

FILED
NOVEMBER 14, 2016
Court of Appeals
Division III
State of Washington

No. 34566-1-III

COURT OF APPEALS,
DIVISION III,
OF THE STATE OF WASHINGTON

SWANSON HAY COMPANY,
HATFIELD ENTERPRIZES, INC., a Washington
corporation,
SYSTEM-TWT TRANSPORT, a Washington corporation,

Appellants,

v.

STATE OF WASHINGTON EMPLOYMENT SECURITY
DEPARTMENT,

Respondent.

BRIEF OF APPELLANT
HATFIELD ENTERPRIZES, INC.

Aaron Riensche, WSBA #37202
Ogden Murphy Wallace PLLC
901 Fifth Avenue, Suite 3500
Seattle, WA 98164-2008
(206) 447-7000

Philip A. Talmadge, WSBA #6973
Thomas Fitzpatrick, WSBA #8894
Talmadge/Fitzpatrick/Tribe
2775 Harbor Avenue SW
Third Floor, Suite C
Seattle, WA 98126
(206) 574-6661

TABLE OF CONTENTS

Page

A. INTRODUCTION 1

B. ASSIGNMENT OF ERROR 2

 1. Assignment of Error 2

 2. Issues Pertaining to Assignment of Error 2

C. STATEMENT OF THE CASE 3

 1. Hatfield’s Operations 3

 2. ESD’s Rigged Audit of Hatfield 4

 3. Procedural History 6

D. ARGUMENT 9

 1. ESD’s reclassification of owner/operators is preempted by federal law. 9

 2. Owner/operators are independent contractors. 10

 3. ESD’s unlawful conduct invalidated the assessment 12

 a. ESD deliberately assessed overinflated taxes to bolster its settlement position. 13

 b. ESD’s conduct was unlawful 14

 c. ESD’s unlawful conduct renders the assessments void as a matter of law 20

E. CONCLUSION 25

TABLE OF AUTHORITIES

	<i>Page</i>
<u>Tables of Cases</u>	
<i>Arbogast v. Town of Westport</i> 18 Wn. App. 4, 567 P.2d 244 (1977).....	9, 22
<i>Ceva Freight, LLC v. Employment Dep’t</i> ___ P.3d ___, 279 Or. App. 570 (2016)	11
<i>Department of Rev., State of Wash. v. March</i> 25 Wn. App. 314, 319, 610 P.2d 946 (1979).....	15
<i>Dykstra v. Skagit County</i> 97 Wn. Ap. 670, 673, 985 P.2d 424 (1999).....	24
<i>In re Jullin</i> 23 Wn.2d 1, 158 P.2d 319 (1945).....	22, 23, 25
<i>In re Townsend</i> 54 Wn.2d 532, 533, 341 P.2d 877, 878 (1959).....	22
<i>Jerome v. Employment Sec. Dep’t</i> 69 Wn. App. 810, 816, 850 P.2d 1345 (1993).....	12
<i>Motley-Motley, Inc. v. State</i> 127 Wn. App. 62, 82, 110 P.3d 812 (2005).....	24
<i>Pullman Power Prods., Inc. v. Marshall</i> 655 F.2d 41, 44 (4 th Cir. 1981)	24
<i>Systems Amusement, Inc. v. State</i> 7 Wn. App. 516, 518, 500 P.2d 1253 (1972).....	22
<i>United States v. LaSalle Nat’l Bank</i> 437 U.S. 298 (1978).....	15
<i>Washington Trucking Ass’ns v. State</i> 192 Wn. App. 621, 369 P.3d 170 (2016).....	9, 20, 22

Statutes

49 C.F.R. § 376.11.....	4
49 U.S.C. § 14102(a).....	4
49 U.S.C. § 14501(c)(1)	9, 10
RCW 9A.80.010(1)(a)	25
RCW 9A.80.010(2).....	25
RCW 50.04.100	12
RCW 50.04.140	2, 7, 10
RCW 50.04.140(1).....	9, 11
RCW 50.04.320	12
RCW 50.12.080	14, 18, 20
RCW 50.12.130	15
RCW 50.12.130(1).....	15

A. INTRODUCTION

Appellant Hatfield Enterprizes, Inc. (“Hatfield”) appeals a decision by the Employment Security Department (“ESD”) to impose unemployment taxes on compensation paid to “owner/operators”—independent truck owners who lease their equipment to trucking companies (“carriers”). This matter comes to the Court as part of an improper, politically motivated effort by ESD to restructure Washington’s trucking industry by eliminating the industry’s historical use of owner/operators as independent contractors.

