

Nº. 35613-9-II

IN THE COURT OF APPEALS OF THE STATE OF WASHINGTON  
DIVISION II

---

LEE'S DRYWALL CO., INC.  
Appellant,

v.

STATE OF WASHINGTON, DEPARTMENT OF LABOR &  
INDUSTRIES,  
Respondent.

07 MAR 21 AM 0:50  
COURT OF APPEALS  
DIVISION II  
STATE OF WASHINGTON  
BY 39 DEPUTY

---

**OPENING BRIEF OF APPELLANT**

---

Appeal from the Board of Industrial Insurance Appeals,  
Docket No. 0514495  
Kathleen A. Stockman, Industrial Appeals Judge

---

Klaus O. Snyder  
WSBA No. 16195  
Attorney for Appellant  
920 Alder Avenue, Suite 201  
Sumner, WA 98390-1406  
(253) 863-2889

**TABLE OF CONTENTS**

	<u>Page</u>
<b>I. ASSIGNMENT OF ERRORS .....</b>	<b>1</b>
1. Error is assigned to Finding of Fact No. 4, which states:  Sufficient evidence was not presented to establish that Zagy’s Drywall maintained a separate set of books or records that reflect all items of income and expenses of its business during the second quarter of 2003. ....	1
2. Error is assigned to Finding of Fact No. 5, which states:  Sufficient evidence was not presented to establish that Zagy’s Drywall had a principal place of business which would be eligible for a business deduction for IRS tax purposes other than that furnished by the contractor for which the business had contracted to furnish services during the second quarter of 2003. ....	1
3. The Department of Labor and Industries interpreted and applied RCW 51.12.070 incorrectly. ....	1
4. The Department of Labor and Industries failed to fulfill its statutory duties to collect industrial insurance premiums from a subcontractor before assessing the prime contractor. ....	1
5. The Department of Labor and Industries improperly implemented new rules without going through rule making procedures required under the Washington Administrative Procedures Act. ....	1

- 6. The new rules are unconstitutional on their face and as applied to Lee’s Drywall Company, Inc., in this case.....1

**II. ISSUES PERTAINING TO ASSIGNMENTS OF ERROR**

- 1. Should the administrative decision be reversed where the agency incorrectly interpreted RCW 51.12.070 (2) and (3) and, based on the incorrect interpretation, then incorrectly applied those subsections and entered findings of fact which are not supported by substantial evidence in the record?..... 1-2
- 2. Should the Department of Labor and Industries be required to follow statutory procedures to collect industrial insurance premiums from a subcontractor or a subcontractor’s successor before it assesses “prime contractor liability”?.....2
- 3. Should the Department Order assessing “prime contractor liability” against Lee’s Drywall be invalidated where the Department created new rules upon which the Order is based without complying with rule making procedure under the Washington Administrative Procedures Act? ....2
- 4. Are the new rules unconstitutional on their face and as applied in this case? .....2

**III. STATEMENT OF THE CASE.....3**

Procedural background .....3

Factual background.....4

**IV. ARGUMENT**

A. Standards of Review .....10

B.	The Department of Labor and Industries erroneously interpreted and applied RCW 51.12.070.....	15
1.	<u>A contractor seeking to establish nonliability for his subcontractor's premiums is not required to establish that the subcontractor's principal place of business was, <b>in fact</b>, eligible for a business deduction under the IRS code. ....</u>	17
2.	<u>A contractor seeking to avoid responsibility for a subcontractor's premiums is not required to prove that the subcontractor's separate set of books, <b>in fact</b>, reflect all items of income and expenses of the subcontractor's business...</u>	19
C.	The Department incorrectly applied RCW 51.12.070(2) and (3), and the resulting Findings of Fact No. 4 and 5 are not supported by substantial evidence in the whole record. ....	21
1.	<u>There is not substantial evidence to support Finding of Fact Number 4.....</u>	21
2.	<u>There is not substantial evidence to support Finding of Fact Number 5.....</u>	24
D.	The Department failed to fulfill its statutory duties pertaining to collection of premiums from Zagy's Drywall. ....	28
E.	The Department of Labor and Industries improperly implemented new rules without complying with rule making procedures.....	31
F.	The Department's new "rules" are unconstitutional on their face and as applied to Lee's Drywall in this case. ....	35

1.	<u>The rules requiring “physical verification” by a contractor violate the constitutional right to privacy.</u>	35
2.	<u>The new “rules” substantially impaired the agreement between Lee’s Drywall and Zagy’s Drywall that obligated Zagy’s Drywall to pay premiums for work done by its own employees.</u>	37
<b>VI.</b>	<b>CONCLUSION</b>	38
<b>VII.</b>	<b>APPENDIX</b>	A-1
	U.S. Const. art. I, § 10	A-1
	26 U.S.C. § 280A	A-2
	Washington Constitution art. I, § 7	A-7
	Washington Constitution art. I, § 23	A-8
	RCW 51.16.070	A-9
	RCW 51.16.200	A-10
	RCW 51.48.040	A-11
	WAC 296-126-050	A-12
	WAC 296-128-025	A-13

## TABLE OF AUTHORITIES

Page

### Table of Cases

#### Washington Cases

<i>Bostain v. Food Exp., Inc.</i> , ---P.3d ---, 2007 WL 611259 .....	11
<i>Budget Rent a Car Corporation v. State, Department of Licensing</i> , 144 Wn.2d 889, 31 P.3d 1174 (2001) .....	34-35
<i>Fluor Hanford, Inc. v. Hoffman</i> , 154 Wn.2d 730, 116 P.3d 999 (2005).....	11
<i>Franklin Cy. Sheriff's Office v. Sellers</i> , 97 Wash.2d 317, 646 P.2d 113 (1982), <i>cert. denied</i> , 459 U.S. 1106, 103 S.Ct. 730, 74 L.Ed.2d 954 (1983).....	12, 13
<i>Gibson v. Department of Employment Sec.</i> , 52 Wn. App. 211, 758 P.2d 547 (1988).....	13
<i>Hamel v. Employment Sec. Dep't</i> , 93 Wash.App. 140, 966 P.2d 1282 (1998), <i>review denied</i> , 137 Wash.2d 1036, 980 P.2d 1283 (1999).....	14
<i>Hardman v. Brown</i> , 153 Wn. 85, 279 P. 91 (1929).....	36
<i>Harstad v. Metcalf</i> , 56 Wash.2d 239, 351 P.2d 1037 (1960) .....	36
<i>Inland Empire Distrib. Sys., Inc. v. Utilities &amp; Transp. Comm'n</i> , 112 Wn.2d 278, 770 P.2d 624 (1989) .....	12
<i>King County v. Cent. Puget Sound Growth Mgmt. Hearings Bd.</i> , 142 Wash.2d 543, 14 P.3d 133 (2000) .....	13-14
<i>Littlejohn Construction Company v. Department of Labor and Industries</i> , 74 Wn. App. 420, 873 P.2d 583 (1994).....	15-16, 20

<i>Margola Assocs. v. City of Seattle</i> , 121 Wash.2d 625, 854 P.2d 23 (1993).....	37
<i>Murphy v. Campbell Inv. Co.</i> , 79 Wn.2d 417, 486 P.2d 1080 (1971).....	19
<i>Pasco v. Public Empl. Relations Comm'n</i> , 119 Wash.2d 504, 833 P.2d 381 (1992).....	11, 15
<i>Puget Sound Bridge &amp; Dredging Co. v. Department of Labor and Industries</i> , 26 Wn.2d 550, 174 P.2d 957 (1946).....	14
<i>R &amp; G Probst v. Department of Labor and Industries</i> , 121 Wn. App. 288, 88 P.3d 413 (2004).....	20, 23
<i>Robison Const., Inc. v. Washington State Dept. of Labor and Industries</i> , 2006 W.L. 3718335 .....	11
<i>Robinson v. City of Seattle</i> , 102 Wash.App. 795, 10 P.3d 452 (2000).....	35-36
<i>St. Paul &amp; Tacoma Lbr. Co. v. Department of Labor &amp; Indus.</i> , 19 Wash.2d 639, 144 P.2d 250 (1943).....	12
<i>State v. Jacobs</i> , 154 Wash.2d 596, 115 P.3d 281 (2005).....	15, 17
<i>State v. Myrick</i> , 102 Wn.2d 506, 688 P.2d 151 (1984).....	35
<i>State v. Tracy</i> , 128 Wn. App. 388, 115 P.3d 381 (2005).....	28
<i>Superior Asphalt &amp; Concrete Co. v. Dep't of Labor &amp; Ind.</i> , 112 Wn. App. 291, 49 P.3d 135 (2002).....	11
<i>Washington State Dept. of Labor and Industries v. Davison</i> , 126 Wn. App. 730, 109 P.3d 479 (2005).....	13
<i>Waste Management of Seattle, Inc. v. Utilities and Transp. Com'n.</i> , 123 Wash.2d 621, 869 P.2d 1034 (1994) .....	12

Administrative Decisions

*In re: BLC Trucking, Inc.*, Docket No. 98 11140, 2000 WL 767815.....30

*In re: Interior Drywall Systems, Inc.*, Docket No. 05-17035, 2006 WL 2954307 .....32

Other Authorities

U.S. Const. art. I, § 10.....37

26 U.S.C. § 280A.....26

Washington Constitution art I, § 7 .....35

Washington Constitution art. I, § 23 .....37

RCW 34.05.010 ..... 33-34

RCW 34.05.570 ..... 10-11

RCW 51.12.050 .....14

RCW 51.12.070 .....5-6, 17, 19-20

RCW 51.16.070 .....20

RCW 51.16.200 ..... 28-29

RCW 51.48.040 .....20

RCW 51.52.115 .....14

WAC 296-126-050.....20

WAC 296-128-025.....20

## **I. ASSIGNMENTS OF ERROR**

1. Error is assigned to Finding of Fact No. 4, which states:

Sufficient evidence was not presented to establish that Zagy's Drywall maintained a separate set of books or records that reflect all items of income and expenses of its business during the second quarter of 2003.

