MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HĪKINA WHAKATUTUKI

BRIEFING

FPAs – Advice on intentional avoidance of FPA coverage through contracting

Date:	5 February 2021	**Priority:**	Medium
Security classification:	In Confidence	**Tracking number:**	2021-2154

Action sought		
	Action sought	**Deadline**
Hon Michael Wood **Minister for Workplace Relations & Safety**	**Agree** to include in the FPA system an ability to penalise employers who misclassify an employment relationship as a contractor arrangement to avoid FPA coverage.	12 February 2021

Contact for telephone discussion (if required)				
Name	**Position**	**Telephone**		**1st contact**
Tracy Mears	Manager, Employment Relations Policy	04 901 8438		✓
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The following departments/agencies have been consulted

Minister's office to complete:

- ☐ Approved
- ☐ Noted
- ☐ Seen
- ☐ See Minister's Notes
- ☐ Declined
- ☐ Needs change
- ☐ Overtaken by Events
- ☐ Withdrawn

Comments

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Date:	5 February 2021	**Priority:**	Medium
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Purpose

This briefing provides advice on the viability of a provision that penalises an employer (or engager) where they substantially change their workforce from employees to contractors with the intent of undermining the Fair Pay Agreement (FPA). We recommend an alternative option to achieve the policy objectives.

Executive summary

You have asked us to consider the viability of a provision that penalises an employer (or engager) where they substantially change their workforce from employees to contractors with the intent of undermining the Fair Pay Agreement (FPA).

We consider there are two policy objectives for this advice:

- to ensure employers are deterred from changing workers onto contracting arrangements that do not reflect the real nature of the working relationship in order to avoid coverage of an FPA; and
- to ensure that where the real nature of the work is employment, that workers receive the benefit of the FPA that has been bargained for their industry or occupation.

Introducing a provision that penalises an employer for substantially changing their workforce from an employment relationship to a contracting arrangement involves a number of risks, limitations and complexities in designing a provision including:

- it does not achieve the outcome of changing those workers' status to bring them into coverage of the FPA;
- it could impinge on freedom to contract where the employer had genuine reasons to change to a contracting model, yet it could still attract a penalty;
- depending on the extent of the penalty, there are risks that a penalty could create rigidity in the market, lead to more substantial business changes or just be seen as the cost of doing business and not be effectual at all;
- there are complexities in the existing jurisprudence around 'intention' and 'undermine' that would need to be worked through.

As such, we propose and recommend an alternative option that introduces a penalty on employers for misclassifying employees as contractors in order to avoid the FPA system.

We consider this option better achieves the policy objectives because it will provide a deterrent for employers who may be considering contracting as a way to avoid the terms and conditions of the FPA and ensure, where it is determined that the worker is an employee, that they fall within the bounds of coverage of the FPA.

Recommended action

The Ministry of Business, Innovation and Employment recommends that you:

1. **Note** you agreed that contractors should not be included in the initial design of the system in order to meet your requested timeframe to introduce the FPA legislation.

Noted

2. **Note** you asked for further advice on ensuring that the system could prevent employers from intentionally undermining the FPA system by changing their workforce from employees to contractors.

Noted

3. **Note** there are a number of risks, limitations and complexities in designing a provision that penalises an employer for changing their workforce to contractors, including:

    a. it does not achieve the policy objective of changing affected workers status to bring them into coverage of the FPA;

    b. it could impinge on freedom to contract where the employer had genuine reasons to change to a contracting model, yet it could still attract a penalty;

    c. depending on the extent of the penalty, there are risks that a penalty could create rigidity in the market, lead to more substantial business changes or just be seen as the cost of doing business and not be effectual at all;

    d. there are complexities in the existing jurisprudence around ‘intention’ and ‘undermine’ that would need to be worked through.

Noted

4. **Agree** to include in the FPA system an ability to penalise employers who misclassify an employment relationship as a contractor arrangement to avoid FPA coverage.

