PART II

The Forms and Consequences of the Fissured Workplace

In his book *The Big Squeeze,* New York Times reporter Steven Greenhouse recounts a cavalcade of woes facing people in their daily work life. Drawing on hundreds of interviews, Greenhouse summarizes the worsening conditions at the workplace faced by millions of workers:

> One of the least examined but most important trends taking place in the United States today is the broad decline in the status and treatment of American workers—white-collar and blue-collar workers, middle-class and low-end workers—that began nearly three decades ago, gradually gathered momentum, and hit with full force soon after the turn of this century. A profound shift has left a broad swath of the American workforce on a lower plane than in decades past, with health coverage, pension benefits, job security, workloads, stress levels, and often wages growing worse for millions of workers.[1]

The book recounts case after case of eroding wages and benefits and the often egregious violation of basic labor standards, abrupt termination of long-standing and loyal employees, flagrant discrimination, and abusive behavior by supervisors.

Scholars and popular writers alike have documented for more than a decade the fact that working conditions in the United States—and those in many other industrialized nations—have declined. Even before the onset of the Great Recession in December 2007, a growing part of the U.S. workforce became increasingly vulnerable to a range of economic, health and safety, and social risks. These troubling conditions have been examined in considerable detail in a number of recent studies.[2]

Part I discussed the origins, causes, and dynamics that have led to the fissured workplace. The strategy pursued by lead businesses in many industries is to pursue core areas of value creation while shedding activities—and employment—to other, subsidiary, business entities. Lead businesses balance the pursuit of core competencies against the effort to shed activities to other organizations via a variety of mechanisms that provide a means of assuring that subordinate organizations adhere to quality, technical, time, and brand standards.

Part II looks at subcontracting, franchising, and supply chain structures: three organizational mechanisms used to ensure this balance that result in fissured workplaces and their connection to worsening conditions as described by Greenhouse and others. Table II.1 presents examples of these three forms that lead to fissured workplaces and examples of each from a variety of industries, ranging from some of the oldest (mining) to the newest (cell phones). Although the occupations that fissuring affects are concentrated at the low-wage end of the labor market (janitors, warehousing, home health aides, fast food), the practice increasingly includes mid-level employees (machine operators, cell tower workers, customer service providers) and even highly skilled workers (journalists and lawyers).

In subcontracting, the lead firm contracts out activities to separate parties. Once shed, these activities are typically further broken apart into subcontracting to other parties, resulting in cascading levels of employment. In contrast, under franchising, the lead business keeps overall control of management of the brand but creates an organizational structure that allows separate business entities—franchisees—to carry out the activities. Finally, in supply chain structures, the lead company plays the key role of coordinator of complicated networks of subsidiary organizations that together provide goods or services.[3]

Each lead business is orbited by successive tiers of business enterprises (described in each row of Table II.1). The nature of the relationship between each tier is specified in the types of contracts or agreements between the respective businesses. For example, the cellular tower industry begins with major cell carriers like AT&T and Verizon who contract with “turfers,” large companies who act as lead contractors. Turfers, in turn, contract the actual work to a next tier, and often several tiers, with small subcontractors providing maintenance services on specific towers. Each subcontracting tier operates for the one above it through bidding systems and highly detailed contracts specifying terms of work.

In a franchised industry like fast foods, the tiers are linked through detailed franchise agreements that specify business operations central to the brand and expectations by the parties on maintaining it. Supply chain structures like retailing rely on standards specifying how each tier will coordinate with others, usually through the adoption of standards regarding both product characteristics and logistics.

The agreements underlying subcontracting, franchising, and supply chains—and the market relationships that arise around them—differ in form but have similar impacts on the pressures facing each tier's bottom line. Since labor is usually a significant component of cost, the tiered structure and the glue that holds it together have consequences for employment conditions. When shifting employment outward to other businesses in more competitive settings operating in low-wage labor markets, the incentive for skirting workplace standards can be significant. The rise of labor standards violations—from failure to pay minimum wages or overtime to requiring employees to work off the clock—reflect this problem.

