Sham contracting and the misclassification of workers in the cleaning services, hair and beauty and call centre industries.

Report on the preliminary outcomes of the Fair Work Ombudsman Sham Contracting Operational Intervention.

November 2011

Australian Government

Fair Work OMBUDSMAN

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About the Fair Work Ombudsman

The Fair Work Ombudsman is an independent Commonwealth statutory agency, created by the Fair Work Act on 1 July 2009.

Our vision is fair Australian workplaces, and our mission is to work with Australians to educate, promote fairness and ensure justice in the workplace. We promote harmonious, productive and cooperative workplace relations and ensure compliance with Australia's workplace laws, by:

- offering people a single point of contact for them to receive accurate and timely advice and information about Australia's workplace relations system
- educating people working in Australia about their workplace rights and obligations
- investigating complaints or suspected contraventions of workplace laws, awards and agreements
- litigating to enforce workplace laws and to deter people from not complying with their workplace responsibilities.

Education and compliance campaigns that focus on specific industries are a proactive strategy we use to achieve compliance with national workplace laws. Education and compliance campaigns have a strong emphasis on engagement with relevant industry associations and unions to deliver our outcomes. This approach provides industry-specific knowledge that shapes the educational activities we undertake, and shares information through industry association and union communication channels.

This report covers the background, methodology and results of the Sham Contracting Operational Intervention conducted in 2011. For more information regarding this activity please contact:

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Executive Summary

Industry participants, including both employer and employee organisations, have long expressed concerns about the practice of 'sham contracting'. Sham contracting occurs when an employer attempts to disguise an employment relationship as an independent contracting relationship. By disguising these relationships as independent contracting, workers can be denied important entitlements and the statutory protections inherent in employment. Avoiding obligatory rates of pay and other entitlements can also give those enterprises an unfair competitive advantage. The issue has become increasingly topical, with concerns over the practice being raised by employer and employee associations, various Parliamentary Committees and by State, Territory and Federal Governments.

In response, in April and May 2011 the Fair Work Ombudsman commenced audits of 102 trading enterprises to assess the extent to which workers engaged by independent contracts should more properly have been considered employees and to provide guidance for any future compliance activity. This Sham Contracting Operational Intervention saw the cleaning services, hair and beauty, and call centre industries selected for audit by the Fair Work Ombudsman. Many roles within these industries can be performed by workers without formal qualifications or lengthy training, and low barriers to entry for new competitors, particularly in the cleaning services industry, create a highly competitive environment that could encourage enterprises to aggressively minimise labour expenses and potentially contravene workplace laws. Nearly 450 working relationships between parties were assessed during the audit.

An additional group of enterprises was selected for audit based on findings of earlier Fair Work Ombudsman investigations which found they had previously misclassified employees as independent contractors. These enterprises, representing a variety of industries, had received a formal Letter of Caution that advised them to change their worker engagement practices.

The report found a significant number of trading enterprises engaged contractors who were assessed as being employees on application of the common law test of employment by Fair Work Inspectors. Although in many instances it did not appear these arrangements were deliberate, in several cases it did appear that the relationship was knowingly or recklessly misrepresented to workers as one of independent contracting. It is expected at least some of these matters will result in the Fair Work Ombudsman seeking court ordered penalties against the companies and involved individuals. These matters remain under investigation.

The audit activity highlighted a need to use different language when describing contracted workers who are assessed as employees at law in circumstances that are neither deliberate nor reckless, as opposed to intentional efforts to deny workers employment benefits by treating them as contractors. Resisting the conflation of both circumstances into the single term 'sham contracting' is likely to encourage more informed and focussed discussion of the issue.

Although the audit activities focussed more heavily on the cleaning services industry than the hair and beauty and call centre industries, the misclassification of employees as independent contractors was found in all three. Where the misclassification of employees as independent contractors involves knowing or reckless misrepresentations to workers, the Fair Work Ombudsman will take a strong litigation focussed posture to preserve and protect the rights and entitlements of vulnerable workers.

There is a need to raise awareness of this problem among businesses more generally and to encourage businesses to exercise a greater degree of diligence over extant and future contracted labour arrangements. The Fair Work Ombudsman has an important role to play in providing education, assistance and advice in this regard.

Part 1 – Sham arrangements and the misclassification of workers

'Sham contracting' – a definitional issue?

The term 'sham contracting' has developed a broader meaning than provided by the contraventions described as 'sham arrangements' in the Commonwealth *Fair Work Act 2009*. When assessing whether a worker is a contractor or an employee, the reality is that work relationships sit on a continuum. At one end is the employee defined by notions of dependence and subordination, and at the other end is the truly entrepreneurial, autonomous independent contractor[1].

There is a perception of significant changes to the structure of businesses over recent decades coupled with an increase in relationships which fall into areas of the continuum between these two ends[2], and contracting represents a significant proportion of the Australian workforce. According to the Australian Bureau of Statistics, in November 2010 1.1 million Australian workers were independent contractors, representing 9.8% of all workers[3]. Fundamentally different from employees, genuine independent contractors are typically regulated by commercial rather than employment laws[4].

Contraventions of the 'sham arrangements' provisions of the Fair Work Act involve knowing or reckless behaviour designed to result in workers being denied employment benefits and protections. Such contraventions are treated seriously and the Fair Work Ombudsman has instituted proceedings against several enterprises for engaging in this type of behaviour.