2. Error is assigned to Finding of Fact No. 5, which states:

Sufficient evidence was not presented to establish that Zagy's Drywall had a principal place of business which would be eligible for a business deduction for IRS tax purposes other than that furnished by the contractor for which the business had contracted to furnish services during the second quarter of 2003.

3. The Department of Labor and Industries interpreted and applied RCW 51.12.070 incorrectly.
4. The Department of Labor and Industries failed to fulfill its statutory duties to collect industrial insurance premiums from a subcontractor before assessing the prime contractor.
5. The Department of Labor and Industries improperly implemented new rules without going through rule making procedures required under the Washington Administrative Procedures Act.
6. The new rules are unconstitutional on their face and as applied to Lee's Drywall Company, Inc., in this case.

## **II. ISSUES PERTAINING TO ASSIGNMENTS OF ERROR**

1. Should the administrative decision be reversed where the agency incorrectly interpreted RCW 51.12.070 (2) and (3) and, based on the incorrect interpretation, then incorrectly applied those subsections and entered findings of fact

which are not supported by substantial evidence in the record? (Assignments of Error Nos. 1, 2, and 3).

2. Should the Department of Labor and Industries be required to follow statutory procedures to collect industrial insurance premiums from a subcontractor or a subcontractor's successor before it assesses "prime contractor liability"? (Assignment of Error No. 4).
3. Should the Department Order assessing "prime contractor liability" against Lee's Drywall be invalidated where the Department created new rules upon which the Order is based without complying with rule making procedure under the Washington Administrative Procedures Act? (Assignment of Error No. 5).
4. Are the new rules unconstitutional on their face and as applied in this case? (Assignment of Error No. 6).

### III. STATEMENT OF THE CASE

*(Note: As used in this Opening Brief of Appellant, "AR" refers to the certified administrative record; "TR" refers to the transcript of the October 6, 2005 administrative hearing; and "CP" refers to the Clerk's Papers.)*

#### Procedural Background

In January of 2005, the Department of Labor and Industries ("Department") sent a Certificate of Audited Prime Contractor Liability to Lee's Drywall Co., Inc. ("Lee's Drywall"). See Ex. 7. On April 1, 2005, the Department issued a Notice and Order of Assessment of Industrial Insurance Taxes to Lee's Drywall Company, Inc. ("Lee's Drywall"), assessing "prime contractor liability" for taxes, penalties, and interest in the amount of \$7,937.90 owed to the State Fund by Lee's Drywall's subcontractor, Zagy's Drywall ("Zagy's"), for the second quarter of 2003. AR 20.

Lee's Drywall filed an appeal from the Order of Assessment and a hearing was held before Kathleen A. Stockman, Industrial Appeals Judge, on October 6, 2005. TR 1, 4. Judge Stockman issued a Proposed Decision and Order affirming the Department's Order finding, *inter alia*, that Lee's Drywall had failed to present sufficient evidence (1) "that Zagy's Drywall maintained a separate set of books or records that reflect all items of income and expenses of its business during the second quarter

of 2003” and (2) “that Zagy’s Drywall had a principal place of business which would be eligible for a business deduction for IRS tax purposes other than that furnished by the contractor for which the business had contracted to furnish services during the second quarter of 2003.” AR 26.

On February 27, 2006, Lee’s Drywall filed a Petition for Review of the Proposed Decision and Order, which was denied on March 13, 2006. AR 2.

Lee’s Drywall sought and obtained judicial review of the Proposed Decision and Order and the Order Denying Petition for Review in the Thurston County Superior Court. AR 15-52. Hon. Wm. Thomas McPhee issued an Order Affirming Agency Action on October 27, 2006, and “for the reasons stated on the record,” affirmed the Decision and Order of the Board of Industrial Insurance Appeals. CP 75-76.

Notice of Appeal was timely filed on November 20, 2006. CP 74-76.

#### *Factual Background*

Jeffrey Wayne Lee has been a drywall subcontractor in Washington for approximately 24 years. TR 14. He was a sole proprietor for 9 years, then incorporated his business 15 years ago as Lee’s Drywall Company, Inc. *Id.*

Isaias Guerrero was an employee of Lee’s Drywall for a period of

time (TR 28-29), then went into business for himself as Zagy's Drywall and solicited Lee's Drywall for work as a subcontractor. TR 29-30. Mr. Lee contracted with Zagy's Drywall because Lee's Drywall "had an abundance of work we were trying to accomplish and we were in need of some drywall installers." TR 28. Further, Mr. Lee knew that Mr. Guerrero had been a reliable and proficient drywall installer and was bilingual, speaking both Spanish and English. TR 29-30. Lee's Drywall subcontracted work to Zagy's Drywall during the second quarter of 2003. TR 32.

Zagy's Drywall submitted invoices to Lee's Drywall and Lee's Drywall paid Zagy's Drywall by check, based on the invoices. TR 33; Ex. 2; Ex. 19.

During the time Lee's Drywall subcontracted with Zagy's Drywall, Mr. Lee was aware of former RCW 51.12.070 (1981). TR 37. That statute, which states that a corporation "who lets a contract . . . shall be responsible primarily and directly for all premiums upon the work," also provided:

a contractor registered under chapter 18.27 RCW or licensed under chapter 19.28 RCW shall not be responsible for any premiums upon the work of any subcontractor if:

(1) The subcontractor is currently engaging in a business which is registered under chapter 18.27 RCW or licensed under chapter 19.28 RCW;

(2) The subcontractor has a principal place of business which would be eligible for a business deduction for internal revenue service tax purposes other than that furnished by the contractor for which the business has contracted to furnish services;

(3) The subcontractor maintains a separate set of books or records that reflect all items of income and expenses of the business; and

(4) The subcontractor has contracted to perform:

(a) The work of a contractor as defined in RCW 18.27.010; or

(b) The work of installing wires or equipment to convey electric current or installing apparatus to be operated by such current as it pertains to the electrical industry as described in chapter 19.28 RCW. . . .

RCW 51.12.070 (1981).

The State wrote, “[i]n this case, there is no doubt that the first and the fourth requirements for the exception are met: Zagy’s was a registered construction contractor, and the work that Zagy’s performed was work which can only be performed by a registered contractor.” AR 79; *see also* TR 26-27.

Exhibit number one was presented at the October 6, 2005 hearing to establish what documentary information Lee’s Drywall had procured about Zagy’s Drywall prior to subcontracting work to Zagy’s Drywall, including copies of Zagy’s Drywall Certificates of Insurance, Zagy’s

Drywall L&I specialty contractor registration, Lee's Drywall Request for Taxpayer Identification Number and Certification, Zagy's Drywall bond and the verification of Zagy's Drywall bond. TR 23-24; Ex.1. When asked why Lee's Drywall had requested and obtained the documents included in Exhibit 1, Mr. Lee stated, "it's required of us from the Department of L & I to get this information before we hire him as a subcontractor." TR 24.

Mr. Lee also presented copies of Zagy's Drywall invoices to Lee's Drywall for work performed during the second quarter of 2003, showing the address of Zagy's Drywall as 33415 26<sup>th</sup> Ave. S.W., Federal Way, WA 98023. TR 32; Ex. 2. Mr. Lee testified that to the best of his knowledge, Zagy's Drywall was "actually doing business out of a location in Federal Way," and that Zagy's Drywall was not "housed within Lee's Drywall Company property." TR 37. The Federal Way address printed on Zagy's Drywall invoices was the same address appearing on the certificates of insurance, L&I specialty contractor registration, surety bond, and Request for Taxpayer Identification Number and Certification included in Exhibit No. 1. Lee's Drywall mailed Internal Revenue Service Form 1099 to Zagy's Drywall at the Federal way address. TR 103.

Mr. Lee testified that because Lee's Drywall received regular invoices from Zagy's Drywall that were consistent with his own records of

the work being done and because Lee's Drywall issued checks to Zagy's Drywall based on the invoices, he believed that Zagy's Drywall was maintaining regular books and records for its business. TR 37-38; Ex. 2. Lynda Wilcox, the Department auditor who audited Zagy's Drywall, stated that Mr. Guerrero himself did Zagy's Drywall "books and records." TR 112.

Mr. Lee's wife, Shirley Lee, is the secretary/treasurer of Lee's Drywall. TR 76. Ms. Lee testified that she performed recordkeeping and accounting tasks for Lee's Drywall. TR 77. She stated that the Certificate of Audited Prime Contractor Liability received in January of 2005 was the first notice the company had that Zagy's Drywall had not paid its L & I premiums for the second quarter of 2003. TR 94; TR 102.