Hatfield is just one of many carriers who have challenged ESD’s owner/operator-reclassification scheme. Two other such carriers are System-TWT Transport (“System”) and Swanson Hay Company (“Swanson”). The Hatfield, System, and Swanson appeals were heard jointly by the same Superior Court judge and have now been consolidated before this Court.

Hatfield and System are represented by the same counsel and raise the same issues on appeal. As such, in the interest of brevity, Hatfield adopts and incorporates by reference the arguments raised in System’s Brief of Appellant, as well as System’s statements of general facts regarding the trucking industry. Hatfield files this separate brief primarily

to set out particular facts that are unique to this appellant. For the reasons established here and explained further in System's brief, the Court should reverse the ESD Commissioner's decision with instructions to set aside the assessment against Hatfield in its entirety.

B. ASSIGNMENT OF ERROR

1. Assignment of Error

The trial court erred in entering its Order Re: Appeal dated June 23, 2016.

2. Issues Pertaining to Assignment of Error

1. The Federal Aviation Administration Authorization Act ("FAAAA") contains an exceedingly broad preemption statute, which preempts any state action that relates even indirectly to a carrier's prices, routes, or services. ESD's reclassification of owner/operators is a direct interference with an established business model in the trucking industry, with many direct and indirect effects on prices, routes, and services. Is ESD's reclassification scheme preempted by federal law? (Assignment of Error Number 1)

2. Under RCW 50.04.140, the independent-contractor exception applies if workers are independently established businesses and work free from the carrier's control and outside its places of business. The evidence showed that: (a) owner/operators make an enormous investment in their businesses; (b) System does not control the method and detail by which owner/operators perform transportation services; and (c) owner/operators work on the open road. Did the Commissioner err in finding that owner/operators are not exempt independent contractors? (Assignment of Error Number 1)

3. The well-settled remedy for unlawful government conduct is exclusion of illegally obtained evidence. In addition, the Washington Court of Appeals recently ruled that ESD's assessments can be found invalid if they do not comply with ESD's own standards. Should the assessment be set aside because: (a) the audit was conducted unlawfully and therefore should be excluded, leaving ESD with no case against Hatfield; and (b) ESD's audit violated ESD's internal standards and was therefore invalid? (Assignment of Error Number 1)

C. STATEMENT OF THE CASE

Hatfield hereby adopts and incorporates by this reference the facts asserted in System's Brief of Appellant. In addition, Hatfield offers the following facts which are specific to Hatfield.

1. Hatfield's Operations

Hatfield is an interstate motor carrier duly licensed by the U.S. Department of Transportation and the Federal Motor Carrier Safety Administration ("FMCSA"). ARH¹ at 35. It has approximately 38 employee drivers who operate equipment owned by Hatfield, and it leases ten additional trucks from independent owner/operators. This business model provides operational flexibility. It allows Hatfield to meet fluctuating demand for its services without purchasing expensive equipment that would sit idle during periods of reduced demand. *Id.*

¹ The Administrative Record for Hatfield is cited herein as "ARH" followed by the volume number. The System record is ARS.

Hatfield engages owner/operators through a written lease agreement, as required by federal law. *See* 49 U.S.C. § 14102(a); 49 C.F.R. § 376.11 *et seq.* Although Hatfield advances some costs as a courtesy (ARH1 at 36), owner/operators are expressly responsible for all expenses incidental to the performance of the agreement, including maintenance, license fees, taxes, fuel, lubricants, cold-weather protections, all necessary tie-down gear and cargo-protection equipment, and insurance. *Id.* at 136–37, 139.