The Fair Work Act provides three 'sham arrangements' contraventions and these are contained in the General Protections provisions of the Act. They are:

> ***Section 357 - Misrepresenting employment as independent contracting arrangement***
> *(1) A person (the **employer**) that employs, or proposes to employ, an individual must not represent to the individual that the contract of employment under which the individual is, or would be, employed by the employer is a contract for services under which the individual performs, or would perform, work as an independent contractor.*
> *(2) Subsection (1) does not apply if the employer proves that, when the representation was made, the employer:*
> *(a) did not know; and*
> *(b) was not reckless as to whether;*
> *the contract was a contract of employment rather than a contract for services.*
>
> ***Section 358 - Dismissing to engage as independent contractor***
> *An employer must not dismiss, or threaten to dismiss, an individual who:*
> *(a) is an employee of the employer; and*
> *(b) performs particular work for the employer;*

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[1] O'Donnell, A. *Non-Standard Workers in Australia: Counts and Controversies* (2004) 17 Australian Journal of Labour Law 1, 25
[2] *ibid*
[3] Australian Bureau of Statistics, *Forms of Employment, Australia, November 2010* (cat. no. 6359.0).
[4] Owens R. And Riley J. *The Law of Work* (2007) 136

in order to engage the individual as an independent contractor to perform the same, or substantially the same, work under a contract for services.

Section 359 - Misrepresentation to engage as independent contractor
*A person (the **employer**) that employs, or has at any time employed, an individual to perform particular work must not make a statement that the employer knows is false in order to persuade or influence the individual to enter into a contract for services under which the individual will perform, as an independent contractor, the same, or substantially the same, work for the employer.*

A contravention of these sections can result in the imposition of penalties by the courts - up to $33,000 per contravention for a body corporate or $6,600 for an individual. As well as requiring knowledge or recklessness, the term 'sham' has also been considered by the courts. Lockhart J in *Sharrment Pty Ltd v Official Trustee in Bankruptcy*[5] described a sham as:

> *'...something that is intended to be mistaken for something else or that is not really what it purports to be. It is a spurious imitation, a counterfeit, a disguise or a false front. It is not genuine or true, but something made in imitation of something else or made to appear to be something which it is not. It is something which is false or deceptive.'*

While this definition of sham implies a deliberate disguise, there are also situations where parties to a relationship have gone to some effort to create and maintain a contract for services that nonetheless is assessed as having the legal characteristics of a contract of employment. These relationships can be absent any deliberate falsity or deception and can arise unintentionally when, for example, a genuine independent contracting relationship is struck and over a period of time the contractor becomes more integrated into the enterprise, accepts less risk or perhaps relinquishes a degree of control over how work is performed. Although these relationships may not necessarily contravene sham arrangement provisions, the worker may nonetheless meet the common law definition of employee. The misclassification of an employee as an independent contractor in these circumstances is far from a benign concept and can potentially lead to other contraventions of the Fair Work Act and other laws. This arises when the employer operates under the belief the worker is not subject to laws and regulations applying to employees and consequently does consider them or comply with them.

Although contraventions of the sham arrangements provisions and the misclassification of employees as independent contractors can each have significant consequences, and to avoid conflating these two related but distinct issues into the one term, in the remainder of this report sham arrangements will be used to describe behaviour that contravenes the sham arrangements provisions of the Fair Work Act, and the misclassification of employees as independent contractors, or simply, misclassification will be used to describe a situation where the worker is considered an employee but no deliberate falsehood is apparent.

[5] (1988) 18 FCR 449 at 454 and subsequently adopted in *Raftland Pty Ltd v Federal Commisioner of Taxation* (2008) 238 CLR 516 at [111]-[112].

Misclassifying employees as independent contractors

Genuine independent contracting relationships allow an enterprise to focus on its core competencies by outsourcing non-core tasks. Outsourcing can reduce the cost of performing those tasks when the contractor has developed the skills and expertise or has specialised equipment that results in efficiencies in the way those tasks are performed. Having those tasks completed by a more efficient enterprise can result in a reduction in the overall cost of performing those tasks and can lessen the administrative cost of managing employed labour in an enterprise. Contracting can be an important and legitimate method for an enterprise to have certain tasks completed or to manage peaks and troughs in demand for its goods or services.

However, depending on the circumstances, the enterprise may risk otherwise contracted workers being held to meet the common law description of employees and subsequently being found liable for the entitlements that would have been due had the worker been engaged as an employee. An enterprise engaging independent contractors is wise to exercise diligence over these arrangements—particularly when arrangements continue for a period of time—to ensure contracted workers have not unwittingly become integrated into the enterprise and become employees under common law. Engaging workers as independent contractors when they should be considered employees can deny those workers important protections and entitlements such as access to leave, minimum rates of pay and superannuation. The worker may also be denied protection from unfair dismissal laws or the benefit of ongoing job security.

Importantly, engaging contractors that are employees at common law introduces a substantial degree of risk to the operations of a business. Misclassification can lead to a contravention of the National Employment Standards, minimum wage orders, and terms of a modern award or enterprise agreement. Misclassification can also lead to contraventions of employer obligations to provide employee records and pay slips. An employer may also be exposed to back payments and superannuation payments and there may be consequent taxation implications. This can be significant and costly, particularly if the misclassification has occurred for a lengthy period before the relationship is disputed. Importantly, the employer may also be held liable for loss or damage suffered by another party as a consequence of the actions of the worker, and those liabilities can be significant. In the 2001 High Court decision of *Hollis v Vabu Pty Ltd*[6], a bicycle courier who was ostensibly an independent contractor was found to be an employee of the company with the result that the company was held vicariously liable for the injury the courier caused to a pedestrian. If done deliberately, misclassifying workers as independent contractors can expose an employer to court-imposed penalties for contraventions of the sham arrangements provisions of the Fair Work Act.

The risk of workers being considered employees increases when those workers perform tasks that involve the application of relatively unskilled labour and that persist for a period of time. While caution needs to be exercised when making general statements about the application of the common law test of employment, it is difficult to see how a cleaner performing simple work for a single principle contractor, who wears their uniform, operates their equipment and accepts little or no commercial risk, can be defined as anything other than an employee. Similarly, a process worker on a manufacturing production line who can only work while the

[6] *Hollis v Vabu Pty Ltd*[6] *[2001] HCA 44; 207 CLR 21; 75 ALJR 1356; 106 IR 80; 181 ALR 263 (9 August 2001)*

production line is operating would be difficult to categorise as operating a business of their own in a genuine entrepreneurial effort to make a profit.