Lynda Wilcox, an auditor with the Department of Labor and Industries with 20 years experience, was assigned the task of auditing Zagy's Drywall and stated that the prime contractor assessment against Lee's Drywall resulted from her audit of Zagy's Drywall. TR 108. Ms. Wilcox testified that Mr. Guerrero came to her office "without many records, just briefly." TR 109. The records Mr. Guerrero brought to Ms. Wilcox included "a few invoices, [her] letter, and a letter from an accountant in Florida, Omni Financial." TR 110. She stated, "He had insufficient records, so I wasn't able to determine an assessment through

the records that he provided.” *Id.* Ms. Wilcox was then asked to explain how the audit of Zagy’s Drywall resulted in a prime contractor assessment against Lee’s Drywall, and she responded:

After I determine the amount of money that Zagy’s owes, I review the account to see if it qualifies for prime contractor liability. And I gather information from the subcontractor to see if it qualifies for prime contractor liability. And I gather information from the subcontractor to see if he would be exempt for – his premiums would be exempt from the prime contractor liability RCW. And in Zagy’s case he did his books and records on the kitchen table, which didn’t qualify for an IRS deduction since it was used for other than just his – the books and records of his company. And since there was a prior audit where he owed a large amount and had not paid that, I determined that I would assess prime contractor liability against the prime contractors that he had worked for to recover the premiums.

TR 112.

On cross-examination, Ms. Wilcox testified that the only things she reviewed before preparing the Certificate of Audited Prime Contractor Liability against Lee’s Drywall was “whatever records that Mr. Guerrero for Zagy’s Drywall showed [her] in [her] office on a particular day and the report from Lee’s Drywall containing the subcontractor report for hangers for the second quarter of 2003.” TR 117. She also stated that she did not contact Lee’s Drywall to inquire whether they had any other information that she could consider before she issued the certificate because “[t]here wasn’t any additional information that [she] needed.” *Id.*

#### **IV. ARGUMENT**

##### **A. Standards of Review**

The Washington Administrative Procedure Act (“APA”) allows a reviewing court to reverse an agency decision when

(a) The order, or the statute or rule on which the order is based, is in violation of constitutional provisions on its face or as applied;

(b) The order is outside the statutory authority or jurisdiction of the agency conferred by any provision of law;

(c) The agency has engaged in unlawful procedure or decision-making process, or has failed to follow a prescribed procedure;

(d) The agency has erroneously interpreted or applied the law;

(e) The order is not supported by evidence that is substantial when viewed in light of the whole record before the court, which includes the agency record for judicial review, supplemented by any additional evidence received by the court under this chapter;

(f) The agency has not decided all issues requiring resolution by the agency;

(g) A motion for disqualification under RCW 34.05.425 or 34.12.050 was made and was improperly denied or, if no motion was made, facts are shown to support the grant of such a motion that were not known and were not reasonably discoverable by the challenging party at the appropriate time for making such a motion;

(h) The order is inconsistent with a rule of the agency unless the agency explains the inconsistency by stating

facts and reasons to demonstrate a rational basis for inconsistency; or

(i) The order is arbitrary or capricious.

RCW 34.05.570(3).

An appellate court reviewing an administrative action sits in the same position as the trial court and applies the APA standards directly to the agency's administrative record. *Superior Asphalt & Concrete Co. v. Dep't of Labor & Ind.*, 112 Wn. App. 291, 296, 49 P.3d 135 (2002) (citing *Tapper v. Employment Sec. Dep't*, 122 Wash.2d 397, 402, 858 P.2d 494 (1993)), *review denied*, 149 Wash.2d 1003, 70 P.3d 964 (2003). This Court will review the Board's decision and record, not the superior court's ruling and record. *Robison Const., Inc. v. Washington State Dept. of Labor and Industries*, 2006 W.L. 3718335 at \*2 (citing *Dept. of Labor & Indus. v. Denny*, 93 Wn. App. 547, 550, 969 P.2d 525 (1999)).

Construction of a statute is a question of law which is reviewed de novo under the error of law standard. *Bostain v. Food Exp., Inc.*, --- P.3d ---, 2007 WL 611259 at \*2, citing *Korlund v. DynCorp Tri-Cities Servs., Inc.*, 156 Wn.2d 168, 177, 125 P.3d 119 (2005); *Fluor Hanford, Inc. v. Hoffman*, 154 Wn.2d 730, 737, 116 P.3d 999 (2005); *Pasco v. Public Empl. Relations Comm'n*, 119 Wash.2d 504, 507, 833 P.2d 381 (1992); *Inland Empire Distrib. Sys., Inc. v. Utilities & Transp. Comm'n*, 112

Wash.2d 278, 282, 770 P.2d 624, 87 A.L.R.4th 627 (1989). The courts retain the ultimate authority to interpret a statute. *Franklin Cy. Sheriff's Office v. Sellers*, 97 Wash.2d 317, 325-26, 646 P.2d 113 (1982), *cert. denied*, 459 U.S. 1106, 103 S.Ct. 730, 74 L.Ed.2d 954 (1983).

“Whether an agency's construction of the statute is accorded deference depends on whether the statute is ambiguous.” *Waste Management of Seattle, Inc. v. Utilities and Transp. Com'n.*, 123 Wash.2d 621, 628, 869 P.2d 1034 (1994). “Where an agency is charged with the administration and enforcement of a statute, the agency's interpretation of an **ambiguous** statute is accorded great weight in determining legislative intent.” *Id.* (citing *Pasco*, 119 Wash.2d at 507, 833 P.2d 381 (citing *Cowiche Canyon Conservancy v. Bosley*, 118 Wash.2d 801, 813-14, 828 P.2d 549 (1992)) (emphasis added). Absent ambiguity, there is no need for the agency's expertise in construing the statute. *Id.* (citing *Pasco*, 119 Wash.2d at 509, 833 P.2d 381. Courts will not defer to an agency determination which conflicts with the statute. *Id.* (citing *Cowiche*, 118 Wash.2d at 815, 828 P.2d 549).

The presumption on appeal that the Board's decision is correct does not apply when only a question of law is presented. *St. Paul & Tacoma Lbr. Co. v. Department of Labor & Indus.*, 19 Wash.2d 639, 641, 144 P.2d 250 (1943) *superceded by statute on other grounds as stated in*

*Pennsylvania Life Ins. Co. v. Employment Sec. Dept.*, 97 Wn.2d 412, 645 P.2d 693 (1982).

“Findings of fact are reviewed for substantial evidence in light of the whole record.” *Washington State Dept. of Labor and Industries v. Davison*, 126 Wn. App. 730, 737, 109 P.3d 479 (2005), citing former RCW 34.05.570(3)(e) (1995); RCW 34.05.570(3)(e) (substantial evidence is “evidence which is substantial when viewed in light of the whole record before the court).

Judicial review is not selective, but must be conducted on the entire record, not by isolating evidence. *Norway Hill Preservation & Protection Ass'n v. King County Council*, 87 Wash.2d 267, 552 P.2d 674 (1976). The duty of the reviewing court to search the entire record for evidence both supportive of and contrary to the agency's findings is found in *Universal Camera Corp. v. NLRB*, 340 U.S. 474, 71 S.Ct. 456, 95 L.Ed. 456 (1951). RCW 34.04.130(6)(e) addresses the clearly erroneous standard of review for factual determinations “in view of the entire record.”

*Franklin County Sheriff's Offices*, 97 Wash.2d at 324, 646 P.2d 113. See also *Gibson v. Department of Employment Sec.*, 52 Wash.App. 211, 216, 758 P.2d 547 (1988) (“The duty of the reviewing court is to search the entire record for facts both supportive of and contrary to the agency's findings.”) Substantial evidence is evidence that is sufficient to persuade a fair-minded person of the truth or correctness of the matter. *King County v. Cent. Puget Sound Growth Mgmt. Hearings Bd.*, 142 Wash.2d 543, 553,

14 P.3d 133 (2000).

On mixed questions of law and fact, the Court independently determines the law, then applies it to the facts as found by the agency. *Hamel v. Employment Sec. Dep't*, 93 Wash.App. 140, 145, 966 P.2d 1282 (1998), *review denied*, 137 Wash.2d 1036, 980 P.2d 1283 (1999).

RCW 51.12.050 provides, in pertinent part:

In an appeal before the board, the appellant shall have the burden of proceeding with the evidence to establish a prima facie case for the relief sought in such appeal . . . Any such person aggrieved by the decision and order of the board may thereafter appeal to the superior court, as prescribed in this chapter.

RCW 51.52.115 provides, in pertinent part:

In all court proceedings under or pursuant to this title the findings and decision of the board shall be prima facie correct and the burden of proof shall be upon the party attacking the same.

However, where, as here, the material facts are not in dispute but the parties differ as to the conclusions to be drawn from the facts and as to the applicability of the statute, the rule that the decision of the Board shall be presumed to be prima facie correct does not apply on appeal to the courts. *Puget Sound Bridge & Dredging Co. v. Department of Labor and Industries*, 26 Wn.2d 550, 555, 174 P.2d 957 (1946), citing *Parker v. Department of Labor & Industries*, 14 Wn.2d 481, 486, 128 P.2d 497(1942).