The contract gives owner/operators sole responsibility for the direction and control of their employees. *Id.* at 140. This includes hiring, firing, setting wages, performance standards, attendance requirements and working conditions, and paying and adjusting grievances. Although Hatfield cannot request that an owner/operator discontinue use of any employee, it can discuss and recommend actions against any owner/operator’s employee who has damaged Hatfield’s customer relations. *Id.*

2. ESD’s Rigged Audit of Hatfield

Hatfield was audited by ESD auditor Gary Cooper (“Cooper”). ARH1 at 121. He issued a February 2012 notice and order of assessment that imposed \$13,616.53 in taxes, penalties, and interest on Hatfield. *Id.* at

127. Before he issued his audit conclusions, however, Cooper contacted ESD's Deputy Director of Unemployment Insurance Audits and collections, Bill Ward ("Ward"), and the supervisor of ESD's Underground Economy unit, Lael Byington ("Byington"), to discuss taxation of owner/operator equipment. ARH2 at 418–19.

Both Ward and Byington were aware that compensation paid to owner/operators included remuneration for equipment rental and that ESD could legally tax only wages, not equipment. *Id.* at 396–97, 407–08. Cooper contacted them about this issue because he "wanted to be on the same page with the rest of the state" and "didn't want to be the rogue auditor." *Id.* at 418. Ward and Byington specifically instructed Cooper to tax equipment, using the full compensation amounts that Hatfield paid to each owner/operator. *Id.* at 420.

Byington's rationalization for deliberately assessing illegal taxes that exceeded ESD's statutory authority was that he knew the carriers were going to appeal anyway. *Id.* at 393.

Q. All right. And so now – so, then, *your idea is we're just going to simply issue a tax assessment with no provision for equipment and let the taxpayer sort out that amount on appeal.* Was that the position of the Department?

.....

THE WITNESS: *At that point in time,*
yes.

Id. at 394–95 (emphasis added). Byington further testified that ESD chose to use the excessive amount to bolster its settlement position on appeal. *Id.* at 398–99.

Cooper followed these instructions, even though he had actual knowledge: (1) that the amounts included compensation for equipment rental; (2) that equipment rental was not wages; and (3) that ESD lacked jurisdiction to tax any compensation other than wages. *Id.* at 421–22.

3. Procedural History

Hatfield appealed the assessment to the Office of Administrative Hearings (“OAH”). ARH1 at 2. After initially losing the files for roughly a year (ARH8, Ex. O), OAH eventually assigned the appeals of Hatfield, Swanson, and one other carrier (MacMillan-Piper, Inc.²) to Administrative Law Judge Terry Schuh (“ALJ Schuh”) for trial. *See* ARH1 at 76.

Hatfield moved for summary judgment on the ground that ESD’s reclassification of owner/operators was preempted under the FAAAA. *Id.* at 8. It also moved to dismiss the assessments because they were the product of arbitrary and capricious agency action. ARH2 at 220. ESD moved for partial summary judgment on liability, arguing that the

² MacMillan-Piper, Inc. eventually appealed to the King County Superior Court, and its appeal is now pending at Division I of this Court.

owner/operators were the carriers' employees as a matter of law. ARH1 at 83. It also moved *in limine* to exclude Hatfield's evidence relating to federal preemption and to the arbitrary and capricious manner in which ESD's audits were conducted. ARH3 at 705.

ALJ Schuh denied the carriers' motions and entered a partial summary judgment in ESD's favor, ruling that federal preemption does not apply, that ESD's conduct was not arbitrary and capricious, and that the carriers could not establish the independent-contractor exception under RCW 50.04.140. ARH1 at 76, 209; ARH2 at 672; ARH3 at 985. He also excluded most of the evidence challenged in ESD's motion *in limine*. *Id.* at 788–800.

The case went to hearing in September 2014. *See* ARH6. With liability established, the only issue was the assessment amount. ARH4 at 1139. In several prior cases, ALJ Todd Gay ("Gay") had recognized that owner/operator compensation included both equipment rental and wages. ARH8, Ex. L at 3. Because ESD has authority to tax only wages, ALJ Gay ordered ESD to issue new assessments that removed equipment payments from the owner/operators' taxable compensation. *Id.*, Ex. M.