Sham arrangements and the reverse onus of proof

As a regulator, the Fair Work Ombudsman is concerned about both deliberate sham arrangements and the misclassification of employees as independent contractors; however the element of intent is important. Section 357(2) of the Fair Work Act provides a defence against a contravention of s. 357(1) if the employer can prove they did not know and were not reckless as to whether the contract was one of employment rather than a contract for services[7]. This provision places the onus on the employer to disprove such a claim and is in addition to a broader reversed onus of proof provision at s. 361 of the Fair Work Act that can apply to all workplace rights contraventions.

Theoretically, it would be up to the employer to prove to the satisfaction of a Court they did not know, and were not reckless to that fact, or prove they did not undertake an action for a particular reason or with certain intent. However, putting any person to the task of defending themselves against what would be expensive and time consuming litigation without a proper exploration of the facts and circumstances of the matter would be inconsistent with the community's expectations about the use of legal proceedings.

As an Australian Government statutory agency, the Fair Work Ombudsman is bound to act as a "model litigant". Our obligations are embedded in the Fair Work Ombudsman's Litigation Policy and require the agency to satisfy two tests before commencing proceedings; firstly that there is sufficient evidence to prosecute the case and secondly that it also is in the public interest to do so. Exploring the sufficiency of evidence requires the organisation to consider if there 'are any lines of defence which are plainly open to' the alleged wrongdoer[8]. As the defence contained in s. 357(2) of the Fair Work Act is plainly open, the agency's own policy quite appropriately requires the exploration of this potential defence before it will consider litigation.

In a practical sense, this means a Fair Work Inspector examining one of these matters will consider whether the employer knew the contract was a contract of employment rather than a contract for services or whether there was a degree of recklessness in structuring the enterprise's operations in this way. Where the Fair Work Inspector assesses that the employer did not know and was not reckless—in other words where the defence appears available—pursuing a contravention of the sham arrangements provisions of the Fair Work Act is not appropriate.

The appropriate course of action to deal with the unintentional misclassification of employees is then clearly quite different from deliberate efforts to deny employees their entitlements. In the former, education and advice and the recovery of entitlements might be reasonable responses, at least in the first instance, and litigation for the imposition of penalties and other remedies appropriate in the latter.

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[7] An almost identical defence existed in the *Workplace Relations Act 1996* and was tested in the case of *CFMEU v Nubrick Pty Ltd [2009] FMCA 981*.

[8] *Litigation Policy of the Fair Work Ombudsman* - available at http://www.fairwork.gov.au/about-us/legal/guidance-notes/pages/default.aspx

The Common Law Test of Employment

It is well established that the common law relies on a multi-factor or multi-indicia test to determine whether a contract for services or a contract of service exists[9]. In practice this involves asking a series of questions about different aspects of the relationship between an enterprise and a worker who has been contracted to supply their labour[10] and making an assessment of the overall nature of the relationship. The practicality of balancing the various indicia has been described as follows:

> *'There is no set number or combination of factors that will determine whether a worker is an employee or a contractor. What a court or tribunal will do is to consider each of the relevant factors and whether they point to an employment relationship or a contract for services. The question is one of overall impression. The adjudicator must balance the indicators that point one way or the other. Because of this, it can sometimes be very hard to be sure how a particular relationship will be categorised.'*[11]

Since there is no single indicator of an employment relationship over one of genuine independent contracting, the various indicia of the employment relationship must be considered in totality in order to determine whether the relationship appears overall to be one of employment or one of contracting. In any proceedings, the courts will look to the real substance of the relationship in question. This may happen even where the employer has gone to some trouble to draft formal terms that present the relationship as one of principal and contractor and that are signed by the worker to acknowledge as much[12]. The relationship is to be determined not simply from the contractual terms agreed to, but also the work practices that are occurring in a specific relationship which go to establishing the totality of the relationship[13].

The various indicators that have been identified through case law are:

- Does the hirer have the right to exercise detailed control over the way work is performed, so far as there is scope for such control?
- Is the worker 'integrated' into the hirer's organisation?
- Is the worker required to wear a uniform or display material that associates them with the hirer's business?
- Must the worker supply and maintain any tools or equipment (especially if expensive)?
- Is the worker paid according to task completion, rather than receiving wages based on time worked?
- Does the worker bear any risk of loss, or conversely have any chance of making a profit from the job?
- Is the worker free to work for others at the same time?
- Can the worker subcontract the work or delegate performance to others?

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[9] *Stevens v Brodribb Sawmilling Co Pty Ltd* (1986) 160 CLR 16; *Hollis v Vabu* (2001) 207 CLR 21
[10] Andrew Stewart *Stewart's Guide to Employment Law Third Edition* The Federation Press, p.47
[11] *Ibid*, p.48
[12] *Whitehead v WorkCover/Employers Mutual Ltd* (2007) 168 IR 443
[13] *Hollis* at [24]

- Is taxation deducted by the hirer from the worker's pay?
- Is the worker responsible for insuring against work-related injury they might suffer?
- Does the worker receive paid holidays or sick leave?
- Does the contract of hiring describe the worker as a contractor?

The categories of relevant factors are not closed. The indicia are tested by a necessarily subjective assessment of behaviours and statements rather than a simple assessment of evidence such as time sheets, forms of payment, insurances, leave entitlements or other documentary evidence. At the heart of the question one might ask 'can it really be said that this person is in a business of their own?' A decision maker assessing the relationship must reach a decision by subjectively considering the answers of a variety of different questions. From a regulatory perspective, this presents challenges in ensuring as far possible that assessment outcomes are consistently repeatable based on the same facts and circumstances. To overcome some of these challenges, a standardised set of questions were developed and tested with external stakeholders, and all Fair Work Inspectors participating in the project were given refresher training prior to the audit activity commencing.