**B. The Department of Labor and Industries erroneously interpreted and applied RCW 51.12.070.**

Since its amendment in 1981, no court has ever found that any provision of what is now RCW 51.12.070 is ambiguous. This Court's review of the Department's construction of the statute is therefore de novo and without deference to the Department's construction of RCW 51.12.070. *Pasco*, 119 Wash.2d at 504, 507, 509, 833 P.2d 381. Because construction of a statute is a question of law, there is no presumption that the Board's decision was correct. *St. Paul & Tacoma Lbr. Co.*, 19 Wash.2d at 641, 144 P.2d 250.

A court's objective in construing a statute is to determine the legislature's intent. *State v. Jacobs*, 154 Wash.2d 596, 600, 115 P.3d 281 (2005). “[I]f the statute's meaning is plain on its face, then the court must give effect to that plain meaning as an expression of legislative intent.” *Id.* (quoting *Dep't of Ecology v. Campbell & Gwinn, L.L.C.*, 146 Wash.2d 1, 9-10, 43 P.3d 4 (2002)). A statutory provision's plain meaning is to be discerned from the ordinary meaning of the language at issue, the context of the statute in which that provision is found, related provisions, and the statutory scheme as a whole. *Id.*

As noted in *Littlejohn Construction Company v. Department of Labor and Industries*, 74 Wn. App. 420, 424, 873 P.2d 583 (1994),

references to RCW 51.12.070 have been infrequent in appellate decisions.

The *Littlejohn* Court did, however, capture the Legislative intent and purpose of this section of the Industrial Insurance Act when it stated,

In 1981, the Legislature significantly amended RCW 51.12.070 by setting forth the circumstances in which a contractor would *not* be liable for industrial insurance premiums of subcontractors' employees. The Legislature eliminated liability only if the contractor and the subcontractor were (1) registered with the State pursuant to RCW 18.27 or licensed with the State pursuant to RCW 19.28 *and* if the subcontractor was (2) truly an independent contractor with its own principal place of business, as well as (3) separate books, and (4) contracted to perform work for the contractor.

*Littlejohn*, 74 Wn. App. at 427, 873 P.2d 583 (footnotes omitted; emphasis by Court).

It should be noted that these four elements are precisely what Mr. Lee established at the administrative hearing on October 6, 2005.

The Department, however, interpreted RCW 51.12.070(2) and (3) as requiring a contractor attempting to establish nonliability for his subcontractor's premiums to prove facts far beyond those set out in *Littlejohn*, *i.e.*, that the subcontractor's principal place of business was, in fact, eligible for a business deduction under the IRS code and that the subcontractor's separate books, in fact, reflected all items of income and expenses of the business.

Consideration of the plain language of the statute and of the

Industrial Insurance Act as a whole establishes that the Department incorrectly interpreted RCW 51.12.070(2) and (3).

1. A contractor seeking to establish nonliability for his subcontractor's premiums is not required to establish that the subcontractor's principal place of business was, **in fact**, eligible for a business deduction under the IRS code.

The meaning of RCW 51.12.070(2) must be discerned from the ordinary meaning of the language at issue, the context of the statute in which the provision is found, related provisions, and the statutory scheme, here, of the Industrial Insurance Act. *Jacobs*, 154 Wash.2d at 600, 115 P.3d 281.

Former RCW 51.12.070(2) provides that a registered contractor is not responsible for any premiums upon the work of any subcontractor if, *inter alia*,

The subcontractor has a principal place of business which would be eligible for a business deduction for internal revenue service tax purposes other than that furnished by the contractor for which the business has contracted to furnish services[.]

There is no requirement in RCW 51.12.070(2) that a contractor establish that the subcontractor's principal place of business is, **in fact**, eligible for a business deduction for internal revenue service tax purposes. As the *Littlejohn* Court suggested, a contractor need only prove that the subcontractor was truly an independent contractor with its own principal

place of business.

Considering the Industrial Insurance Act as a whole, the Court will find no provision authorizing a contractor to enter a subcontractor's residence to make a determination that a portion of the residence is, in fact, eligible for a business deduction under the IRS code, nor will the Court find any provision requiring a subcontractor to admit a contractor to his residence for that purpose. Further, the Court will find that the Department has not promulgated any rules authorizing a contractor to enter a subcontractor's residence or requiring a subcontractor to admit a contractor into his residence for that purpose. Finally, there is no statute or administrative rule requiring that contractors become experts or hire experts on IRS tax code provisions to make determinations of whether a subcontractor's residence is, in fact, eligible for a business deduction.

Based on the language of RCW 51.12.070(2) itself and consideration of the Industrial Insurance Act as a whole, it is clear that the Department incorrectly interpreted RCW 51.12.070(2) to require a contractor to establish that a subcontractor's principal place of business is, **in fact**, eligible for a business deduction under the IRS code. First, the plain language of RCW 51.12.070(2) does not support such a requirement; and second, there is no statutory or regulatory provision empowering a contractor to enter the residence of a subcontractor for that purpose or

requiring a subcontractor to admit a contractor for that purpose.

In *Murphy v. Campbell Inv. Co.*, 79 Wn.2d 417, 420, 486 P.2d 1080 (1971), the Court reiterated: “this court has long held that a thing within the letter of the law, but not within its spirit, may be held inoperative where it would otherwise lead to an absurd conclusion.” The conclusion that RCW 51.12.070(2) requires a contractor to become an expert on the intricacies of the federal tax code or to hire such an expert, then to enter the residence of a subcontractor to determine whether the subcontractor’s residence is, in fact, eligible for a business deduction is “absurd.” Yet, in the context of a hearing on “prime contractor liability,” there is no other way to obtain the evidence that the Department found was missing in Lee’s Drywall’s case. This Court should rule that the Department interpreted RCW 51.12.070(2) incorrectly in this case.

2. A contractor seeking to avoid responsibility for a subcontractor’s premiums is not required to prove that the subcontractor’s separate set of books, in fact, reflect all items of income and expenses of the subcontractor’s business.

Former RCW 51.12.070(3) provides that a registered contractor is not responsible for any premiums of a subcontractor if, inter alia, “[t]he subcontractor maintains a separate set of books or records that reflect all items of income and expenses of the business[.]” There is no requirement in RCW 51.12.070(3) that a contractor prove that a subcontractor’s books

**in fact** reflect all items of income and expenses of the subcontractor's business. All that the contractor needs to establish is the fact suggested by the *Littlejohn* Court: that the subcontractor keeps separate books from those of the contractor. *Littlejohn*, 74 Wn. App. at 427, 873 P.2d 583.

Consideration of the Industrial Insurance Act and of rules promulgated by the Department reveals that the Department is empowered to obtain the books and records of an employer, and employers are required to keep and provide their books and records when requested by the Department. See RCW 51.16.070, 51.48.040, WAC 296-128-025, and *R & G Probst v. Department of Labor and Industries*, 121 Wn. App. 288, 293-294, 88 P.3d 413, *review denied*, 152 Wn.2d 1034, 103 P.3d 201 (2004). However, there are no such provisions empowering contractors to obtain books and records of subcontractors, who may, in fact, be their own competitors.

There is no way to establish that a subcontractor's separate books and records, in fact, include all income and expenses of the subcontractor's business except to obtain those books and records. Only the Department<sup>1</sup> has authority to do so. To construe RCW 51.12.070(3) as requiring a contractor to present evidence that a subcontractor's books

---

<sup>1</sup> WAC 296-126-050(3) requires a subcontractor to make employment records available its own employees.

included all of the subcontractor's income and expenses is "absurd." The Court should rule that the Department incorrectly interpreted RCW 51.12.070(3).

**C. The Department incorrectly applied RCW 51.12.070(2) and (3), and resulting Findings of Fact No. 4 and 5 are not supported by substantial evidence in the whole record.**

Because the Department incorrectly interpreted RCW 51.12.070(2) and (3), it required Lee's Drywall to produce evidence that is neither required by the statute nor available to Lee's Drywall, and resulted in Findings of Fact that are not supported by substantial evidence.

1. There is not substantial evidence to support Finding of Fact Number 4.

Finding of Fact Number 4 states:

Sufficient evidence was not presented to establish that Zagy's Drywall maintained a separate set of books or records that reflect all items of income and expenses of its business during the second quarter of 2003.

AR 26.

When the whole record is considered, the evidence that Zagy's Drywall maintained a separate set of books includes Mr. Lee's testimony and documentary evidence that he received invoices from Zagy's Drywall which he checked against his own records of work performed by Zagy's Drywall and that he paid Zagy's Drywall with checks in accord with the

invoices. TR 37-38. In addition, Lynda Wilcox testified that Mr. Guerrero “did his books and records on his kitchen table, which didn’t qualify for an IRS deduction since it was used for other than just his – the books and records of his company.” TR 112. Clearly, when viewed in its entirety, the record establishes that Zagy’s Drywall had a set of books separate from the books of Lee’s Drywall.

The evidence also established that, after receiving insufficient records for auditing purposes from Mr. Guerrero personally, Ms. Wilcox failed to conduct any further investigation of Zagy’s Drywall’s books and records to determine whether those books and records “reflect[ed] all items of income and expenses” of Zagy’s Drywall pursuant to RCW 51.12.070(3). TR 117. The record also indicates that Ms. Wilcox was aware that the Department – but **not** the prime contractor – had authority to audit employers’ books and to subpoena all of the books and records of Zagy’s Drywall. TR 119; TR 126 (when asked how “a prime contractor is supposed to have the authority to secure such records from subcontractors,” Ms. Wilcox, an L&I auditor with 20 years of experience, responded, “I wouldn’t know.”). TR 126.