Although ESD had stipulated in those prior cases that 70% of owner/operator compensation was for equipment and only 30% was for

wages (ARH2 at 326), ESD refused to enter into the same agreement with Hatfield. Instead, it forced Hatfield to establish this bifurcation between equipment and wages at hearing, even though ESD had no contrary evidence. *See* ARH6, 9/17/2014 trans. at 81. ALJ Schuh agreed with Hatfield. He ruled that only 30% of owner/operator remuneration was taxable wages. ARH4 at 1143–44. He also set aside ESD’s assessment of penalties. *Id.* at 1144–45.

The parties filed cross appeals with the ESD Commissioner’s Review Office (“CRO”). Hatfield appealed the finding of liability. *Id.* at 1150–54. ESD appealed the waiver of penalties and the 70% equipment reduction, continuing to argue that all remuneration should be treated as wages. *Id.* at 1166-70. The CRO issued the Commissioner’s final decision on August 21, 2015, affirming the ALJ on all counts. *Id.* at 1179.

Hatfield timely sought judicial review in the Spokane County Superior Court. CP 92–191. The Honorable Harold Clarke III heard Hatfield’s appeal jointly with the appeals filed by Swanson and System. CP 301. Judge Clarke affirmed the CRO’s decision. CP 300.

Hatfield, Swanson, and System all timely appealed Judge Clarke’s ruling. CP 83–91 (Swanson), CP 302–11 (Hatfield), CP 640–49 (System). This Court entered an order consolidating the three cases on July 26, 2016.

D. ARGUMENT

Hatfield hereby adopts and incorporates by this reference all arguments raised in System's Brief of Appellant. As explained by System, ESD's assessments must be set aside for three separate and independent reasons. First, ESD's efforts to restructure the trucking industry relate to carriers' prices, routes, and/or services and are therefore preempted by the FAAAA, at 49 U.S.C. § 14501(c)(1). Second, Hatfield does not control the method and detail of owner/operators' work, and owner/operators are therefore independent contractors under RCW 50.04.140(1). And third, ESD's failure to use its audit power in good faith, in particular by deliberately assessing unlawful taxes, renders the assessment invalid and void under such authority as *Arbogast v. Town of Westport*, 18 Wn. App. 4, 567 P.2d 244 (1977), and *Washington Trucking Ass'ns v. State*, 192 Wn. App. 621, 369 P.3d 170 (2016).

1. ESD's reclassification of owner/operators is preempted by federal law.

The legal arguments raised in System's brief with respect to FAAAA preemption apply equally to Hatfield. That statute prohibits a state from taking any action "related to a price, route, or service of any motor carrier." 49 U.S.C. § 14501(c)(1).

On this point, Hatfield presented unrebutted testimony of three industry experts: Larry Pursley, then president of the Washington Trucking Associations (ARH1 at 28–33); Kent Hatfield, Hatfield’s president (*id.* at 34–38); and Joe Rajkovic, a former owner/operator and former director of the Owner/Operator Independent Drivers Association, Inc. (*id.* at 39–42). These experts concurred that owner/operators have long been an important cornerstone of the trucking industry and that ESD’s efforts to convert them into employees will have a significant effect on the industry. *See id.* at 31–33, 35, 37, 41–42. They established that the main purpose of engaging owner/operators is to provide operational flexibility and that interference with that relationship will increase costs and therefore prices, limit services, and/or affect routes. *Id.* at 30–33, 35–37, 42. This effort to restructure the industry is therefore preempted under 49 U.S.C. § 14501(c)(1).

2. Owner/operators are independent contractors.

System’s legal arguments on RCW 50.04.140 also apply to Hatfield. Under the Employment Security Act, owner/operators are independent contractors, and therefore not subject to unemployment taxes, if Hatfield establishes three elements: (a) that their work is free from direction or control by Hatfield; (b) that they perform their services

outside of Hatfield's places of business; and (c) that they are customarily engaged in an independently established trade, occupation, profession, or business. RCW 50.04.140(1).

Element (c) is met for the reasons explained in System's brief and also in Judge Clarke's opinion. *See* CP 296. Element (b) is met for the reasons explained in System's brief and in the CRO's decision in System's appeal. *See* ARS2 at 375–78. Finally, with respect to element (a), Hatfield likewise adopts System's arguments, as well as Judge Clarke's opinion as to the appropriate analysis (CP 300), and the Oregon Court of Appeals' recent opinion in *Ceva Freight, LLC v. Employment Dep't*, ___ P.3d ___, 279 Or. App. 570 (2016).