The range of issues and factors that need to be considered when making an assessment of the employment status requires each case to be assessed individually on its facts. As Bromberg J in *On Call Interpreters and Translators Agency Pty Ltd v Commissioner of Taxation* described:

> *'...the absence of a simple and clear definition which explains the distinction between an employee and an independent contractor is problematic....[I]n the circumstances of the bicycle couriers dealt with in Hollis, the parties involved needed to travel to the High Court to obtain a clear exposition of the legal status of the couriers.'*[14]

Regulatory responses to the misclassification of workers and sham arrangements

The Fair Work Ombudsman has responded to a range of matters across the spectrum from the misclassification of workers to deliberate sham arrangements including the dismissal of employees for the purpose of reengaging them as independent contractors. In taking action, the Fair Work Ombudsman considers its obligations to be a model litigant including whether there is public interest in commencing proceedings and the general deterrence value that may be derived from doing so. In all these cases, the defence available under the relevant statutes was considered before any proceedings were commenced.

In *Rajagpolan v BM Sydney Building Materials Pty Ltd [2007] FMCA 1412*, an eighteen year old male worker was treated as an independent contractor and denied shift allowances, personal leave, superannuation payments and other entitlements,

[14] *On Call Interpreters and Translators Agency Pty Ltd v Commissioner of Taxation (No 3) [2011] FCA 366 (13 April 2011) at [206].*

but was assessed as being a casual employee. The court ordered penalties totalling $16,500 against the employer for a number of breaches of the relevant award.

In *Fair Work Ombudsman v Land Choice Pty Ltd and Anor [2009] FMCA 1255*, the court found the respondent was reckless as to whether a contract was really a contract of employment rather than a contract for services. The company and its director were fined $29,440 for contraventions of the sham arrangements provisions of the *Workplace Relations Act 1996*, as well as record keeping requirements and other associated contraventions of the applicable award provisions including pay rates and leave entitlements. The court also ordered $15,119 in back payments to the affected employee.

On 24 December 2009, the Fair Work Ombudsman commenced legal action against Maclean Bay Pty Ltd, operators of the Diamond Island Resort at Bicheno on Tasmania's east coast, alleging that from October 2008 to April 2009, twelve of the resorts employees were converted into independent contractors and continued to perform the same duties. The liability hearing ran from 25 to 28 July 2011 in the Federal Court of Australia and the decision remains reserved at the time this report was prepared.

In Fair Work Ombudsman vs Contracting Plus Pty Ltd & Anor [2011] FMCA 191 (10 March 2011), the Federal Magistrates Court in Brisbane ordered penalties of $178,750 against the company and $35,750 against its director after the Fair Work Ombudsman filed proceedings where it alleged 116 call centre employees were underpaid almost $46,000 and incorrectly treated as independent contractors. The court awarded penalties for contraventions of the sham arrangement provisions as well as the resulting underpayments.

On 27 June 2011, the Fair Work Ombudsman filed proceedings in the Federal Magistrate's Court in Sydney against company director John Mineeff. The Fair Work Ombudsman will allege Villtruck Pty Ltd owner-operator Mr Mineeff converted an employee of the second-hand truck business into an independent contractor performing the same duties. The company went into liquidation in 2010 so proceedings were confined to the company director.

In 2011, the Fair Work Ombudsman entered into an enforceable undertaking with Sydney-based photographic business Signature Portrait Studios after the company and its director admitted it had dismissed an employee for the purpose of re-engaging her as an independent contractor and misrepresented the employment as an independent contracting arrangement. The company, a small business, also admitted consequential contraventions of applicable industrial instruments governing employee's pay and other conditions. The company undertook to pay $4,200 in wages, make a payment to a community legal centre and issue an apology to the affected employees.

In 2011, the Federal Magistrates Court fined two company executives after a Fair Work Ombudsman investigation found they had dismissed nine sales employees and re-engaged them as independent contractors on commission-only payments. The case, *Fair Work Ombudsman v Centennial Financial Services & Ors [2011] FMCA 459 and [2010] FMCA 863*, saw the executives ordered to pay $16,950 in fines to the workers after the company went into liquidation in 2009.

Also in 2011, the Fair Work Ombudsman launched a prosecution against New South Wales homewares company Metro Northern Enterprises Pty Ltd. In this case, which is yet to be heard, the Fair Work Ombudsman will allege four sales promotion

workers were paid as independent contractors on a commission-only basis but should have been classified as employees, contravening sham arrangement provisions as well as conditions of the relevant industrial instrument.

In a major case involving call centre workers, in 2011 the Fair Work Ombudsman launched a prosecution against two companies for alleged sham arrangements. Facing court are Telco Services Australia Pty Ltd and Trimatic Contract Services Pty Ltd over the alleged misclassification of almost 10,000 workers as independent contractors.

Lastly, the Fair Work Ombudsman launched a 2011 prosecution against Perth serviced apartment provider Quest South Perth Holdings Pty Ltd alleging three employees were dismissed and re-engaged as independent contractors to perform the same duties. Also facing court in this matter is Contracting Solutions Pty Ltd which it is alleged provided advice and was involved in the conversion of the employees to contractors.

Extended liability to persons involved in contraventions

The Fair Work Ombudsman is also concerned that parties may be complicit in avoiding workplace relations responsibilities by knowingly entering into commercial arrangements with lowest-cost providers resulting in the procurement of workers on below-award rates of pay. This is so even if those workers operate under an ABN. Turning a corporately sanctioned 'blind eye' to outsourced work that is performed by another enterprise using contractors on below-award rates of pay may expose enterprises up the procurement chain to liability through the broad provisions of s. 550 of the Fair Work Act. This is particularly relevant when those workers are assessed as being employees.

The Fair Work Ombudsman will increasingly examine decisions made in the procurement chain for evidence this has occurred. All parties should undertake due diligence when outsourcing work to contracted workers, particularly to lowest-cost providers, to ensure lower costs are attributable to efficiencies in the business and not due to the potential exploitation of workers on below-award rates.