In spite of its explicit authority to inspect an employer’s records granted in RCW 51.16.070, 51.48.040, and WAC 296-128-025, and in spite of its ability to command production of an employer’s records by

subpoena (*see R & G Probst*, 121 Wn. App. at 293-294, 88 P.3d 413 (2004), the Department did not subpoena Zagy's Drywall books and records, and presented no evidence whatsoever that the books and records of Zagy's Drywall did **not** include "all items of income and expenses."

There is no authority granted to one employer to inspect, audit, or subpoena another employer's books either by statute or by administrative regulation promulgated by the Department of Labor and Industries. Clearly, without any legal authority to obtain such information, Lee's Drywall could not present evidence establishing whether the books and records of Zagy's Drywall included "all items of income and expenses."

The Department, however, does have authority to obtain that information and, in the context of a hearing to determine whether an employer must pay the premiums of a subcontractor, the Department alone has the ability to present such evidence. The Legislature authorized the Department to inspect, audit, or subpoena an employer's books and records, but did not authorize an employer to do the same. Without such authority, a contractor has no ability to inspect, audit, or obtain the books and records of a subcontractor.

Instead of ruling that Lee's Drywall failed to present sufficient evidence that Zagy's Drywall maintained a separate set of books including all items of income and expenses, the administrative law judge should

have ruled that the Department failed to present sufficient evidence that Zagy's Drywall books and records did **not** include all items of income and expenses.

Looking at the record as a whole, there is not substantial evidence to support Finding of Fact Number 4. The evidence established that Zagy's Drywall had a set of books and records separate from the books and records of Lee's Drywall, and the Department – the only party with the ability to do so – failed to show that Zagy's Drywall books and records did **not** include all items of income and expenses.

2. There is not substantial evidence to support Finding of Fact Number 5.

Finding of Fact Number 5 states:

Sufficient evidence was not presented to establish that Zagy's Drywall had a principal place of business which would be eligible for a business deduction for IRS tax purposes other than that furnished by the contractor for which the business had contracted to furnish services during the second quarter of 2003.

AR 26.

The plain and unambiguous language of RCW 51.12.070(2) sets out one of the requirements which must be shown to excuse a contractor from being responsible for premiums of a subcontractor:

[t]he subcontractor has a principal place of business which **would be** eligible for a business deduction for internal revenue service tax purposes **other than that furnished by**

**the contractor** for which the business has contracted to furnish services.

(Emphasis added.) The language of the statute does not require that a contractor establish that the subcontractor's principal place of business was, **in fact**, eligible for a business deduction, but that such place of business was separate from that of the contractor's place of business.

Mr. Lee testified that Zagy's Drywall was not housed within Lee's Drywall, located in Sumner, and presented numerous documents showing that the business address of Zagy's Drywall was in Federal Way, thus establishing that Zagy's Drywall had a principal place of business which was "other than" Lee's Drywall. TR 37; Ex. 1 and 2.

Judge Stockwell's finding that sufficient evidence was not presented to establish that Zagy's Drywall had a principal place of business "which would be eligible for a business deduction for internal revenue service tax purposes" was based upon Lynda Wilcox's testimony that "Mr. Guerrero did his books at his kitchen table; therefore, the use of his kitchen table to do his bookwork precludes any finding that any other portion of his home qualified for the deduction." AR 24-25.

This is a mischaracterization of Ms. Wilcox's testimony as well as a misstatement of tax law: what Ms. Wilcox actually stated was that Mr. Guerrero "did his books and records on the kitchen table, which didn't

qualify for an IRS deduction since it was used for other than just his – the books and records of his company.” TR 112. Ms. Wilcox testified that “the kitchen table” did not “qualify for an IRS deduction.” *Id.* Ms. Wilcox also testified that she is not a CPA and is neither trained in the IRS tax code nor an expert in interpretation of the provisions of the IRS code. TR 133.

26 U.S.C. § 280A (a) states the general rule that “no deduction otherwise allowable under this chapter shall be allowed with respect to the use of a dwelling unit which is used by the taxpayer during the taxable year as a residence.” 26 U.S.C. § 280A (c)(1) sets out an exception to the general rule: a deduction is allowable to the extent it is “allocable to a portion of the dwelling unit which is exclusively used on a regular basis – (A) as the principal place of business for any trade or business of the taxpayer.” 26 U.S.C. § 280A (c)(1)(C) continues:

For purposes of subparagraph (A), the term “principal place of business” includes a place of business which is used by the taxpayer for the administrative or management activities of any trade or business of the taxpayer if there is no other fixed location of such trade or business where the taxpayer conducts substantial administrative or management activities of such trade or business.

Thus, under IRS Code, a subcontractor’s residence may be his principal place of business if it (or some portion of it) is used for the administrative or management activities of his business and there is no

other fixed location of such business where the subcontractor conducts substantial administrative or management activities of such trade. The record reveals that Mr. Guerrero did his administrative work for Zagy's Drywall in his residence, and there was no evidence whatsoever that he performed such activity at any other fixed location. His residence or some portion thereof, then, "would be" eligible for a business deduction for internal revenue tax purposes. This is all that is required under the plain language of RCW 51.12.070.

Lee's Drywall was not required, under the statute, to establish that all or some portion of Mr. Guerrero's residence was, **in fact**, eligible for a business deduction. Further, the fact that Mr. Guerrero's "kitchen table" was not used exclusively for Zagy's Drywall administrative purposes does not establish that no portion of his residence was eligible for a business deduction.

Similar to the separate set of books requirement discussed above, a contractor has no legal authority to enter the residence of a subcontractor to conduct an inspection to determine whether some portion of the residence is, in fact, used exclusively for business purposes, and is, in fact, eligible for a business deduction. Nor is there any statutory requirement that contractors must become experts in interpretation and application of the IRS code. As this Court has written, "We construe statutes to avoid

strained or absurd results.” *State v. Tracy*, 128 Wn. App. 388, 395, 115 P.3d 381 (2005) (citing *Strain v. W. Travel, Inc.*, 117 Wn. App. 251, 254, 70 P.3d 158 (2003), *review denied*, 150 Wn.2d 1029, 82 P.3d 243 (2004).

Under 26 U.S.C. § 280A, Mr. Guerrero’s residence “would be” eligible for a business deduction if some portion thereof was used exclusively for Zagy’s Drywall purposes. Because Mr. Lee provided uncontroverted documentary evidence of the business address of Zagy’s Drywall, and because that business address was separate from Lee’s Drywall, and because a residence or some portion thereof “would be” eligible for a business deduction provided Mr. Guerrero complied with provisions the IRS code, there is not substantial evidence in the record to support Finding of Fact Number 5.

**D. The Department failed to fulfill its statutory duties pertaining to collection of premiums from Zagy’s Drywall.**

RCW 51.16.200 provides, in pertinent part:

Whenever any employer quits business, or sells out, exchanges, or otherwise disposes of the employer’s business or stock of goods, **any tax payable hereunder shall become immediately due and payable, and the employer shall, within ten days thereafter, make a return and pay the tax due; and any person who becomes a successor to such business shall become liable for the full amount of the tax** and withhold from the purchase price a sum sufficient to pay any tax due from the employer until such time as the employer shall produce a receipt from the department showing payment in full of any

tax due or a certificate that no tax is due and, if such tax is not paid by the employer within ten days from the date of such sale, exchange, or disposal, the successor shall become liable for the payment of the full amount of tax, and the payment thereof by such successor shall, to the extent thereof, be deemed a payment upon the purchase price, and if such payment is greater in amount than the purchase price the amount of the difference shall become a debt due such successor from the employer . . . .

(Emphasis added.)

In September of 2003, Zagy's Drywall was closed and Mr. Guerrero went out of business as Zagy's Drywall. TR 130. Exhibit 8 reveals that the L&I specialty contractor license issued to Zagy's Drywall was suspended on September 2, 2003. Ms. Wilcox testified that Mr. Guerrero brought his Zagy's Drywall records to her office "sometime in the summer of 2004" and that she was aware that the Zagy's Drywall license "had expired or was suspended." TR 130; TR 128. The first notice that Lee's Drywall had that Zagy's Drywall had not paid its premiums for the second quarter of 2003 was in January of 2005. TR 102. Exhibit 8 also reveals that a new specialty contractor license was issued to a G M Drywall on February 22, 2005, which business was owned by Mr. Guerrero, with the place of business listed in Federal Way, Washington.

Ms. Wilcox stated that "[t]he employer can open a new UBI number and start a new business, but we do have successorship laws and ways to track that and to review that if we know that they have started a

new business.” TR 129. Indeed, in *In re: BLC Trucking, Inc.*, Docket No. 98 11140, 2000 WL 767815, the Department on July 10, 1997, assessed BLC Trucking as the successor of Pacific Transportation Group, Inc., for industrial insurance taxes owed by Pacific Transportation for the second quarter of 1992 through the first quarter of 1996. The Board of Industrial Insurance Appeals noted in that decision, “RCW 51.16.200 provides that a successor **shall** become liable for the full amount of the tax.” *Id.* at \*2 (emphasis added). In this case, the Department did nothing to attempt to collect the second quarter 2003 premiums from G M Contracting, the successor to Zagy’s Drywall.