As discussed in Chapter 4, shifting activities outside of lead companies to successive tiers also means a change in the wage-setting process. When janitors were direct employees of manufacturers, hotels, or financial institutions, the higher wages earned by others inside company walls pulled up the wage levels of janitors. Once janitorial activities shift to other businesses in orbiting tiers, those job referents become irrelevant to wage setting. Janitorial wages move closer to those prevailing in the more narrow market of other contractors of cleaning services or of franchised janitorial service providers. The downward pressure on wages and associated benefits intensifies with each cascading tier of fissured employment depicted in Table II.1.

Finally, the tiered organization of fissured workplaces can create coordination failures, particularly where it is superimposed on complicated production processes. When the steps of production are broken into activities overseen by different business organizations, the actions of workers of one employer are more likely to create risks for the workforce of another. This has been a longstanding problem in construction. As more and more places of work are

Table II.1 Three organizational forms resulting in fissured workplaces (selected examples in parentheses)

Industry	Lead business	1st tier	2nd tier	3rd tier	4th tier
Subcontractor model					
Coal mining	Mine controlling business (Massey Energy)	Mine operators (Performance Coal Co.)	Contract operators (Black Diamond Construction Inc.)		
Cellular phones	Cell phone carriers (AT&T)	Turfing managers (Nsoro)	Lead subcontractor (WesTower)	Second-level subcontractor (ALT Inc.)	Third-level subcontractor
Logistics operations	Retailer or manufacturer (Walmart; Hershey)	Logistics provider (Schneider Logistics)	Temporary help company (PWV)	Second-level temp. agency (Rogers-Premier)	
Cable services	Media provider (Time Warner)	Regional cable turfer (Cascom)	Installers as independent contractors		
Franchise model					
Fast food	Franchisor (KFC; Pizza Hut)	Franchisee (Morgan's Foods Inc.)	Labor contractor		

Janitorial and building services	Lead company in variety of sectors	Franchisor (Coverall)	Regional franchisee	Local franchisee	Labor contractor
Hotels (hybrid model)	Hotel/motel brands (Marriott)	Franchisee/owner (Host Hotels and Resorts)	Brand or independent operating company (Crestline Hotels and Resorts)	Labor staffing company (Hospitality Staffing Solutions)	Subcontracted landscaping or janitorial service
Supply chain model					
Apparel	Manufacturer or retailer (Forever 21)	Contract manufacturer/ subcontractor (CMR Clothing Inc.)	Second-tier contractor (CUI Sewing Inc.)	Third-tier contractor	
Food industry	Food processor	Growers	Farm labor contractors	Farm workers as independent contractors (prior to 1987)	
Computer industry	Computer brand (Apple)	Contract manufacturer (Foxcomm)	Subcontractors	Sub-subcontractor	

composed of multiple employers operating under one roof, new risks arise, and with them health and safety problems, including elevated fatality rates (as we shall see in the case of cell towers).

Part II explores the three major organizational forms that create fissured workplaces and examines their impacts on workers. We start in Chapter 5 with the use of subcontracting. Its use, once a hallmark of a small number of industries, has spread widely. When paired with independent contracting, its consequences can be particularly pernicious.

Chapter 6 looks at a more subtle form of fissuring—franchising. Born out of core strategies focusing on building brands, franchising represents a distinctive form of fissuring that allows the franchisor to focus on core competency while ensuring that the businesses that provide the products and services keep up with standards. Franchising has now spread far beyond the fast-food industry commonly associated with it.

Chapter 7 looks at supply chains in the context of fissuring. Whereas companies like Ford and IBM once built internal empires of suppliers through expansion and vertical integration, modern supply chains achieve even more complicated coordination of hundreds and often thousands of suppliers. But they do so by carefully steering that network from the center, establishing detailed, demanding, and high-stakes requirements and thereby satisfying the core requirements of the lead businesses at their center.

5

The Subcontracted Workplace

There is nothing new about subcontracting as a form of organizing business, production, and the workplace. It is how the construction industry in the United States has been organized since the 1800s. It has long been a distinctive feature of women's garment manufacturing, for example. And it has been a basic part of the movie industry since the early days of Hollywood.

All of these old-school applications of subcontracting reflect sectors where a substantial part of producing goods requires specialized activities, often combined in different ways to fit highly diverse end uses. Construction is driven by its end use: a commercial building requires one combination of expertise and skills, while a power plant requires something quite different. There is enormous end use variation even within types of construction—a walk along a downtown city street is enough to prove this. Other industries that have drawn on the subcontracting model similarly require specialized activities to create varied products. The women's sector of the clothing industry in the United States, given its far more varied product offerings, has always drawn on more extensive subcontracting than the men's sector.[1] Movies require a wide variety of artistic, cinematic, production, and service tasks, also shifting according to the genre and the specific film being made.