Agree / Disagree

Tracy Mears
Manager, Employment Relations Policy
Workplace Relations & Safety Policy, MBIE

05 / 02 / 2021

Hon Michael Wood
Minister for Workplace Relations & Safety

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Background

5. In December we provided you advice on whether the FPA system can be future-proofed so that contractors can be incorporated smoothly into the system in the future (briefing 2021-1541 refers).

6. The Fair Pay Agreements Working Group (FPAWG) report noted there was a risk that FPAs could create perverse incentives to define work outside employment regulation (regulatory arbitrage), and noted it was important for FPAs to cover all workers. However, it acknowledged that including contractors in FPA coverage would be a significant change to the employment relations model, and that the Government may wish to give effect to the recommendation through other work in your work programme.

7. As part of our advice, we considered options for quickly incorporating contractors, including:

    - A requirement that bargaining parties agree terms for contractors ahead of time.
    - A requirement that bargaining parties discuss terms for contractors ahead of time.
    - A prohibition on undermining the FPA by changing their business models to avoid its reach.

8. On balance we did not recommend any of the options due to the complexity in designing a staggered approach to incorporating contractors, instead we recommended deferring work on including contractors.

You asked for further advice on including a provision that prohibited intentionally undermining the FPA by changing their workforce from employees to contractors

9. You agreed that contractors should not be included in the initial design of the system but asked for further advice on ensuring that the system could prevent employers from intentionally undermining the FPA system by changing their workforce from employees to contractors.

10. We had previously advised that this could act as a safeguard against regulatory arbitrage while contractors are not initially included in the system, by discouraging employers from engaging contractors instead of employees where that had the effect of undermining the FPA.

11. We had also advised that there were risks of this approach, including that it could be difficult to design in a way which was clear and enforceable. We also advised that the prohibition may also have unintended consequences, and could have the effect of discouraging the use of contractors for legitimate business reasons.

12. This briefing provides further advice on the viability of this option and recommends a proposed alternative.

There was parallel work underway on developing better protections for contractors which was paused to accelerate your other priorities in the work programme

13. In early 2020, MBIE consulted on the ‘Better Protections for Contractors’ document. The consultation sought public feedback on more general approaches to deal with misclassification risks and improve the outcomes for vulnerable contractors. The consultation sought feedback on options to:

    - Deter the misclassification of employees as contractors.
    - Make it easier for workers to access a determination of their employment status.

- Change who is an employee under New Zealand law.
- Enhance protections for contractors without making them employees.

14. Some of the policy options in relation to better protections for contractors could help minimise the risk of arbitrage we have identified in relation to FPAs, either by reducing instances of misclassification or increasing the likelihood of vulnerable contractors being recognised as employees (and therefore being brought within coverage of FPAs).

15. This work has been paused until mid-2021 due to capacity constraints from the existing work programme.

We have reviewed whether it is viable to have a provision that prohibits intentionally undermining the FPA via contracting

16. We have explored how to best ensure that employers do not intentionally undermine the FPA by shifting the workforce from employment to contracting. We consider there are two policy objectives that this option is trying to achieve:

    - to ensure employers are deterred from moving workers onto contracting arrangements that do not reflect the real nature of the working relationship in order to avoid coverage of an FPA; and
    - to ensure that where the real nature of the work is employment, that workers receive the benefit of the FPA that has been bargained for their industry or occupation.

17. For the purposes of this work we have assumed that contractors will not be brought into the FPA system until the provision is in place and some FPAs are under negotiation or in force.

18. When considering the options in relations to these topics, we considered the following criteria:

    - Sufficient deterrent: employers are deterred from moving employees onto contracting arrangements in order to avoid coverage of an FPA
    - FPA applies to all employees: workers who are in employment relationships are within coverage of an applicable FPA and have the terms and conditions of the FPA apply
    - Consistency with other ERES interventions: whether the option is consistent with the current approach under the Employment Relations Act (the ER Act) or Equal Pay Act 1972 or the approach being developed for the Screen Industry Workers Bill (depending on which is more relevant for that particular aspect).