The Sham Contracting Operational Intervention

Despite initiating proceedings against several enterprises for contraventions of sham arrangements provisions of workplace law, the Fair Work Ombudsman has continued to receive complaints that independent contractors should more properly be considered employees, or that employees have been terminated only to be re-engaged as independent contractors in the same role. Audit activities undertaken by the Fair Work Ombudsman have previously highlighted risk factors for the potential underpayment and misclassification of workers in the cleaning services industry. While certain cleaning tasks involve the application of specialist skills, for example cleaning the exterior windows of high-rise buildings using rope access, the majority of cleaning work does not require specialist technical skills and experience has shown these workers receive pay rates that are at or close to the statutory minimums.

Similarly, while call centre workers may well be genuine contractors involved in supporting specialist products for which they have unique expertise, many call centre environments involve workers engaged in rigidly organised shift work and strictly

enforced break periods, and are required to stick to tightly scripted conversations. It is difficult to see how workers in these circumstances exercise control over their own work and be considered as running their own businesses in an effort to make a profit.

Finally, the Fair Work Ombudsman has received complaints regarding ‘rent-a-chair’ contracting arrangements in hair dressing salons and received concerns about the legitimacy of contracted massage therapists in day spas. While these occupations may require specific training or even formal qualifications, the degree of control over the working arrangements can result in these workers being assessed as employees.

Prior to commencing the audit activity, stakeholders, including both employer and employee associations, were consulted and their views sought on the prevalence of sham or mistaken contracting in their respective industries. There was agreement that the practice was likely to exist to varying degrees in each of the industries nominated. For these reasons, the cleaning services, call centre and hair and beauty industries were selected for audit, although our experience suggests that misclassified arrangements can exist in any industry and are not confined to these industries alone.

Part 2 – Results of the audits

It is important to note that the audit activity was not constructed in order to provide a statistically valid study into the prevalence of sham arrangements or the misclassification of workers. Rather, the audit activity was conducted using a partially targeted sample of enterprises. Since the sample set was not chosen entirely randomly—that is, enterprises were selected from a combination of referral information, where contraventions were previously suspected, some random selections, and by selecting enterprises that had recently advertised for ABN workers—care must be exercised when drawing conclusions from the data provided. The sample set was deliberately biased towards enterprises that did engage independent contractors, so drawing conclusions from this data about the prevalence of independent contracting more generally would not be valid.

The audit activity found a range of outcomes across the spectrum of working relationship; from genuine independent contracting relationships to potential contraventions of the sham arrangement provisions of the Fair Work Act. In the majority of instances where enterprises engaged independent contractors they were assessed as being genuine contracting relationships. However, the misclassification of employees as independent contractors was found in some of the cases, and less commonly, in circumstances where contraventions of the sham arrangements provisions of the Fair Work Act may have occurred.

Summary of Outcomes

In summary, of the 102 enterprises audited, 11 had employee-only workforces or did not engage contractors. Of the remaining 91 enterprises that were trading and did engage contractors, 21 (23%) were assessed as having misclassified employees as independent contractors and one third of those were assessed as either knowingly or recklessly having done so and are therefore suspected of having contravened the sham arrangement provisions of the Fair Work Act. Four of those matters occurred in the cleaning services industry, one in the call centre group, and two in the letter of caution follow-up group. Those matters are currently being considered for litigation. It is worth noting that these enterprises engage varying numbers of workers, from 2 to 45.

Of the remaining 14 matters where misclassification occurred many have or will shortly be resolved by way of either an educative response or a formal Letter of Caution. Each matter involves an assessment of the nature, circumstances and overall facts of the misclassification, as well as an assessment of whether the workers were paid less than the statutory minimum that would apply to an employee performing the same role. Enterprises receiving either educative correspondence or a formal Letter of Caution may be included in future audits to determine whether engagement practices have been altered. In some instances, enterprises have voluntarily rectified the calculated underpayments and have taken steps to formally engage the workers as employees.

To the extent that the audit targeted industries we knew had a prevalence of contractors, and some businesses we thought from experience a problem may exist, the result demonstrates the misclassification of employees as independent contractors is reasonably common. Twenty-one enterprises engaged independent contractors who we assess should more properly be considered as employees under the common law employment test. We believe seven of those twenty-one did so

knowingly or recklessly or in other circumstances that would contravene the sham arrangement provisions of the Fair Work Act. Table 1 below provides the initial outcomes of the audits into the enterprises on the target list.

Audit Outcomes	*No.*	*% of total*
No evidence of misclassification or sham arrangements	62	60.8%
Misclassification of workers as independent contractors	21	20.6%
(where sham arrangements also suspected)	*(7)*	*(6.9%)*
No contractors engaged	11	10.8%
Ongoing investigation	8	7.8%
Totals	102	100.0%

Table 1 – Audit outcomes as at 28 October 2011

Target Group	*No. Audited*	*No. Misclassifying*	*% of Total Misclassifying*	*% of Group Misclassifying*
Cleaning services	65	14	13.7%	21.5%
Hair and beauty	16	2	2.0%	12.5%
Call centre	14	3	2.9%	21.4%
Letter of Caution	7	2	2.0%	28.6%
	102	21	19.1%	

Table 2 – Misclassification of workers by target group in enterprises that engaged contractors as at 28 October 2011

Eight matters are still under investigation at the time of preparing this report. Some of those matters involve a detailed analysis of a large number of workers. Those matters were selected for further investigation because of concerns over the manner in which contractors were engaged or because on initial assessment it was inconclusive as to whether the contractors should be considered employees. It is likely that at least some of these matters will result in an assessment that contractors are actually employees.

Observations of the cleaning services industry

Workers in the cleaning services industry rarely require technical training or formal qualifications to undertake work. There are some exceptions in niche aspects of the industry, such as exterior window cleaning that uses specialist access techniques, but on the whole the majority of general cleaning duties can be performed without the need for specialist equipment.