Producing buildings, garments, or movies by hiring specialized companies to do different pieces of the work, particularly where that work requires expertise and investment in skills and equipment that may be used for only a limited period of time, lends itself to subcontracting. A company specializing in electrical work (or embroidery for women's dresses or costume design in film) can invest in its expertise and sell that expertise to multiple parties, each in need of those services for a limited period of time and having no desire to make long-term commitments. The lead company undertaking the work operates through market relationships with a set of subcontractors, drawing on them as the production of the building or the creation of the film warrants.[2]

Subcontracting, however, began to move beyond its traditional sectors as its advantages as a part of fissured strategies became apparent. Its use has spread into new sectors and deepened within those where it was traditionally applied. The use of subcontracting differs both in terms of the types of jobs it targets and its applications in industries where the practice has historically been uncommon. Though the focus of subcontracting and the way it plays out differs across sectors, its effects on the workplace are similar. Employment conditions at the bottom of fissured structures reflect the design of lead company strategies, including the way they choose to parcel out secondary work to other parties. The industries that emerge "underneath" lead players reflect, in part, organizational design decisions aimed at aligning the interests of the parties to the extent possible (particularly to the extent that they support the strategies of the lead players).

As a result, the lower tiers of fissured structures in many industries are very competitive; have low barriers for new entrants; provide services that are relatively easily observed; or draw on contractual provisions, monitoring technologies, and organizational formats that make the consequences of failing to meet standards costly. The upshot is that conditions at the secondary level (and below) are frequently tough: competitive, price sensitive, and subject to fluctuating demand.[3]

A second characteristic of the fissured workplace in subcontracted organizations is coordination problems: the more tasks are divided among different business entities, the harder it becomes to coordinate them. The private incentives pushing toward fissuring the workplace thereby create social problems and costs in the form of increased safety and health risks and, at worst, deaths at the workplace. This chapter illustrates these characteristics with case studies from a number of disparate industries.

We begin by looking at how subcontracting expanded from its traditional focus to a more general employment strategy in a very old industry: underground coal mining. We then turn to a contemporary industry—telecommunications—and examine how the rapid growth of smartphones was accommodated by the application of subcontracting to cell tower maintenance. The impact of subcontracting models on a landmark U.S. business—

Hershey—illuminates how multitiered contracting can make improbable sources of labor (such as university students in a State Department–sponsored visa program) seem plausible and allow egregious violations of safety standards to occur under the nose of historically responsible employers. Finally, we look at how multitiered subcontracting in the cable industry changed what were once employees of cable media companies into independent contractors.

Past as Prologue: Fissured Coal Mines and the "New" Subcontracting

Subcontracting was long used in underground coal mining for reasons similar to those found in construction, the garment industry, and cinema: certain operations require high degrees of skill and expertise but are not part of the day-to-day operation of the mining company. For example, blasting contractors are engaged by mine operators to undertake the dangerous work of opening new seams for subsequent mining. Blasting contractors obtain the work, do their operations, and move on to the next job. Fissured subcontracting in mining was pioneered much more recently, however, and foreshadows various types of subcontracting practices that are now emerging in other industries.[4]

In order to sell coal as an energy source (thermal coal) or as an input for producing steel and other products (metallurgical coal), it must be extracted from the ground, brought to the surface, and taken to processing facilities, where it is sorted, cleaned, and prepared for shipping.[5] Processing plants for coal are capital-intensive, and multiple mines may use a common processing facility. There are therefore economies of scale for a coal operator arising from the processing of coal that—in tandem with the gains from controlling rights to those coal reserves—have led the industry to be concentrated.[6]

At its peak, the United Mine Workers of America (UMWA) represented the majority of coal miners in the eastern United States. Miners covered by the union's collective bargaining agreement earned high wages, were part of the first industry-wide health care system negotiated by a union, received pensions, and were protected by a union-led health and safety system at the mine face that acted as a complement to the Mine Safety and Health Administration (MSHA). The UMWA negotiated with its industry counterpart, the

Bituminous Coal Operators Association (BCOA). But as the union declined in its coverage of mine workers and leverage in the industry, major union and nonunion coal companies began to challenge not only the UMWA at the bargaining table, but also the financial obligations that had been negotiated for current and retired members.