There are risks with progressing with an 'intent to undermine an FPA' provision and it will not directly result in workers coming within coverage of the FPA

19. The provision would likely involve penalising an employer (or engager) where they substantially change their workforce from employees to contractors with the *intent of undermining the FPA*. This would cover both where the nature of the work was one of contracting and where the real nature of the work was employment.

20. To attract a penalty the employer would need to either make a substantial group of workers redundant and rehire them as contractors or hire most workers on a contractor basis going forward, with the intention of avoiding coverage of the FPA. A worker (or the Labour Inspectorate) would be able to take a case that the employer intentionally used contracting arrangements in order to avoid coverage of the FPA. The employer could be penalised where the Authority or Court is satisfied that the employer's actions in using contracting arrangements amount to intentionally undermining the FPA.

21. Under this approach, while employers could face a penalty, it will not necessarily mean those contractors would then be brought within coverage of the FPA. Under existing settings, individual employees (or the Labour Inspectorate on an individual employee's behalf) would need to take a case challenging the nature of the contract to get a determination that the worker is in fact an employee. This relies on the worker wanting to challenge the existing classification. We have seen in other contexts that many contractors do not want to challenge their status.

There are risks that a penalty could create rigidity in the market, lead to more substantial business changes or just be seen as the cost of doing business

22. The strength of the incentives for employers to comply with the provision would depend on the how significant a cost the penalty might be:

    - **Setting the penalty high creates a double edged sword:** on the one hand it could create serious rigidity in the market because employers fear changing their business models in case they fall foul of the penalty (limiting even genuine contracting). On the other hand, if an employer was prepared to substantially change the nature of their business model they may be incentivised to shut down the company and liquidate (ending liability) and recommence trading under a different name and business model. It would be difficult to prevent this in practice.

    - **But setting a low-medium penalty is unlikely to be a significant deterrent:** if a business wants to 'substantially' change their business model away from employment to contracting, this is likely to involve a significant change in cost for the business. An employer who is considering this may just factor in the cost of the one-off penalty into the change process. It would be difficult to prevent this in practice.

We spoke to the Legislation Design Advisory Committee (LDAC) who raised some risks and inconsistencies that this provision may create

23. LDAC did not think this provision would adequately incentivise behaviour as it would not result in the workers bring brought into the FPA system (rather the only direct result would be that the employer could be penalised), if that was the objective of having such a penalty. There was also concern that this could impinge on genuine contracting arrangements, as any substantial shift, including where it is agreed by both parties and done for genuine reasons, may be seen as undermining the FPA and be penalised. This could impact on the common law principle of freedom of contract – that the parties are free to determine for themselves what primary obligations they will accept.

24. LDAC also raised concerns that if an employer wanted to 'undermine' the FPA through other means, for example, by reducing the workforce by automation or by reducing the workforce's hours from full time to part time, there would be no corresponding penalty.

Adapting business structures can be a legitimate response to changes in the operating environment, including through bargaining

25. As LDAC raised above, one of the possible responses to higher wages or more expensive terms and conditions could be to substantially change the structure of the workforce within the bounds of employment. This consequence was evidenced in the review of the implementation of the Care and Support Workers (Pay Equity) Settlement Act 2017. After the settlement, many workers reported having their hours of work substantially reduced or being asked to undertake more responsibilities, including those of more senior positions.

26. This response from employers is a way of adapting to manage the increased costs of operation. This is not behaviour that can be constrained without creating a level of rigidity in the market that can lead to other consequences, for example, redundancies or constraining innovation.