Neither did the Department seek payment of the second quarter 2003 premiums from Zagy’s Drywall in “action at law in the name of the state as plaintiff” pursuant to RCW 51.16.150.

Instead, Ms. Wilcox testified that “the only things” she reviewed before issuing the Certificate of Audited Prime Contractor Liability were “whatever records that Mr. Guerrero for Zagy’s Drywall showed [her] in [her] office on a particular day and the report from Lee’s Drywall containing the subcontractor report for hangers for the second quarter of 2003” because “there wasn’t any additional information that [she] needed.” TR 117.

While former RCW 51.12.070 does state that the “primary and

direct” responsibility for all premiums lies with the firm that lets a contract, it also provides that a registered contractor has no responsibility for premiums of a registered subcontractor who performs work described in RCW 18.27.010 and chapter 19.28 RCW, has a principal place of business separate from that of the contractor, and maintains a set of books or records separate from that of the contractor.

The Court should rule that the Industrial Insurance Act requires that the Department at a minimum take the actions authorized under the Act to collect premiums from an independent subcontractor or its successor before assessing the “prime contractor” for an amount owed to the State fund by the subcontractor. A finding that the Department need make no efforts to collect premiums from a subcontractor, but can merely fall back on RCW 51.12.070 to assess “prime contractor liability” would render much of RCW 51.12.070 a nullity.

**E. The Department of Labor and Industries improperly implemented new rules without complying with rule making procedures.**

Whether a contractor is required to establish that a subcontractor’s principal place of business is **in fact** eligible for a business deduction under the IRS code and/or establish that the subcontractor maintained a separate set of books that **in fact** included all income and expense of the subcontractor’s business in order to avoid responsibility for the

subcontractor's premiums has never been considered in a published (or unpublished) appellate case, even though former RCW 51.12.070 was adopted in 1981.

In spite of the fact that the former statute was 24 years old when the Department decided that Lee's Drywall would be required to provide such evidence, there is only one other Department decision requiring such evidence, handed down in 2006. *See In re: Interior Drywall Systems, Inc.*, Docket No. 05-17035, 2006 WL 2954307 at \*2 (imposing liability on contractor because subcontractor "did not have a principal place of business that would be eligible for a business deduction for Internal Revenue Service tax purposes and did not maintain a separate set of books or records that reflected all items of income and expense of the business.").

On April 5, 2005, the Department sent to Lee's Drywall (and presumably, to all contractors) a notice or information sheet entitled "Prime Contractor Liability in the Construction Industry." Ex. 12; *see also* TR 125. There is no statute in existence and the Department has promulgated no administrative rules that authorize a contractor to enter a subcontractor's residence to determine eligibility for a business deduction under the IRS code or to obtain a subcontractor's books to determine whether they include all income and expenses of the subcontractor's

business.

In spite of these facts, the information sheet states: "You have a right to examine and verify a subcontractor's books and records and their place of business." Ex. 12. The information sheet does not identify the source of this "right," nor does any such "right" exist. The information sheet also states, "Assurance that a subcontractor maintains the required records and maintains a principal place of business can only be achieved by physical verification by you or your representative (For example your accountant)." Ex. 12.

Because Lee's Drywall had not physically verified Zagy's Drywall records or its principal place of business, the Department ruled that he had failed to satisfy the requirements of RCW 51.12.070 (2) and (3). Effectively, the Department has developed new rules without engaging in the rulemaking procedure required by the APA.

"Rule" means any agency order, directive, or regulation of general applicability (a) the violation of which subjects a person to a penalty or administrative sanction; (b) which establishes, alters, or revokes any procedure, practice, or requirement relating to agency hearings; (c) which establishes, alters, or revokes any qualification or requirement relating to the enjoyment of benefits or privileges conferred by law; (d) which establishes, alters, or revokes any qualifications or standards for the issuance, suspension, or revocation of licenses to pursue any commercial activity, trade, or profession; or (e) which establishes, alters, or revokes any mandatory standards for any product or material which must be met before

distribution or sale.

RCW 34.05.010(16).

Here, the “physical verification” requirements announced in the information sheet sent to Mr. Lee are “rules” because they are “of general applicability, and (a) failure to comply with the new requirements subjects a contractor to liability for a subcontractor’s industrial insurance premiums; (b) the new requirements establish and/or alter the type and amount of evidence required at an agency hearing on “prime contractor liability”; and (c) the new requirements establish and/or alter the long-standing factors which a contractor must establish to avoid responsibility for a subcontractor’s premiums.

The Department’s new rules add additional requirements to RCW 51.12.070: a contractor must “physically” verify that a subcontractor’s principal place of business is, in fact, eligible for a business deduction under the IRS code, and a contractor must “physically” verify that a subcontractor’s books, in fact, include all income and expense of the subcontractor’s business in order to avoid “prime contractor liability.”

These additional requirements are “rules” under the APA definition that required compliance with rule making procedures. “The ‘remedy when an agency has made a decision which should have been made after engaging in rule making procedures is invalidation of the

action.”” *Budget Rent a Car Corporation v. State, Department of Licensing*, 144 Wn.2d 889, 895, 31 P.3d 1174 (2001) (quoting *Hillis v. Dep’t of Ecology*, 131 Wn.2d 373, 399-400, 932 P.2d 139 (1997)); RCW 34.05.570(2)(c). The Court should invalidate the “rules” set out in the information sheet in Exhibit 12 as well as the assessment of “prime contractor liability” against Lee’s Drywall.

**F. The Department’s new “rules” are unconstitutional on their face and as applied to Lee’s Drywall in this case.**

1. The rules requiring “physical verification” by a contractor violate the constitutional right to privacy.

The Washington State Constitution requires that “[n]o person shall be disturbed in his private affairs, or his home invaded, without authority of law.” Washington Constitution art. I, § 7. This provision protects “those privacy interests which citizens of this state have held, and should be entitled to hold, safe from governmental trespass absent a warrant.” *State v. Myrick*, 102 Wn.2d 506, 511, 688 P.2d 151 (1984).

While “[o]nly governmental intrusion into individual privacy falls within this prohibition” (*Robinson v. City of Seattle*, 102 Wash.App. 795, 808-809, 10 P.3d 452 (2000)), a private individual complying with the new “rules” created by the Department of Labor and Industries would be carrying out an activity required by the government, i.e., would be acting as an instrumentality or agent of the government. An intrusion into the

home of a subcontractor by a contractor attempting to comply with the new “rules” should be considered a “governmental intrusion.”

The new rules require a contractor seeking to avoid responsibility for a subcontractor’s premiums pursuant to RCW 51.12.070 to physically enter the residence of a subcontractor in order to comply with the rules. *See Ex. 12* (“Assurance that a subcontractor maintains the required records and maintains a principal place of business can only be achieved by physical verification by you or your representative (For example your accountant).” There is no authority in law for such entry into a subcontractor’s home, and no warrant would be issued for this purpose. In effect, the new rules require a contractor to violate article 1, section 7 of the Washington State Constitution.

The requirement that a contractor “physically verify” that a subcontractor’s books and records include all income and expenses of the subcontractor’s business also violates article 1, section 7 of the Washington Constitution, which guarantees that no person’s “private affairs” will be invaded without authority of law. Private accounting records and books are “private affairs” subject to constitutional protection. *See, e.g., Harstad v. Metcalf*, 56 Wash.2d 239, 242, 351 P.2d 1037 (1960); *Hardman v. Brown*, 153 Wn. 85, 88-89, 279 P. 91 (1929).

In effect, the Department’s new “rules” require contractors to

conduct illegal exploratory searches of a subcontractor's home if that is the subcontractor's principal place of business and of a subcontractor's private accounting books and records in order to avoid responsibility for a subcontractor's premiums under RCW 51.12.070. This Court should declare the new "rules" unconstitutional on their face because they violate the constitutional right to privacy in one's home and in their "private affairs."

2. The new "rules" substantially impaired the contract between Lee's Drywall and Zagy's Drywall which required Zagy's Drywall to pay premiums for work done by its own employees.

The contract clauses of the federal and state constitutions both prohibit legislative action that substantially impairs the obligation of contracts. U.S. Const. art. I, § 10; Washington Const. art. I, § 23. Substantial impairment will be found where the complaining party relied on the supplanted part of the contract and on existing state law pertaining to the contract's enforcement. *Margola Assocs. v. City of Seattle*, 121 Wash.2d 625, 653, 854 P.2d 23 (1993).

The agreement between Lee's Drywall and Zagy's Drywall included a provision that Zagy's Drywall would pay the premiums on the work done by its own employees. This arrangement is authorized because Zagy's Drywall was a registered subcontractor subject to Title 51, just as

was Lee's Drywall. RCW 51.12.070. Under the statute, Lee's Drywall was not responsible for premiums on the work of Zagy's Drywall because Zagy's Drywall was a registered subcontractor doing work of a contractor as defined in RCW 18.27.010, had its own principal place of business, and maintained a separate set of books or records. RCW 51.12.070. Lee's Drywall relied on the provision of its agreement with Zagy's Drywall that Zagy's Drywall would pay its own premiums, and relied on RCW 51.12.070 for enforcement of that provision.

The Department's new "rules" requiring Lee's Drywall to physically verify additional facts before being excused from responsibility for Zagy's Drywall's premiums substantially impaired the agreement between Lee's Drywall and Zagy's Drywall in violation of the contracts clause of both the Washington Constitution and the federal constitution. For this reason, the Court should find that the new "rules" are unconstitutional as applied to Lee's Drywall in this case.