The use of subcontracting to undertake basic mining operations beyond specialty applications is often attributed to the A. T. Massey Coal Company.[7] The so-called Massey Doctrine was based on classifying coal reserves held by the company into three groups:[8] reserves with high-quality coal, in thick seams and good mining conditions; reserves with seams of average height or mining conditions; and reserves with thin seams and difficult mining conditions. The company would own and operate mines of the first type and use subsidiaries or contractors for the second type, while still maintaining some level of control and stake in them. For the third type of reserve, however, the company "desire[d] to have only a brokerage relationship . . . no long-term contractual or financial arrangement. This is the coal that, in a weak market, will be available at the lower price . . . This is the coal that we should buy or market ourselves rather than have it compete with us."[9] The Massey Doctrine does this by having the company or one of its subsidiaries (which controls the rights to the coal reserves, maintains control over access into and out of the mine, and operates the processing facility) hire a small contracting firm to extract coal. The lead mining company specifies the price the contractor will be paid for each ton extracted and provides the contractor with all engineering, mine plans, and other materials needed to undertake the work. It may also lease, sell, and or provide the contractor with financing for the equipment in the mine or for use in mining. The company also specifies to the contractor how, when, and where the coal is delivered, allowing it to adjust both the price paid and the charges for service to the contractor, and to determine quality standards for coal purchased.[10] Of course, the price paid to the contractor is that set by the coal company on the basis of its own internal calculations; the coal operator subsequently sells the coal based on the market price or a price it has negotiated through long-term contracting with utilities (common in the industry). In both cases, the price is well above the price the coal company pays the contractor.

The benefits to a unionized mining company are clear: by subcontracting, it places the union miner outside the boundaries of the firm, placing a contractor between itself and the miner and distancing itself from a set of liabilities associated with being an employer. These include contractual and legislated requirements ranging from accumulated vacation days, health and welfare contributions, and workers' compensation payments to federal and state black lung obligations and other statutory payments.[11] These additional payments for state and federal statutory requirements such as workers' compensation are significant, and for companies with a unionized workforce, the additional costs associated with health and welfare and pension requirements are even more substantial. If the coal company attempts to use subcontracting as a means of union avoidance (as Massey was accused of doing), the potential benefits for the company from contracting are clear.

If the lead company requires contractors to hire former unionized workers (as required by the UMWA/BCOA contract), one would expect no savings arising from shifting employment (since those costs would presumably show up in the costs of the contractor and the price that contractor would be willing to accept for undertaking the mining operations). But if the unequal bargaining power of the coal company in its negotiation with the contractor can achieve a price below that level (perhaps because of the contractor's potential ability to fly under the radar, its inexperience in business, or simply the higher likelihood of insolvency), the lead coal company can reduce its costs through contracting.[12] A lawyer involved in environmental litigation in contracting cases remarked that "depending on specific circumstances, a large company can shift between $3 and $5 (in costs) for each ton of coal mined from its shoulders onto the small mine operator or society at large."[13]

And there was another benefit to lead coal companies like Massey through the arrangement: by using the Massey Doctrine, coal operators were able to shift employment of long-standing employees to the small contractors, who assumed the obligations for future health care obligations. They did so by requiring the contractor to hire from a panel of former employees (often union workers) of the lead company. This was not beneficence, but a means to make the contractor the "last signatory operator" for whom the miner worked, thereby transferring the lifetime health care obligations created under the UMWA/BCOA agreement as well as other health care obligations under the Mine Safety and Health Act to the contractor.[14] In essence, the Massey Doctrine provided a backdoor approach to subvert a variety of long-term commitments to miners and their families negotiated over decades between the UMWA and the BCOA. A spokesman for the BCOA defended the practice, arguing, "Look around in corporate America at what people are doing to avoid health-care and other payments. They're contracting out work. That's the whole point of using contractors."[15]