On element (a), the CRO found that Hatfield could not show freedom from direction or control despite *conceding* that the following facts show "autonomy" in owner/operators' work:

- "Hatfield does not control the hours that the owner-operators work, nor does it require them to work fulltime." ARH4 at 1195.
- Owner/operators "are not required to accept the loads offered by Hatfield; and they can, and sometimes do, decline loads." *Id.*
- Owner/operators "decide the route they will take for pick-up and delivery" and may "broker their own loads for their return trips." *Id.*

- Owner/operators' are responsible for insurance, other expenses, and any lost or damaged cargo. *Id.* at 1196.

What the CRO overlooked was the contract's express provision that "all parties are entitled to exercise the discretion and judgment of an independent person, business or contractor in determining the methods and means to be used" ARH1 at 135. Because these facts show that Hatfield does not control the methods and details of owner/operators' work, this element was satisfied. *See Jerome v. Employment Sec. Dep't*, 69 Wn. App. 810, 816, 850 P.2d 1345 (1993). The CRO thus erred in upholding ESD's decision.

3. ESD's unlawful conduct invalidated the assessment.

Finally, ESD's deliberate assessment of unlawful taxes provides a third ground for reversal. It is undisputed that ESD's taxing authority is limited to wages for personal services and that ESD has no authority to tax money paid for equipment rental. RCW 50.04.100, .320. It is also beyond dispute that ESD violated this provision by assessing taxes on remuneration that included equipment payments. ESD's audits violated ESD's standards, and the resulting assessment was therefore invalid.

- a. ESD deliberately assessed overinflated taxes to bolster its settlement position.

ESD's auditor, Cooper, candidly admitted that when he issued Hatfield's assessment, he *knew* he was assessing taxes on remuneration paid for equipment rental. ARH6, 9/16/2014 trans. at 147–49. Cooper also admitted that he was aware, at the time, that ALJ Gay had ordered ESD to bifurcate equipment and wages in several prior cases and that ESD had subsequently allocated 70% to equipment and 30% to wages. *Id.* at 149, 151, 156. He testified further that he actually calculated two different assessment amounts for Hatfield: one treating 100% of remuneration as wages and one counting only 30% as wages. *Id.* at 156.

Further, Cooper contacted two of his superiors at ESD—Byington and Ward—and asked them whether he should perform the bifurcation. They specifically instructed him not to bifurcate. *Id.* at 152. Byington admitted that he knew this practice would result in taxes being assessed on equipment payments. ARH2 at 587. His explanation for deliberately allowing these unlawful assessments was that “any discussion would happen as a possible appeal settlement.” *Id.* at 399. In other words, rather than attempt to identify the accurate assessment amount, as would occur in any good-faith audit, ESD intentionally assessed excessive tax amounts to strengthen its settlement leverage.

b. ESD's conduct was unlawful.

While not denying that it attempted to tax equipment payments,³ ESD attempts to justify this unlawful conduct with three arguments: (1) that Hatfield had supposedly not produced any information from which a bifurcation could be made; (2) compensation was not bifurcated between equipment and services on the Form 1099 reports that Hatfield issued to owner/operators; and (3) RCW 50.12.080 allows ESD to issue an “arbitrary” report when an employer has failed to provide a report. None of these arguments has any merit.

The argument that Hatfield did not provide information to support bifurcation rings hollow where ESD failed to make any effort to ascertain a proper bifurcation. Because his superiors ordered him not to bifurcate, Cooper did not request *any* information on this issue. ARH6, 9/16/2014 trans. at 152. Cooper admitted, however, that Hatfield provided all the information he requested. *Id.* at 153.

³ ESD previously tried to argue that this tactic did not result in an overinflated assessment. The argument was based on the statutory cap on the amount of compensation that can be subject to tax for a given individual. ESD claimed that Hatfield paid owner/operators so highly that even when their compensation was reduced by 70% it was still above the statutory cap. But after ALJ Schuh ordered ESD to apply the 70%/30% split and waive penalties, ESD reduced the assessment by more than \$7,000, from \$13,616.53 to \$6,565.37, even though penalties accounted for less than \$2,000 (ARH1 at 127), thereby laying to rest any notion that including equipment did not increase the assessment.