This makes cleaning services readily accessible by non-skilled labour and the audit activity identified a higher proportion of more vulnerable workers[15] in this industry. The low barriers of entry into the cleaning industry create an environment with high levels of competition often with little obvious differentiation between providers. This

[15] The FWO Litigation Policy describes a 'vulnerable worker' as including (but not limited to): *young people, trainees, apprentices, people with a physical or mental disability or literacy difficulties, recent immigrants and people from non-English speaking backgrounds, the long-term unemployed and those re-entering the workforce, outworkers, people with carer responsibilities, indigenous Australians, employees in precarious employment (e.g. casual employees) and people residing in regions with limited employment opportunities and/or with financial and social restraints on their ability to relocate to places where there might be greater job opportunities*

environment is likely to favour the lowest cost provider. With the ability to access a large and potentially vulnerable labour pool; a need to keep costs low to remain competitive; and labour typically representing the most significant cost to the enterprise, the environment is one that presents a higher risk of non-compliance with workplace laws and obligations.

Case study – misclassified workers receive back payments.

A small Queensland-based cleaning company engages both employees and independent contractors. The director of the company was interviewed and satisfied investigating Fair Work Inspectors that he had taken reasonable steps to assure himself that the arrangements in which he engaged the contractors was genuine. However, an assessment of the independent contracting relationships determined that these workers should be considered employees.

Under the circumstances, it is unlikely that a contravention of the sham arrangements provisions of the Fair Work Act could be made out since the director would be likely to invoke the sham arrangements defence provision in s. 357(2). The director is now working with the Fair Work Ombudsman to rectify any underpayments, and at the time of report preparation has voluntarily repaid almost $12,000 to two employees and is undertaking calculations for the remaining eight workers. The employer has received a Letter of Caution.

The cleaning industry also showed a prevalence of multi-tier contracting. This is the situation where enterprise A subcontracts enterprise B to undertake the cleaning work. In some instances enterprise B will then subcontract enterprise C to do the same, and so on. Around fifteen enterprises audited were second or third tier contractors of which the majority were in the cleaning industry. With each tier presumably taking a proportion of the contract value, the amount of money flowing to the actual workers reduces with each subcontracting arrangement - exacerbating the potential for workers to receive less than the statutory minimum payable to employees.

Additionally, the audit found a practice in the cleaning industry where subcontracted arrangements were with other incorporated enterprises, and these were often companies with sole directors who perform the actual work. On the face of it, these arrangements are ostensibly between two companies in a commercial agreement yet an assessment of at least some of these working relationships showed an employment arrangement.

Case study – does contracting only with other companies avoid possible sham arrangements?

A large cleaning company engaging in excess of 150 companies was audited. During the audit it was found the company almost exclusively engages other cleaning companies to perform its cleaning work.

A sample of 13 of the contracted companies was audited. The companies typically consisted of a director who was also the sole worker for the company. An analysis of the working relationship indicates employment yet ostensibly the working arrangements are contractual in nature and between two companies. The matter remains under investigation.

Where the misclassification of workers occurred, company directors often advised they had structured their companies based on other enterprises they had previously worked for. In several instances, these were former cleaners who decided to start their own cleaning businesses and simply replicated business models they were familiar with.

Case study – a contracted cleaner who has 'morphed' into an employee

A small company is a cleaning provider with a sole director. The company has several contracts including one to clean the branches of a bank. The director chose to engage contractors to provide this service to the bank. Over a period of time the company secured additional cleaning contracts for more branches of the bank and the volume of work increased.

John used to work for a cleaning company as an employee but wanted to try working for himself. He got an ABN and became aware the small company was looking for cleaners. He started contracting for the company. Initially, John sub-contracted only a few hours a week for the company and also performed work for a range of other clients. The director was very happy with the work that John did and over time gave him more work. The work increased to the point where John now works about 40 hours per week exclusively for the company.*

John and the company director agree to the hours required at each site and John is paid an hourly rate. John is happy with the arrangement and believes the benefits of being in business for himself make the arrangements worthwhile. John is happy that he now gets all his work from the company as he no longer needs to go out looking for additional clients.

However, an assessment showed that John is likely to now be considered an employee of the company. At some point in the past the arrangement changed from being one of genuine independent contracting to one of employment, although neither party intended that to happen and it would be difficult to pinpoint precisely when that occurred.

The company is now at risk of being held liable for the actions of John, and could be found responsible for providing the minimum entitlements and conditions that are attached to employment.

The company has been given an educative letter and encouraged to seek advice regarding the arrangements.

**Names have been changed to protect confidentiality.*

Observations of the hair and beauty industry

In 2008, the hairdressing and beauty industry in Australia was responsible for engaging more than 84,000 workers in small to medium enterprises[16]. The industry includes specialist roles such as hair stylists, beauticians, massage therapists, nail technicians and day spa services. Entry into the industry typically requires a combination of both technical and service skills and encompasses a wide variety of formal tertiary qualifications, such as Certificates and Diplomas, as well as practical experience and specific on-the-job training.

[16] Service Skills Australia *Hairdressing & beauty: Environmental scan 2009*, Service Skills Australia, Sydney

The two enterprises identified as misclassifying employees as independent contractors in this industry engaged less than 10 workers and occurred in the hairdressing and day spa subcategories.

Case study – misclassification in the hairdressing industry

A hairdressing company engaged two independent contractors along with several employees. The independent contractors performed the same work as the employees, with defined working hours and expectations. The company stated that it had received advice regarding the engagement of contractors and believed it had done so properly. However an assessment of the working relationships indicates the contracted workers should be considered employees.

An analysis of all amounts paid to the contractors showed they were paid above the minimum award rates and no underpayments were apparent.

The hairdressing company received a Letter of Caution in relation to the arrangements and has been encouraged to seek advice.