The arrangement requires a large number of small contractors willing to do the work. This appeared not to be a problem for Massey and other major coal companies. In an investigative report, Paul Nyden reported that Massey used five hundred contractors in Appalachia between the early 1980s and the mid-1990s. An abundance of small operators—sometimes family-owned enterprises with few assets of their own, other times companies that had declared bankruptcy under a different name—bid for the opportunity to work as contractors. Contractors were often undercapitalized and operating under tight margins. Not surprisingly, attrition among this group was exceedingly high.[16] For example, between 1980 and 1993, Island Creek Coal hired sixty different contractors to operate a few small mines in Elk Creek, West Virginia. Of the sixty, fifty-two were out of business by the end of the period, with nine filing for bankruptcy. A similar proportion of Massey's contractors went out of business over the same period.[17]

The doctrine created perverse incentives. Once work had been shifted to contractors, Massey or companies like Island Creek had little incentive to ensure that their contractors contributed required payments to either state funds or, where appropriate, union funds. As a result, Massey and Island Creek owed up to $120 million to the West Virginia Workers' Compensation Fund and over $50 million to UMWA health and retirement funds.[18] Nyden documented at least a dozen contractors that sued Massey or Island Creek Coal (the other focus of his investigative piece) between 1988 and 1993 on the basis of a range of claims including breach of contract, price gouging, mismanagement, misrepresentation, and fraud. For example, a suit by Soho Coal Company against several Massey subsidiaries alleged that the former had lost $650,000 in potential revenues from Massey's practice of rounding its selling price to the lowest dollar figure and on estimated weights of delivery that benefited Massey. The same suit accused Massey of using the contracting arrangement to get out of its liabilities to union miners formerly in its employ.[19] Soho's financial pressures spilled over, in turn, to its subcontractors, including five small mining companies that opened and shut down between 1987 and 1990.

The volatility among contracting firms meant precarious employment for their workforces. As contractors came in and exited, they often left behind a workforce with lost wages, intermittent work, and lost benefits. In many of the cases documented by Nyden, miners in their late forties and early fifties lost long-term jobs with a major coal company, and with them health care coverage for themselves and their families. And with their loss of contract jobs, they faced a labor market with little interest in hiring people in their late forties or older.

Finally, contracting was associated with increased fatality risk during the period. From 1980 to 1993, thirty-eight men were killed in mines affiliated with A. T. Massey Coal and Island Creek Coal. Even though the majority of the coal produces during those years was extracted from mines operated directly by Massey and Island Creek, twenty-seven of the deaths (or 72%) occurred in contract mines operating under those two companies.[20]

In the late 1990s, some states made efforts through legislation and the courts to combat the most harmful effects of subcontracting on the health care, pensions, and wages of miners. In 1993 the West Virginia legislature passed the Wage Payment and Collection Act (WPCA) to clarify contractor versus owner/lessor responsibility for liabilities owed to either miners or the government. Subsequent opinions of the West Virginia Supreme Court of Appeals regarding the act indicated that the court was taking a "broad, reality-based definition of employer under the WPCA which looks beyond contractual relationships to examine the actual relationship between the parties, the employee and the third party."[21] Nonetheless, using corporate restructuring to shift pension and health care liabilities to other parties continues. In May 2013, a court approved a proposal by Patriot Coal Corporation to reduce its pension and health benefit payments to 13,000 unionized miners and retirees as part of its bankruptcy proceedings. Most of the affected miners never worked for Patriot directly, since Patriot acquired pension and health care liabilities when it was created as a spin-off of Peabody Energy in 2007.[22]

The use of subcontracting did not end in the mid-1990s, and actually increased significantly between 1993 and 2011. Figure 5.1 charts the increase in hours and employees among contractors and the decline in both for operators (companies that directly undertake mining). Although contractors still undertake a minority of total production, their share has risen considerably.[23]

Contracting continues to be attractive because of its impact on lowering labor costs for mining companies. It has also proved to be a means of attempting to avoid civil penalties arising from violations of MSHA standards.[24] Take the case of Ember Contracting Corporation, a contract miner.