ESD's obligations to the taxpayer required it, at the very least, to request evidence in a good-faith effort to issue an accurate assessment. ESD has a duty to wield its audit power in good faith. *Department of Rev., State of Wash. v. March*, 25 Wn. App. 314, 319, 610 P.2d 946 (1979) ("Of course, the audit power must be used in good faith.") (citing *United States v. LaSalle Nat'l Bank*, 437 U.S. 298 (1978)). ESD's plan to use litigation and the administrative hearing to sort out amounts that it should have identified at the audit stage was bad faith.

Further, the Legislature has armed ESD with subpoena power. *See* RCW 50.12.130. To the extent ESD needed information beyond what it could have obtained from Hatfield, it had ample authority to subpoena from owner/operators "the production of books, papers, correspondence, memoranda, and other records deemed to be necessary as evidence in connection with any dispute or the administration of [the Employment Security Act]." RCW 50.12.130(1). This subpoena power defeats any contention that ESD's duty to conduct audits in good faith somehow begins and ends with a superficial inquiry into an employer's records.

Hatfield produced testimony from two expert witnesses who established that ESD's tactics cannot be considered a good faith use of the audit power. Accounting expert Steve Bishop ("Bishop"), for example,

testified that ESD's actions would not even qualify as a true "audit" in any customary sense of the word. ARH2 at 289–90.

Former State Auditor Brian Sonntag ("Sonntag") explained that in order to use its audit power in good faith an agency must attempt to establish the correct amount at the audit stage. He rejected ESD's contention that the availability of an administrative appeal somehow relieves ESD of this responsibility. According to Sonntag, the right to appeal "is cold comfort to any taxpayer. No taxpayer should be required to go through the expense and burden of an appeal because the agency did not conduct a proper audit." *Id.* at 278.

Sonntag characterized ESD's arguments as "simply another way of saying it can do whatever it wants and the best taxpayers can hope for is that, if they go through the expense and burden of an appeal, they might ultimately be vindicated." *Id.* In short, ESD's audits fail to conform to its own policy documents, and experienced experts testify that they were not audits at all, but rather shams that forced Hatfield into costly litigation that should not have even been necessary. *See id.* at 277. ESD's resort to an arbitrary assessment amount, without any effort to identify the correct amount, was bad faith.

Hatfield's Form 1099 reports are immaterial where ESD had actual knowledge that equipment payments were included in owner/operator remuneration. A corollary argument offered by ESD is that its faulty assessment was somehow Hatfield's fault. According to ESD, when Hatfield reported owner/operator compensation on Form 1099, it placed the entire amount in the box for "non-employee compensation," instead of dividing it into different categories.

As Bishop explained, however, the "non-employee compensation" box is "a catch-all box" for payments that do not have a specific designation. ARH6, 9/17/2014 trans. at 70. Hatfield did *not* misrepresent owner/operator compensation in its reporting to the federal government. *Id.* at 72.

In any event, ESD's focus on Form 1099 is a red herring. ESD had *actual knowledge* that owner/operator compensation included equipment payments, and it made no effort to ensure that its assessment accounted for this undisputed fact. As Sonntag explained, ESD's deliberate imposition of unlawful taxes, without even trying to ascertain the correct amount, failed to comply with the most basic auditing standards applicable to all state taxing authorities. ARH2 at 278.

The statute allowing arbitrary reports does not excuse ESD from its duty to conduct audits in good faith. RCW 50.12.080 allows ESD to issue an arbitrary report if an employer has *failed* to make or file a required report. It is undisputed that Hatfield filed regular reports with ESD, and it reported compensation paid to owner/operators on Form 1099. As such, RCW 50.12.080 simply is not applicable.