If you did wish to progress with this option, there are also complexities in the existing jurisprudence that we would need to work through

27. It will be critical to be clear about what is intended by an 'intention to undermine the FPA'. The 'passing on' provisions in the *ER Act* make it a breach to pass on collectively agreed terms where the employer did so with the 'intent to undermine' and where it has the 'effect of undermining the collective agreement'. The Courts read the provisions extremely strictly and would likely take a similar approach here. For example, the full Employment Court in *National Distribution Union v General Distributors*[1] said on the 'intention to undermine':

> *"If the undermining is an incidental, albeit known or foreseen consequence of an employer's act done or omission committed for some other purpose that will be insufficient to establish the necessary intention to undermine. Further, recklessness by an employer as to the consequences of an act or omission that may have the effect of undermining may not be sufficient to establish that employer's intention to undermine."*

28. It also said, in relation to undermining the collective agreement, that it is:

> *"not concerned with the undermining of the union, its ability to bargain, its ability to attract members, or future bargaining for a future collective agreement. It is concerned solely with the undermining of an extant collective agreement. In this part of the Act as opposed to others, Parliament has confined the effects of undermining to a collective agreement…*

29. The respondent on behalf of the employer, had submitted that strictly speaking, an executed collective agreement is unable to be undermined - it can be breached in some respect, but not undermined as it has, in a legal sense, been perfected. The Court appeared to have sympathy for this view stating that it "it may well be that an operative collective agreement might only be undermined by passing on in extreme cases."

30. The jurisprudence that has strictly interpreted 'intent to undermine' means it may be more challenging to design a provision that achieves your policy objectives. It will be important to be specify in the legislation the actions of employers that are intended to be captured.

We consider an alternative option may better achieve the policy objective, with fewer risks

31. We explored alternative options that could better achieve the policy objective of both penalising employers for intentionally changing employees to contractors in order to avoid FPA coverage, and bringing those workers within coverage of the FPA.

Alternatively, you could introduce a penalty on an employer who misclassifies an employment relationship as a contracting arrangement in order to avoid an FPA

32. Currently under the ER Act an individual worker, or a Labour Inspector on a worker's behalf, may challenge the status of the worker's working arrangement and get a determination about whether they are in fact an employee rather than a contractor. Where a worker has been misclassified as a contractor, the employer must change the agreement to an employment agreement and apply employment law. The employer would be held liable for unpaid employment entitlements (eg the minimum wage, holiday pay). However, there is no corresponding penalty on the employer for the misclassification itself (including where the employer did so intentionally).

[1] [2007] ERNZ 120 (EmpC)

33. There are two variants to this option:

    - you could either apply a penalty to an employer who misclassifies employees as contractors to avoid FPA coverage, or

    - you could apply a penalty more generally in all situations where misclassification has occurred.

34. In either situation, the penalty could be scaled, with small entry-level fines for employers who had acted carelessly in believing that the nature of the work was contracting, to larger fines where the employer intentionally misclassified an employment relationship as a contracting arrangement.

35. This option does not prohibit genuine contracting arrangements from being agreed and therefore is less likely to infringe on freedom of contract.

36. This option also relies on the worker, or Labour Inspectorate, taking a case. This means that the determination about classification is done on a case-by-case basis and would not result in a group of workers being reclassified as workers unless the group of workers agreed to have a case taken on the group's behalf (however, the determination is still on an individual worker basis). The work on dependant contractors explores options to make improvements that could provide better support for these groups of workers and more appropriate mechanisms to address concerns around misclassification.

37. Employers would be able to be penalised each time they misclassified a worker. This should provide a sufficient, and ongoing, incentive for employers to reflect the real nature of the working arrangement.

On balance, we recommend this approach because we consider it better meets the policy objectives

38. We recommend including in the FPA system an ability to penalise employers who misclassify an employment relationship as a contractor arrangement to avoid FPA coverage. We consider this option will provide a deterrent for employers who may be considering contracting as a way to avoid the terms and conditions of the FPA and ensure, where it is determined that the worker is an employee, that they fall within the bounds of coverage of the FPA.

39. We recommend limiting the penalty to misclassification directly linked to the FPAs. The penalty would apply once an FPA is agreed. After that point, if an employer misclassifies an employment arrangement as a contracting arrangement to avoid coverage of an FPA they would be able to be penalised. We note that a penalty directly linked to an FPA could create different outcomes for essentially the same behaviour:

    - an employer could be penalised for misclassifying employees as contractors where the occupation falls within the boundaries of an FPA

    - whereas an employer wouldn't be penalised if:

        i. the occupation falls outside FPAs (though in either situation the employer would be liable for paying wage arrears and any entitlements that the worker did not receive under their contracting arrangement), or

        ii. the misclassification of employees as contractors occurred in an occupation covered by an FPA, but before the FPA was in place.