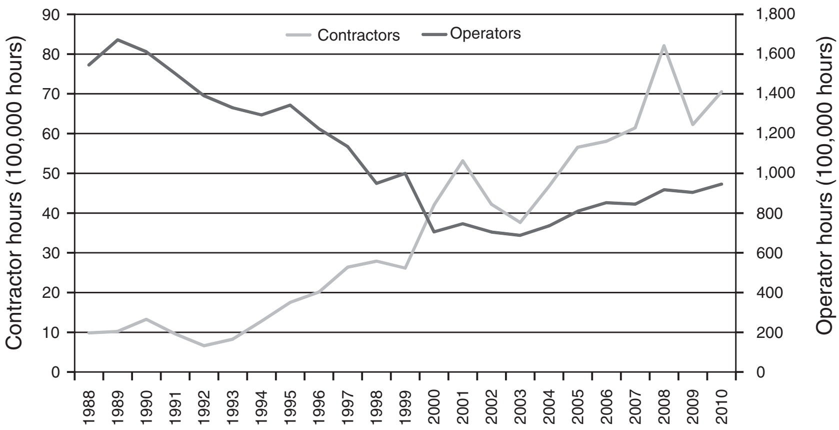

FIGURE 5.1. Trends in contractor and mine operator employment hours in underground coal mining, 1988–2010. *Note:* Data taken from the MSHA self-extracting accident and employment files for underground coal mines. Data available at http://www.msha.gov/stats/part50/p50y2k/p50y2k.htm.

In the early part of 2008, Ember received 247 citations from MSHA for health and safety violations, resulting in total penalties exceeding $225,000. Ember claimed inability to pay because doing so would threaten the company's financial viability, noting that, among other things, the company had lost its line of credit as a result of the penalties. But in subsequent litigation against the company, MSHA found that when Ember stopped its mining activities at sites in the summer of 2009, "its owners sold Ember's assets to a related company, EC Management." It turned out that EC Management was owned by the same two principals that owned Ember. One of the owners "admitted that E. C. Management bought Ember's equipment solely to pay off Ember's debt." Additionally, in January 2010 the two Ember owners formed a separate contract mining company, G. R. Mining, which operates in the same location as Ember and hired many of the employees who previously worked at Ember.[25]

In ruling on the penalty liabilities facing Ember, the administrative law judge ruled that Ember had to pay the entire penalty amount. The judge stated that "Ember has not satisfied its burden of proving that imposition of the total proposed civil penalty would adversely affect its ability to continue in business." Ember should have gone into bankruptcy if it could not continue to operate. However, the company "chose to shift money, business opportunities, and contracts between the other companies owned by its principals like a corporate shell game."

Although coal industry fortunes ebb and flow with the larger energy market (and are certainly at a low ebb at the time of this writing), the burden continues to fall hardest at the lower reaches of the subcontracting chain and on the miners at the mine face. Contract miners in underground operations face significantly higher rates of traumatic injuries than miners working as direct employees of operators in otherwise comparable mines. Even more troubling, miners working for contractors face a 40% higher exposure to fatality risks than those who work as direct employees, even after controlling for a variety of other mine-level characteristics associated with fatalities.[26]

The Massey Doctrine and its influence on subcontracting in the coal industry have broader lessons: subcontracting work is not incompatible with lead companies continuing to maintain substantial influence on the methods and operations of the units working below them—sometimes multiple levels below. By setting out goals regarding output and prices as well as influencing the timing and methods of production, lead companies can draw on multiple tiers of subcontractors while pursuing their core strategies.[27] But by pushing the employment relationship outside of the boundaries of the lead firms, very different pressures arise for the companies and the workforce below them, with smaller and smaller margins at lower and lower levels of subcontracting resulting in increasingly dangerous conditions.

iPhones, Cell Towers, and Telecommunications Fissuring

We all want more reliable cell phone service. Unfortunately, keeping cellular towers upgraded has become a deadly business, in part because of the financially driven strategy through which such jobs are subcontracted. Between 2003 and 2011, almost one hundred workers died building and maintaining towers to support consumers' insatiable demand for smartphone service.

Major carriers like AT&T and Verizon, rather than directly employing workers to build and maintain cell towers, have spun off that work to other parties, who in turn subcontract it to others, who may subcontract out even further. Layers of employment are created, with the lead company setting overall prices for work and often dictating specific conditions regarding quality, scheduling, deadlines, and other requirements that affect how the work is done. In the case of AT&T, this form of subcontracting was developed to rapidly expand and service cellular towers in order to increase coverage and the data capacity demand arising from the introduction of the iPhone. By subcontracting to multiple tiers, carriers are expanding networks to fit a competitive strategy. But such hyper-subcontracting also leads to a loss of control of the workplace, and in particular of safety. The consequence is a fatality rate in cell tower work far in excess of those in industries often regarded as the most dangerous: three times that of coal mining and more than ten times that of construction overall.