Observations of the call centre industry

Over the last ten years there have been substantial advances in information and communication technologies that have enabled the call centre industry to become one of the fastest growing industries of many developed and developing economies[17]. The call centre industry is often subject to high staff turnover[18] with labour representing the most significant proportion of operating costs[19]. There are often no specific technical qualifications required to work in the industry.

The entities audited performed services that included outgoing sales calls, door-to-door sales; fundraising efforts; market research functions and call centre technical support to customers. Of the three enterprises believed to have misclassified employees as independent contractors, two related to workers that performed door-to-door sales and one related to call centre operations.

[17] Access Economics *'Nearshoring: Examining true value in customer contact networks'* March 2010
[18] Estimates range from 24% for full time staff to 49% of all staff as the Australian average in Wallace. C. Et al *Australian contact centre industry benchmarking report 2008*
[19] *Ibid*. 61% of the total budget is spent on wages.

Case study – a genuine contractor in a call centre operation.

A company runs a business providing internet access, computer hardware and maintenance support to consumers, and includes a call centre that provides customer support.

A contractor has been engaged to develop and implement a software solution that will improve the way the company undertakes its business. The contractor is a worker who is in business for himself.

The contractor has been engaged to provide a new software solution for the call centre operations. The contractor will be paid a fixed price for the final product. The amount of profit the contractor's company makes is dependent on how efficiently he can develop and implement the solution for the IT company.

Although the contractor may spend a good deal of time in the IT company he was assessed as being a genuinely independent contractor.

Case study – misclassification in the call centre industry

A company involved in marketing including call centre consultants was audited and found to have a number of independent contractors. An assessment of the independent contractors indicated they were in a genuine contracting relationship. However, one contractor was engaged in a managerial position that was assessed as being employment. The company had sought and apparently relied upon advice from an accountancy firm in structuring its operations.

The contractor subsequently left the company of his own volition. The company received a Letter of Caution in relation to the arrangement.

Regulatory and enforcement outcomes resulting from the audit

Sham arrangements

At the time of preparation of this report, seven matters were identified that involved potential contraventions of the sham arrangements provisions of the Fair Work Act. These matters have been subject to a full investigation, including the collection of evidence and where applicable the conduct of formal records of interview with a view to assessing their suitability for litigation and application for court-awarded penalties.

Two of these matters arose from the Letter of Caution follow up group of enterprises. These two enterprises had previously been cautioned and advised to alter their contractor engagement practices after an assessment showed they should be considered employees. The audit activity revealed that they continued to engage independent contractors in a manner where they should be considered employees. In these circumstances, the previous Letter of Caution is likely to negate the statutory defence if the arrangements are found to persist after a reasonable period of time.

The use of a Letter of Caution is valuable in other respects too. One of the Letter of Caution follow-up group was re-audited and found to have engaged all of its previously contracted workers as employees, thereby ensuring an alignment of the rights and entitlements of its workforce with the common law assessment of their status.

Misclassification of employees as independent contractors

At the time of preparing this report, fourteen enterprises were assessed as having misclassified workers as independent contractors. Each matter assessed as involving the misclassification of employees as independent contractors has also been subject to a full investigation to determine the facts and other circumstances that led to the relationship being one of employment.

There are a range of outcomes applicable to those enterprises that include the receipt of educative advice that the arrangements are likely to be more like employment than contracting and to urge the enterprise to seek advice; the enterprise may receive a formal Letter of Caution that their engagement practices constitute employment and be advised to take measures to remedy the relationship; the enterprise may be asked to voluntarily comply with rectifying identified underpayments; the enterprise could be issued a statutory compliance notice requiring it to remedy any consequent provisions of relevant industrial instruments or the National Employment Standards (NES); or litigation for penalties for contraventions of the NES, modern awards and other employee obligations is also possible. Any such proceedings would be subject to the normal considerations of public interest and in accordance with the litigation policy of the Fair Work Ombudsman.

More generally, it is apparent that the misclassification of employees as independent contractors is fairly common, at least among those enterprises selected for audit and that engaged contractors. The prevalence of the issue suggests a broader educative response is required to better inform business of the nature of employment and to encourage the active monitoring of contracting relationships.

As of 28 October 2011, of the 14 misclassification matters identified, 8 have been or are likely to be resolved by way of an educative response, 4 enterprises by formal Letter of Caution, and 2 matters are being assessed for the appropriate outcome.

Misclassification of employees as independent contractors - why did parties get it wrong?

The majority of the enterprises identified that had misclassified workers as independent contractors were in the cleaning industry and this also represented the largest group audited. Many of these enterprises were small businesses.

These small businesses typically lack any dedicated human resource management function, and, when structuring their operations, principals in the enterprise were often found to have replicated business models they had seen or experienced elsewhere. This included cleaners who had previously contracted to a cleaning company and having decided to start their own business, simply replicated the engagement practices they were familiar with. Some principals of these enterprises described the arrangements as the ‘industry norm’. The audit activity highlighted the

need to better focus educative materials to reach small and medium enterprises on the true nature of employment and the risks of misclassifying workers.

In several instances principals of the enterprises had received advice from accountants in how to structure their operations. Since workplace law is quite different to taxation law and financial accounting practices, it appears the legality or appropriateness of the arrangements under relevant workplace laws was often not considered. The audit highlighted the important role accountancy firms play in providing advice to businesses and the role they can play in highlighting business risk in certain contracting relationships.

In other instances, the relationship between the independent and principal contractor commenced as a genuine contracting relationship but the relationship changed through the passage of time. The ‘morphing’ of a relationship from being one of genuine independent contracting to an employment relationship can occur when a contractor becomes more integrated into an enterprise and ceases working for others. Although it can be difficult to determine at precisely what point in time a contractor becomes more like an employee, the audit activity highlighted the need for businesses to exercise diligence over the management of contracting relationships, particularly when those relationships continue for a period of time. Allowing a contracting relationship to develop into one of employment adds significant elements of risk to a business and denies the worker the entitlements and protections they ought to enjoy.