Further, this statute requires that if ESD uses this provision, it must make its report “upon the basis of such knowledge as may be available.” RCW 50.12.080. The knowledge that was indisputably available to ESD, when it deliberately assessed taxes on equipment here, included:

- a) that Hatfield engaged owner/operators under a contract entitled “Agreement of Lease and Conduct,” which designated Hatfield as the “Lessee” and provided that the “Contractor hereby leases to the Lessee, and the Lessee hereby hires from the Contractor the equipment . . .” (ARH1 at 136);
- b) that ALJ Gay had remanded eight prior carrier appeals to ESD with instructions to apply a reduction that accounts for equipment payments (ARH8, Exs. L, M);

- c) that ALJ Gay had suggested two acceptable methods for calculating the required reduction, both of which could be accomplished through comparing industry-average data to the compensation amounts that could easily be found on the Form 1099 reports (*id.*, Ex. L at 3);
- d) that those other carriers had provided ESD with information that allowed it to determine the percentage allocable to equipment (ARH2 at 396–97);
- e) that after receiving that information from the other carriers, ESD agreed that a 70% reduction was appropriate (ARH2 at 326);
- f) that information showing the division of costs between wages and equipment for Hatfield’s employee drivers was available at ESD’s request (ARH6, 9/16/2014 trans. at 153);
- g) that Cooper had seen settlement sheets that told him “amounts for equipment versus amounts for settlements” (ARH2 at 376);

- h) that after seeing these documents, Cooper prepared an alternative assessment applying a 70% reduction for equipment (ARH6, 9/16/2014 trans. at 156); and
- i) that including the full compensation amount in the assessment would necessarily result in taxes being imposed on equipment (*id.* at 148–49).

ESD cannot reasonably claim to have determined, in good faith, that treating 100% of owner/operator remuneration as wages was a reasonable estimation of Hatfield’s tax liability based on the knowledge available to it. To the contrary, it chose to *disregard* the available knowledge. Its resort to RCW 50.12.080, therefore, was improper.

- c. ESD’s unlawful conduct renders the assessments void as a matter of law.

ESD’s deliberate imposition of unlawful taxes renders the resulting assessment void, for at least two reasons.

First, assessments not in compliance with an agency’s standards are invalid. Division II of this Court recently held that ESD’s assessments can be invalidated in the administrative process if they “resulted from an improper audit process that violated ESD’s own standards.” *Washington Trucking*, 192 Wn. App. at 647. This holding related directly to audits of trucking carriers overseen by Ward and Byington. *Id.* at 633–34.

Hatfield presented overwhelming evidence that the audit process here was improper and violated ESD's standards. ESD has a Tax Audit Manual, which mandates compliance with Generally Accepted Auditing Standards ("GAAS"). ARH2 at 445. It also has a Status Manual, which establishes an "Independent Trucker" test for determining whether a truck driver is an employee or an independent contractor. *Id.* at 488. Sonntag and Bishop established that ESD's audits did not comply with GAAS or ESD's manuals. *Id.* at 275–77, 293. And Cooper admitted that he does not use the Tax Audit Manual and does not even know what factors it directs auditors to consider in deciding whether to reclassify a worker. *Id.* at 552–53.

Unable to dispute these findings, ESD instead took the remarkable position that it does not require its auditors to comply with its manuals. Citing the testimony of Cooper, Ward, and its statewide audit coordinator, Gerritt Eades ("Eades"), ESD argued that the Tax Audit Manual is merely a "tool or guideline," but not a "binding standard." *Id.* at 527.

But Sonntag explained that the failure to require adherence to basic auditing standards is itself a bad-faith use of an agency's audit power. *Id.* at 276. Further, Eades admitted that ESD's audits are required to comply with the U.S. Department of Labor's Tax Performance System

requirements. *Id.* at 594–96. The Tax Performance System, in turn, *mandates* “a formal Field Audit manual.” *Id.* at 624. As such, ESD’s attempt to disavow its own manuals is just more evidence of its failure to follow its own standards. The resulting assessment against Hatfield is therefore invalid. *Washington Trucking*, 192 Wn. App. at 647.

Second, ESD’s knowing assessment of unlawful taxes was, by definition, arbitrary and capricious. This Court has the authority to set aside an agency determination that results from unlawful, arbitrary or capricious action. *See In re Townsend*, 54 Wn.2d 532, 533, 341 P.2d 877, 878 (1959). *See also Systems Amusement, Inc. v. State*, 7 Wn. App. 516, 518, 500 P.2d 1253 (1972) (noting the Due Process Clause is protection against arbitrary and capricious action by the state and any violation thereof may be declared void). Actions of an agency in excess of its statutory authority are likewise void. *Arbogast*, 18 Wn. App. at 7–8.

