materials prepared with respect to these issues that we would provide the Committee upon request.

Magnitude of the Problem: PCRB was asked to estimate the extent to which independent contractors may have been improperly omitted from Unemployment Insurance and Workers Compensation Insurance in the existing system.

PCRB is aware of a study done in Massachusetts using Unemployment Tax audits that purported to derive such estimates by using "new employees" discovered upon the event of such audits as a surrogate for the group of interest.

After reading the Massachusetts study, PCRB asked the Department of Labor & Industry whether audits similar to those used in the Massachusetts report were conducted by the Unemployment Insurance authorities in Pennsylvania, and we were advised in the affirmative. Further, the Department of Labor & Industry provided summary data of such audits covering a period of over two full years (calendar year 2006, calendar year 2007 and an initial part of calendar year 2008) and including some 11,000 audits to PCRB. Using the same approach as that applied in Massachusetts PCRB has developed the following key estimates:

- "New employees" found in Unemployment Insurance Tax audits in Pennsylvania during the period for which data was provided accounted for approximately 9 percent of total employees ultimately identified for the group of accounts that were audited.

- Payrolls attributed to "new employees" found in Unemployment Tax audits in Pennsylvania during the period for which data was provided accounted for approximately 3 percent of total payroll ultimately identified for the group of accounts that were audited.

- Because Unemployment Insurance is collected on the basis of employee earnings subject to an annual cap of $8,000, the impact of the omitted "new employees" is more than the 3 percent of total wages but less than the 9 percent of total employees each noted above. PCRB has applied some commonly-used wage distributions together with some simplistic but reasonable assumptions to estimate that the omitted "new employees" would represent approximately 7.7 percent of the total Unemployment Insurance obligations ultimately found for the group of accounts that were audited.

- For workers compensation business, the 3 percent of total payroll accounted for by the "new employees" would amount to almost $81 million per year in premium payments (the total commercial market for workers compensation insurance in Pennsylvania is approximately $2.7 billion annually).

It is imperative to understand that the Pennsylvania data and estimates referred to above were developed under, and are applicable to, the CURRENT statutory and administrative systems. They are not, and cannot be, prognostications of the population of individuals and/or entities that may be affected by HB 2400, which would among other

provisions change the definition of "independent contractor", perhaps quite significantly as discussed below.

HB 2400: In reading HB 2400 PCRB has identified a number of observations and/or comments that may be of interest to the Committee. These are briefly summarized below:

- HB 2400 defines employees as being individuals performing services for "wages". The term "wages" is not defined in HB 2400, nor is it defined in the current Pennsylvania Workers' Compensation Act. The Pennsylvania Workers' Compensation Act defines "employee" in substantial part as a natural person who performs services for another in exchange for a "valuable consideration". PCRB would anticipate considerable controversy around the question of whether payments made to "independent contractors" would be either wholly or partly considered "wages".

- The three conditions required to avoid designation as an employee under HB 2400 would, in PCRB's opinion, be all but impossible to achieve. The first condition would require the Department of Labor & Industry to opine that an individual will not be subject to direction and control of the party for which services are being performed. PCRB cannot fathom how the Department would be at liberty to make such a finding with even peripheral cognizance of prevailing case law in Pennsylvania. The second condition requires that the services being performed not be in the usual course of the business of the party for whom they are performed. The broad spectrum of contracting operations classically raising disputes about independent contractor status would seem automatically disqualified on the basis of this condition alone. Only the third condition, mandating that the individual performing the services be customarily engaged in an independently established trade, occupation, profession or business, would seem to be met with some regularity in most circumstances that come to PCRB's mind in the context of independent contractor questions. (This may be argued to be a strong point of the legislation's approach since exceptions to the rule would be very rare, but it also means that the dislocation from current practices could be far-reaching and profound.)

- Many "independent contractors" may have their own voluntary compensation insurance policies. HB 2400 does not provide any recognition of those policies as a means of meeting requirements of the Act, and since contractors may want or need such policies when working for homeowners or other similar "non-business" entities, coverage and premium determination for their policies would appear to require detailed review of all past contracts to determine which ones were "covered" by the entity for which services were performed and which were not.

- At the point of implementation, this statue would split the vast majority of Pennsylvania workers compensation policies into a "prior" portion (during which these provisions would not apply) and a "subsequent" portion (during which they

would apply). This would unavoidably present some issues of auditing and reporting of exposures that would ease somewhat in subsequent years.

- PCRB understands that incentives for compliance and enforcement of the provisions of this law may be critical to accomplishing the intended equity between premium payers and for workers intended to have the benefit of coverage under the Workers Compensation Act. That said, the processes set forth for stop work orders, probation periods, administrative and additional penalties appear to be extensive. Such processes and procedures could collectively require a substantial level of support resources to maintain and execute on a timely basis, presenting a cost to the system without counterpart today.

PCRB would be happy to attempt to provide responses to questions that interested parties may have about the above commentary, and appreciates the opportunity to participate in today's meeting.