## **VI. CONCLUSION**

The Department incorrectly interpreted RCW 51.12.070, incorrectly applied RCW 51.12.070, made findings of fact that are not supported by substantial evidence in the record, failed to take actions authorized by statute against Zagy's Drywall or its successor to collect premiums owed by Zagy's Drywall, and created new "rules" without

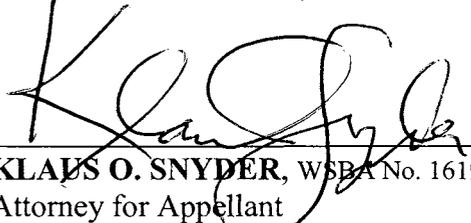
following rule-making procedures required under the APA, which new rules violate constitutional protections against invasion of privacy in one's home and private affairs and impairment of contracts.

The Court should invalidate the assessment against Lee's Drywall for premiums owed by Zagy's Drywall, rule that the Department's new "rules" are invalid, and reverse the Department's decision that Lee's Drywall failed to present sufficient evidence under RCW 51.12.070(2) and (3) to be excused from responsibility for the premiums owed by Zagy's Drywall.

DATED this 20<sup>th</sup> day of March, 2007.

Respectfully submitted,

**SNYDER LAW FIRM, LLC**



**KLAUS O. SNYDER**, WSBA No. 16195  
Attorney for Appellant

## APPENDIX

### **U.S. Const. art. I, § 10-Powers Prohibited of States**

No state shall enter into any treaty, alliance, or confederation; grant letters of marque and reprisal; coin money; emit bills of credit; make anything but gold and silver coin a tender in payment of debts; pass any bill of attainder, ex post facto law, or law impairing the obligation of contracts, or grant any title of nobility.

No state shall, without the consent of the Congress, lay any imposts or duties on imports or exports, except what may be absolutely necessary for executing its inspection laws: and the net produce of all duties and imposts, laid by any state on imports or exports, shall be for the use of the treasury of the United States; and all such laws shall be subject to the revision and control of the Congress.

No state shall, without the consent of Congress, lay any duty of tonnage, keep troops, or ships of war in time of peace, enter into any agreement or compact with another state, or with a foreign power, or engage in war, unless actually invaded, or in such imminent danger as will not admit of delay.

**26 U.S.C. § 280A-Disallowance of certain expenses in connection with business use of home, rental of vacation homes, etc.**

(a) General rule.--Except as otherwise provided in this section, in the case of a taxpayer who is an individual or an S corporation, no deduction otherwise allowable under this chapter shall be allowed with respect to the use of a dwelling unit which is used by the taxpayer during the taxable year as a residence.

(b) Exception for interest, taxes, casualty losses, etc.--Subsection (a) shall not apply to any deduction allowable to the taxpayer without regard to its connection with his trade or business (or with his income-producing activity).

(c) Exceptions for certain business or rental use; limitation on deductions for such use.--(1) Certain business use.--Subsection (a) shall not apply to any item to the extent such item is allocable to a portion of the dwelling unit which is exclusively used on a regular basis

(A) as the principal place of business for any trade or business of the taxpayer,

(B) as a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business, or

(C) in the case of a separate structure which is not attached to the dwelling unit, in connection with the taxpayer's trade or business.

In the case of an employee, the preceding sentence shall apply only if the exclusive use referred to in the preceding sentence is for the convenience of his employer. For purposes of subparagraph (A), the term "principal place of business" includes a place of business which is used by the taxpayer for the administrative or management activities of any trade or business of the taxpayer if there is no other fixed location of such trade or business where the taxpayer conducts substantial administrative or management activities of such trade or business.

(2) Certain storage use.--Subsection (a) shall not apply to any item to the extent such item is allocable to space within the dwelling

unit which is used on a regular basis as a storage unit for the inventory or product samples of the taxpayer held for use in the taxpayer's trade or business of selling products at retail or wholesale, but only if the dwelling unit is the sole fixed location of such trade or business.

(3) Rental use.--Subsection (a) shall not apply to any item which is attributable to the rental of the dwelling unit or portion thereof (determined after the application of subsection (e)).

(4) Use in providing day care services.

(A) In general.--Subsection (a) shall not apply to any item to the extent that such item is allocable to the use of any portion of the dwelling unit on a regular basis in the taxpayer's trade or business of providing day care for children, for individuals who have attained age 65, or for individuals who are physically or mentally incapable of caring for themselves.

(B) Licensing, etc., requirement.--Subparagraph (A) shall apply to items accruing for a period only if the owner or operator of the trade or business referred to in subparagraph (A)

(i) has applied for (and such application has not been rejected),  
(ii) has been granted (and such granting has not been revoked), or  
(iii) is exempt from having, a license, certification, registration, or approval as a day care center or as a family or group day care home under the provisions of any applicable State law. This subparagraph shall apply only to items accruing in periods beginning on or after the first day of the first month which begins more than 90 days after the date of the enactment of the Tax Reduction and Simplification Act of 1977.

(C) Allocation formula.--If a portion of the taxpayer's dwelling unit used for the purposes described in subparagraph (A) is not used exclusively for those purposes, the amount of the expenses attributable to that portion shall not exceed an amount which bears the same ratio to the total amount of the items allocable to such portion as the number of hours the portion is used for such purposes bears to the number of hours the portion is available for use.

(5) Limitation on deductions.--In the case of a use described in paragraph (1), (2), or (4), and in the case of a use described in paragraph (3) where the dwelling unit is used by the taxpayer during the taxable year as a residence, the deductions allowed

under this chapter for the taxable year by reason of being attributed to such use shall not exceed the excess of

(A) the gross income derived from such use for the taxable year, over

(B) the sum of

(i) the deductions allocable to such use which are allowable under this chapter for the taxable year whether or not such unit (or portion thereof) was so used, and

(ii) the deductions allocable to the trade or business (or rental activity) in which such use occurs (but which are not allocable to such use) for such taxable year.

Any amount not allowable as a deduction under this chapter by reason of the preceding sentence shall be taken into account as a deduction (allocable to such use) under this chapter for the succeeding taxable year. Any amount taken into account for any taxable year under the preceding sentence shall be subject to the limitation of the 1st sentence of this paragraph whether or not the dwelling unit is used as a residence during such taxable year.

(6) Treatment of rental to employer.--Paragraphs (1) and (3) shall not apply to any item which is attributable to the rental of the dwelling unit (or any portion thereof) by the taxpayer to his employer during any period in which the taxpayer uses the dwelling unit (or portion) in performing services as an employee of the employer.

(d) Use as residence.--

(1) In general.--For purposes of this section, a taxpayer uses a dwelling unit during the taxable year as a residence if he uses such unit (or portion thereof) for personal purposes for a number of days which exceeds the greater of--

(A) 14 days, or

(B) 10 percent of the number of days during such year for which such unit is rented at a fair rental.

For purposes of subparagraph (B), a unit shall not be treated as rented at a fair rental for any day for which it is used for personal purposes.

(2) Personal use of unit.--For purposes of this section, the taxpayer shall be deemed to have used a dwelling unit for personal purposes for a day if, for any part of such day, the unit is used--

(A) for personal purposes by the taxpayer or any other person who has an interest in such unit, or by any member of the family (as defined in section 267(c)(4)) of the taxpayer or such other person;

(B) by any individual who uses the unit under an arrangement which enables the taxpayer to use some other dwelling unit (whether or not a rental is charged for the use of such other unit);  
or

(C) by any individual (other than an employee with respect to whose use section 119 applies), unless for such day the dwelling unit is rented for a rental which, under the facts and circumstances, is fair rental.

The Secretary shall prescribe regulations with respect to the circumstances under which use of the unit for repairs and annual maintenance will not constitute personal use under this paragraph, except that if the taxpayer is engaged in repair and maintenance on a substantially full time basis for any day, such authority shall not allow the Secretary to treat a dwelling unit as being used for personal use by the taxpayer on such day merely because other individuals who are on the premises on such day are not so engaged.

(3) Rental to family member, etc., for use as principal residence.--

(A) In general.--A taxpayer shall not be treated as using a dwelling unit for personal purposes by reason of a rental arrangement for any period if for such period such dwelling unit is rented, at a fair rental, to any person for use as such person's principal residence.

(B) Special rules for rental to person having interest in unit.--

(i) Rental must be pursuant to shared equity financing agreement.-  
- Subparagraph (A) shall apply to a rental to a person who has an interest in the dwelling unit only if such rental is pursuant to a shared equity financing agreement.

(ii) Determination of fair rental.--In the case of a rental pursuant to a shared equity financing agreement, fair rental shall be determined as of the time the agreement is entered into and by taking into account the occupant's qualified ownership interest.

(C) Shared equity financing agreement.--For purposes of this paragraph, the term "shared equity financing agreement" means an agreement under which--

(i) 2 or more persons acquire qualified ownership interests in a dwelling unit, and

(ii) the person (or persons) holding 1 or more of such interests--

(I) is entitled to occupy the dwelling unit for use as a principal residence, and

(II) is required to pay rent to 1 or more other persons holding qualified ownership interests in the dwelling unit.