40. Applying the penalty more broadly to the entire ERES system would be pre-empting the policy work underway for dependent contractors (as this was one of many options consulted on) and would be a significant policy change that would be out of scope of FPA legislation.

Submitters considered a similar option as part of the 'Better Protections for Contractors discussion document'

41. As part of the *Better Protections for Contractors* discussion document, an option was presented to introduce penalties for misrepresenting an employment relationship as a contracting arrangement (ie on a general basis where misclassification has occurred). Of those workers or worker-aligned organisations that provided a response, approximately 80 per cent supported introducing a penalty for misclassifying employees as contractors. Approximately 60 per cent of employers and industry groups that chose to respond to the proposal supported it. However, the majority did so on the conditional basis that only deliberate misclassification should be penalised, and that accidental misclassification, or where the worker consented to the working arrangement, should not attract a penalty.

42. Some supported greater penalties on the grounds that it would send a clear signal and reduce the financial incentive to misclassify workers. Others stated that penalties would not be an effective deterrent and are not likely to work in practice, they considered that efforts should be directed towards detecting non-compliance. Some suggested it would be difficult to determine an intentional breach by an employer as both parties would have agreed to contract in that manner.

Next steps

43. We are providing advice on the remaining aspects of the design of the FPA system required to seek Cabinet approval to draft the Bill and to inform the drafting instructions. The schedule for the project is set out in the table below:

Milestone	Date
Advice on consequential changes to other design aspects Advice on remaining advice on system issues	All provided by 19 February 2021
Cabinet paper drafted RIA prepared	12 March 2021
Agency consultation completed and incorporated RIA quality assurance completed Finalised Cabinet paper provided to Minister	26 March 2021
DEV Cabinet Committee	14 April 2021

Annex One

59B Breach of duty of good faith to pass on, in certain circumstances, in individual employment agreement terms and conditions agreed in collective bargaining or in collective agreement

(1) It is not a breach of the duty of good faith in section 4 for an employer to agree that a term or condition of employment of an employee who is not bound by a collective agreement should be the same or substantially the same as a term or condition in a collective agreement that binds the employer.

(2) However, it is a breach of the duty of good faith in section 4 for an employer to do so if—

(a) the employer does so with the intention of undermining the collective agreement; and

(b) the effect of the employer doing so is to undermine the collective agreement.

(3) It is not a breach of the duty of good faith in section 4 for an employer to agree that a term or condition of employment of an employee should be the same or substantially the same as a term or condition reached in bargaining for a collective agreement.

(4) However, it is a breach of the duty of good faith in section 4 for an employer to do so if—

(a) the employer does so with the intention of undermining the collective bargaining; or

(b) the effect of the employer doing so is to undermine the collective bargaining.

(5) It is not a breach of the duty of good faith in section 4 if anything referred to in subsection (2) or subsection (4) is done with the agreement of the union concerned.

(6) In determining whether subsection (2)(a) and (b) or subsection (4)(a) or (b) applies, the following matters must be taken into account:

(a) whether the employer bargained with the employee before they agreed on the term or condition of employment:

(b) whether the employer consulted the union in good faith before agreeing to the term or condition of employment:

(c) the number of the employer's employees bound by the collective agreement or covered by the collective bargaining compared to the number of the employer's employees not bound by the collective agreement or not covered by the collective bargaining:

(d) how long the collective agreement has been in force:

(e) *Repealed*.

(7) Subsection (6) does not limit the matters that may be taken into account for the purposes of subsection (2)(a) and (b) or subsection (4)(a) or (b).

(8) Every employer who commits a breach of the duty of good faith under this section is liable to a penalty under this Act.