This principle applies to an initial adjudication that the issuing officer knows is incorrect. *See In re Jullin*, 23 Wn.2d 1, 158 P.2d 319 (1945). In *Jullin*, for example, the claimant filed a claim for benefits which showed on its face that the claimant was ineligible. A subdivision of the office of unemployment compensation (“Division”) nevertheless accepted the incomplete and invalid claim and made an “initial

determination” that benefits were potentially payable in a specified weekly amount. *Jullin*, 23 Wn.2d at 3. The Supreme Court held that the impropriety of allowing an invalid initial claim nullified the entire process:

While the administration of the unemployment compensation act is entrusted to the commissioner, his administration thereof must be in accordance with the provisions of the act itself and the rules prescribed thereby. He is a public officer appointed to administer trust funds.

These trust funds are contributed solely and entirely by the employers subject to the act. The employers are therefore vitally concerned in the proper administration and disposition of such funds. The commissioner must administer the act justly and fairly, for the benefit of all concerned, in accordance with law, and ***unless his powers are so exercised his acts are of no effect***. In the case of *In re Elvigen's Estate*, 191 Wash. 614, 71 P.2d 672, 676, we quoted with approval the following statement from 46 C.J. 1033, Officers § 290: “Powers conferred upon a public officer can be exercised only in the manner, and under the circumstances, prescribed by law, and ***any attempted exercise thereof in any other manner or under different circumstances is a nullity***.”

Id. at 15-16 (emphasis added, citation omitted). Because the claim was invalid on its face, any “initial determination” by the Division became ineffective and valueless. *Id.* at 18. The same is true of ESD’s assessment

here, which the auditor issued *knowing* that it purported to impose unlawful taxes.

ESD also violated Hatfield's constitutional rights. An agency violates substantive due process when its decision is "irrational, arbitrary and capricious" or "was tainted by improper motive." *Motley-Motley, Inc. v. State*, 127 Wn. App. 62, 82, 110 P.3d 812 (2005) (citing *Dykstra v. Skagit County*, 97 Wn. App. 670, 673, 985 P.2d 424 (1999)). ESD's deliberate imposition of unlawful taxes was arbitrary and capricious. And its motive—to gain bargaining leverage—was improper.

An agency's failure to comply with its own advisory interpretations of the law or its own procedures establishes a procedural due process violation if the party has been prejudiced. *Motley-Motley*, 127 Wn. App. at 81 (citing *Pullman Power Prods., Inc. v. Marshall*, 655 F.2d 41, 44 (4th Cir.1981)). "Prejudice relates to the inability to prepare or present a defense." *Id.* ESD's tactics—failing to make any effort to conduct a fair audit in good faith, instead placing the burden on Hatfield to do ESD's audit work for it, through extensive litigation on appeal, at a cost that far outpaces the amount of the assessment—deprived Hatfield of

any meaningful ability to appeal this assessment. Under *Jullin*, this assessment was a nullity.⁴

E. CONCLUSION

For the foregoing reasons, as explained in detail in System's Brief of Appellant, the Court should reverse the CRO's ruling with instructions to set the assessment against Hatfield aside.

Respectfully submitted,



Aaron Riensche, WSBA #37202
Ogden Murphy Wallace PLLC
901 Fifth Avenue, Suite 3500
Seattle, WA 98164-2008
(206) 447-7000

Philip A. Talmadge, WSBA #6973
Talmadge/Fitzpatrick/Tribe
2775 Harbor Avenue SW
Third Floor, Suite C
Seattle, WA 98126
(206) 574-6661

Attorneys for Appellant
Hatfield Enterprises, Inc.

{APR1483790.DOCX;3/12579.000002/}

⁴ In fact, to the extent ESD intended to use the excessive amount for leverage on appeal, the misconduct graduates to a criminal violation. Official misconduct is a gross misdemeanor. RCW 9A.80.010(2). It arises when a public servant, with intent to deprive another person of a lawful right or privilege, "intentionally commits an unauthorized act under color of law." RCW 9A.80.010(1)(a).