(D) Qualified ownership interest.--For purposes of this paragraph, the term "qualified ownership interest" means an undivided interest for more than 50 years in the entire dwelling unit and appurtenant land being acquired in the transaction to which the shared equity financing agreement relates.

(4) Rental of principal residence.--

(A) In general.--For purposes of applying subsection (c)(5) to deductions allocable to a qualified rental period, a taxpayer shall not be considered to have used a dwelling unit for personal purposes for any day during the taxable year which occurs before or after a qualified rental period described in subparagraph (B)(i), or before a qualified rental period described in subparagraph (B)(ii), if with respect to such day such unit constitutes the principal residence (within the meaning of section 121) of the taxpayer.

(B) Qualified rental period.--For purposes of subparagraph (A), the term "qualified rental period" means a consecutive period of--

(i) 12 or more months which begins or ends in such taxable year, or

(ii) less than 12 months which begins in such taxable year and at the end of which such dwelling unit is sold or exchanged, and for which such unit is rented, or is held for rental, at a fair rental.

(e) Expenses attributable to rental.--

(1) In general.--In any case where a taxpayer who is an individual or an S corporation uses a dwelling unit for personal purposes on any day during the taxable year (whether or not he is treated under this section as using such unit as a residence), the amount deductible under this chapter with respect to expenses attributable to the rental of the unit (or portion thereof) for the taxable year

shall not exceed an amount which bears the same relationship to such expenses as the number of days during each year that the unit (or portion thereof) is rented at a fair rental bears to the total number of days during such year that the unit (or portion thereof) is used.

(2) Exception for deductions otherwise allowable.--This subsection shall not apply with respect to deductions which would be allowable under this chapter for the taxable year whether or not such unit (or portion thereof) was rented.

(f) Definitions and special rules.--

(1) Dwelling unit defined.--For purposes of this section--

(A) In general.--The term "dwelling unit" includes a house, apartment, condominium, mobile home, boat, or similar property, and all structures or other property appurtenant to such dwelling unit.

(B) Exception.--The term "dwelling unit" does not include that portion of a unit which is used exclusively as a hotel, motel, inn, or similar establishment.

(2) Personal use by shareholders of S corporation.--In the case of an S corporation, subparagraphs (A) and (B) of subsection (d)(2) shall be applied by substituting "any shareholder of the S corporation" for "the taxpayer" each place it appears.

(3) Coordination with section 183.--If subsection (a) applies with respect to any dwelling unit (or portion thereof) for the taxable year--

(A) section 183 (relating to activities not engaged in for profit) shall not apply to such unit (or portion thereof) for such year, but

(B) such year shall be taken into account as a taxable year for purposes of applying subsection (d) of section 183 (relating to 5-year presumption).

(4) Coordination with section 162(a)(2).--Nothing in this section shall be construed to disallow any deduction allowable under section 162(a)(2) (or any deduction which meets the tests of section 162(a)(2) but is allowable under another provision of this title) by reason of the taxpayer's being away from home in the pursuit of a trade or business (other than the trade or business of renting dwelling units).

(g) Special rule for certain rental use.--Notwithstanding any other provision of this section or section 183, if a dwelling unit is used during the taxable year by the taxpayer as a residence and such dwelling unit is actually rented for less than 15 days during the taxable year, then--

- (1) no deduction otherwise allowable under this chapter because of the rental use of such dwelling unit shall be allowed, and
- (2) the income derived from such use for the taxable year shall not be included in the gross income of such taxpayer under section 61.

**Washington Constitution Art. I, § 7**

**Invasion of Private Affairs or Home Prohibited**

No person shall be disturbed in his private affairs, or his home invaded, without authority of law.

**Washington Constitution Art. I, § 23**

**Bill of Attainder, Ex Post Facto Law, Etc.**

No bill of attainder, ex post facto law, or law impairing the obligations of contracts shall ever be passed.

**RCW 51.16.070-Employer's records-Unified business identifier-Confidentiality.**

(1)(a) Every employer shall keep at his place of business a record of his employment from which the information needed by the department may be obtained and such record shall at all times be open to the inspection of the director, supervisor of industrial insurance, or the traveling auditors, agents, or assistants of the department, as provided in RCW 51.48.040.

(b) An employer who contracts with another person or entity for work subject to chapter 18.27 or 19.28 RCW shall obtain and preserve a record of the unified business identifier account number for the person or entity performing the work. Failure to obtain or maintain the record is subject to RCW 39.06.010 and to a penalty under RCW 51.48.030.

(2) Information obtained from employing unit records under the provisions of this title shall be deemed confidential and shall not be open to public inspection (other than to public employees in the performance of their official duties), but any interested party shall be supplied with information from such records to the extent necessary for the proper presentation of the case in question: PROVIDED, That any employing unit may authorize inspection of its records by written consent.

**RCW 51.16.200-Payment of tax by employer quitting business-  
Liability of successor.**

Whenever any employer quits business, or sells out, exchanges, or otherwise disposes of the employer's business or stock of goods, any tax payable hereunder shall become immediately due and payable, and the employer shall, within ten days thereafter, make a return and pay the tax due; and any person who becomes a successor to such business shall become liable for the full amount of the tax and withhold from the purchase price a sum sufficient to pay any tax due from the employer until such time as the employer shall produce a receipt from the department showing payment in full of any tax due or a certificate that no tax is due and, if such tax is not paid by the employer within ten days from the date of such sale, exchange, or disposal, the successor shall become liable for the payment of the full amount of tax, and the payment thereof by such successor shall, to the extent thereof, be deemed a payment upon the purchase price, and if such payment is greater in amount than the purchase price the amount of the difference shall become a debt due such successor from the employer.

No successor may be liable for any tax due from the person from whom the successor has acquired a business or stock of goods if the successor gives written notice to the department of such acquisition and no assessment is issued by the department within one hundred eighty days of receipt of such notice against the former operator of the business and a copy thereof mailed to such successor.

**RCW 51.48.040-Inspection of employer's records.**

(1) The books, records and payrolls of the employer pertinent to the administration of this title shall always be open to inspection by the department or its traveling auditor, agent or assistant, for the purpose of ascertaining the correctness of the payroll, the persons employed, and such other information as may be necessary for the department and its management under this title.

(2) Refusal on the part of the employer to submit his or her books, records and payrolls for such inspection to the department,

or any assistant presenting written authority from the director, shall subject the offending employer to a penalty determined by the director but not to exceed two hundred fifty dollars for each offense and the individual who personally gives such refusal is guilty of a misdemeanor.

(3) Any employer who fails to allow adequate inspection in accordance with the requirements of this section is subject to having its certificate of coverage revoked by order of the department and is forever barred from questioning in any proceeding in front of the board of industrial insurance appeals or any court, the correctness of any assessment by the department based on any period for which such records have not been produced for inspection.

**WAC 296-126-050-Employment Records.**

- (1) Every employer shall keep for at least three years a record of the name, address, and occupation of each employee, dates of employment, rate or rates of pay, amount paid each pay period to each such employee and the hours worked.
- (2) Every employer shall make the record described in subsection (1) available to the employee, upon request, at any reasonable time.
- (3) Every employer shall, upon written request by the employee, furnish within ten working days of the request to each employee who is discharged a signed written statement, setting forth the reasons for such discharge and the effective date thereof.

**WAC 296-128-025-Place for keeping records and availability for inspection.**

Each employer shall keep the records required by this regulation safe and accessible at the place or places of employment or at one or more established central recordkeeping offices where such records are customarily maintained. All such records shall be open at any time to inspection and transcription or copying by the director and his duly authorized representative and to the employee, upon request for that employee's work record, at any reasonable time.

1  
2  
3  
4  
5  
6  
7  
8  
9  
10  
11  
12  
13  
14  
15  
16  
17  
18  
19  
20  
21  
22  
23  
24  
25  
26  
27  
28  
29  
30  
31  
32  
33  
34  
35  
36  
37  
38  
39  
40  
41  
42  
43  
44  
45  
46

07 MAR 21 AM 10:19  
STATE OF WASHINGTON  
BY \_\_\_\_\_  
DEPUTY

COURT OF APPEALS  
DIVISION II

COURT OF APPEALS, DIVISION II  
OF THE STATE OF WASHINGTON

**LEE'S DRYWALL CO., INC., a**  
Washington corporation,  
  
Appellant,  
  
vs.  
  
**STATE OF WASHINGTON,**  
**DEPARTMENT OF LABOR &**  
**INDUSTRIES,**  
  
Respondent.

No. **35613-9-II**

**DECLARATION OF SERVICE**

Pursuant to RAP 5.4(b), I hereby certify that on March 20<sup>th</sup>, 2007, I caused a true and correct copy of the **Opening Brief of Appellant** to be served on the following listed counsel of record:

James W. Johnson  
Assistant Attorney General  
Labor & Industries Division  
7141 Cleanwater Dr. SW  
Olympia WA 98504  
Ph: 360.586.7728 / Fax 360.584.7717  
[jamesj@atg.wa.gov](mailto:jamesj@atg.wa.gov)

( ) Via U.S. Mail  
(xx) Via Facsimile  
(xx) Via Hand Delivery  
(xx) Via Email

The undersigned declares under penalty of perjury, under the laws of the State of Washington, that the foregoing is true and correct.

DATED this \_\_\_\_ day of March, 2007.

/s/

Denise F. Manning / J. Sarah Jackson