Part 3 – Conclusion and Recommendations

The audit activities revealed the misclassification of employees as independent contractors in each of the targeted industries. The audit activity has demonstrated that greater awareness among businesses of the circumstances that can lead an independent contractor being assessed as an employee would be beneficial.

Businesses that engage contractors, particular for lengthy periods of time, should periodically review the nature of the relationship to assess whether the arrangements have become more like employment. Apart from denying the worker the benefits attached to employment, the business is potentially exposed to risk arising from workplace law, taxation law, superannuation law and worker's compensation law if the worker should be considered an employee.

Given a heightened risk of these arrangements existing in the cleaning services industry, it should remain the focus of ongoing regulatory compliance activities including if necessary by further audit campaigns.

Any employee who is terminated to be re-engaged as an independent contractor should immediately seek advice and assistance by calling the Fair Work Infoline on 13 13 94.

Appendix A – Sham Contracting Operational Intervention Methodology

Stakeholder engagement

During the planning phase of the project, external stakeholder engagement was undertaken to assist in shaping the project methodology and selecting both industries and enterprises for audit.

External stakeholder engagement involved conversations regarding the perceived nature and extent of sham contracting with the following organisations:

- Australian Contract Cleaners Association
- Australian Council of Trade Unions
- Australian Services Union
- Building Services Contractors Association of Australia
- Hair and Beauty Association
- Independent Contractors Association
- Shop Distributors and Allied Association
- United Voice

The discussions with the various stakeholders revealed certain commonalities:

- All the stakeholders consulted suspected that sham contracting was occurring to varying degrees in the industries over which they have coverage;

- Industry associations generally offered that any engagement in this practice by enterprises disadvantaged the majority of employers that were doing the right thing;

- Unions were concerned that workers in these arrangements were being denied the benefits and protections of employment;

- There was a general feeling there was insufficient information available to inform workers and employers of what sham contracting actually is;

- All were willing to participate in any education and compliance activities undertaken by FWO.

There was also a wide variety of anecdotal evidence provided of the types of 'sham contracting' practices that were believed to be occurring in the industries. However, aside from one employee association, no specific enterprises were nominated as engaging in the practice.

The external stakeholder group was later consulted on industry specific campaign material that was developed to assist in informing workers and enterprises of the nature of sham contracting.

Identifying the Target Employer List

The list of enterprises selected for audit was compiled using several different sources of information, including previous investigations, referrals from the Fair Work Ombudsman's National Cleaning Services Campaign, searches of employment websites advertising for ABN holders to perform work, and matters where Letters of Caution had been issued. It must be noted that the final target list was comprised of a mixture of targeted and random selection methodologies and this impacts any inferences that can be drawn from the overall results.

Preparation of sham arrangements education and advice material

One significant point raised during the external stakeholder engagement meetings was that there was insufficient information available to industry participants to adequately explain what sham arrangements are. As a direct result of this feedback, the Fair Work Ombudsman developed one generic and three industry-specific brochures containing general information on sham arrangement contraventions, as well as case examples demonstrating practical differences between employees and contractors in typical roles for each of the three industries.

The scenario-based examples developed for inclusion in the brochures were added to the independent contractor resources on the Fair Work Ombudsman Internet site to supplement the material already available. Work has also commenced on an interactive online employment assessment tool to assist workers or hirers in assessing working arrangements.

Attendance at industry and vocational events

Fair Work Inspectors attended six industry or vocational events where they provided real-time advice to participants and distributed the sham arrangement brochures. The events attended were:

- The Big Meet – Western Australia
- The National Careers and Employment Exposition – NSW
- The National Careers and Employment Exposition – Queensland
- The National Careers and Employment Exposition – South Australia
- The National Careers and Employment Exposition – Victoria
- CleanScene - Victoria

Media release

A media release was issued announcing the commencement of the project. A similar release was prepared and forwarded to external stakeholders for their use, and detailed the FWO resources available for industry participants with electronic links to it. The external stakeholders were invited to distribute this information amongst their membership.

Undertaking the compliance activities

The audit activities formed the core operational work of the project. Audits began with an initial letter advising enterprises that audits were being undertaken. This was accompanied with a request for records to identify whether independent contractors were actually engaged. A high level of engagement and cooperation by the enterprises targeted was evident, with the vast majority providing documents voluntarily and promptly. Once received, the records were analysed and assessed to ensure the enterprise engaged contractors.

Representatives of the enterprise were then interviewed about their understanding of the nature of the relationship with the worker, and were also asked about the factual circumstances that surrounded their engagement of the worker. Responses were recorded using an assessment tool. This was typically done by attendance at the principal place of business.

Where contracting arrangements were occurring, Fair Work Inspectors arranged to attend sites where the work was undertaken. Particularly in relation to the cleaning industry, this also involved attending premises that were being cleaned late at night or in the early hours of the morning. Depending on the number of contractors engaged by the enterprise, either all of the contractors or a sample of them was questioned in relation to their understanding of the nature of the relationship with the enterprise as well as the factual circumstances surrounding their engagement.

In some instances Fair Work Inspectors experienced difficulties when seeking to engage with workers. There was often a greater reluctance to participate in the audit by workers who contracted to a single hirer. This was attributed to a fear that any involvement in the audit could jeopardise the future relationship with the hirer and therefore their sole source of income. Some workers expressed a view they were happy and content in their contracting arrangements and were unwilling to participate in the audit. Some of these workers stated that the various advantages they enjoyed as a result of their contractor status provided a reason to protect it. Since there is no compulsion for people to participate in an interview or answer questions under the Fair Work Act, the assessment could only be made on the information and documentation available at the time.

Ultimately the determination that a worker is in fact an employee rather than an independent contractor is based on the subjective application of the tests of employment. During the audit activity Fair Work Inspectors assessed nearly 450 working relationships against the common law employment test and arrived at the results detailed in this report.