Expanding and Maintaining Cell Networks

It is not hyperbole to say that wireless communication usage exploded after 1990. In that year there were an estimated 5 million subscriber connections. By 2011 the number of subscriber connections reached more than 331 million.[28] Texting provides an evocative measure of the exponential growth of wireless communication services in an even shorter period: in the second quarter of 2006, the average number of monthly text messages per mobile subscriber was 79 as compared to 216 phone calls per subscriber. By the second quarter of 2008, the number of monthly texts per subscriber had climbed to 357, leaving in the dust the number of phone calls, which had decreased to 204.[29] The growth in cell phone and smartphone use and wireless communication in general required a similar expansion of the infrastructure to support it. In 1990 there were a total of 5,616 cell tower sites in the United States. By 2011 that number had climbed to 283,385.[30]

Constructing networks that provide the fastest, most extended, and most reliable service has become a major driver of competitive strategy. This means that creating a comprehensive network for mobile users is a core aspect of the business. Developing and coordinating mobile networks is capital-intensive, entailing huge economies of scale (even in the long run, the average costs decline with scale). And given the network economies that are basic to the industry, the bigger the network and the more capable it is of handling the ever-growing demands of digital traffic, the more valuable it becomes to consumers.[31]

Yet developing and coordinating networks does not require that the carrier itself undertake physical construction or maintenance of those networks.

Cell tower construction and ongoing maintenance have been subjected to two levels of fissuring. A major investigative report for ProPublica and PBS Frontline by Liz Day and Ryan Knutson examined this distinctive model of subcontracting that characterizes the industry.[32] The carrier bids out a contract—for millions of dollars of potential work—to a major company, called a turfer.[33] The turfer's contract requires it to provide the carrier with building and maintenance services over a period of time. Other turfers used by the carriers include major construction and engineering firms like General Dynamics and Bechtel as well as firms that specialize in the telecommunications field, like Nsoro.

The Turfer Model of Subcontracting

An agreement between AT&T (then Cingular) and Nsoro LLC Inc. obtained by ProPublica/Frontline illustrates the nature of the subcontracting model.[34] The agreement requires Nsoro to undertake project management for two types of services: those "in support of Cingular's overall new build program" and those to "manage the construction (and related services) of all cell sites at the regional and market levels of the organization. Contractor regional project managers will report to the appropriate Cingular counterparts on the status of the cell site completion and progress toward market goal." The agreement awards Nsoro a base rate of $95,000 (the "Baseline Purchase Order Price") per job under the agreement.

The turfer, however, is a project manager for the carrier and does not directly undertake the cell tower work. Instead, it bids that work out to subcontractors with the crews that actually climb towers, build scaffolds, remove and replace elements on the towers, and do other work on the site. In the case referred to above, Nsoro bid out work to a variety of subcontractors. In one illustrative case documented by Day and Knutson, it subcontracted to a company, WesTower Communications, for a job to "Remove 9 Antennas and Install 9 New Antennas," for which it would be paid $21,000.[35] WesTower Communications, in turn, subcontracted to another company, ALT Inc., which actually undertook the work.[36]

The agreement between WesTower and ALT includes language stating that the subcontractor "shall assume all responsibility and liability with respect to matters regarding the safety and health of its employees and the employees of lower tier subcontractors and suppliers and shall ensure that all such subcontractors or suppliers fully comply with the safety and health provisions contained in this Agreement." It lays these requirements out in detail in an appendix to the agreement and allows WesTower to stop work if it finds evidence of subcontractor failure to follow requirements. But the agreement also makes clear that neither ALT nor any subcontractors working below it "shall be deemed to be WesTower employees or agents, it being understood that Subcontractor and its lower tier subcontractors are independent for all purposes and at all times."

As in other cases giving rise to fissured workplaces, the overall standards for work are set at the top by the carrier. These include performance and technical specifications (the work to be done and the quality standards which must be met), the deadlines for completion of the work, overall caps on pricing over the area serviced by the turfer, and the penalties (liquidated damages) paid by the turfer for failure to meet standards. Carriers like AT&T have an enormous stake in these outcomes beyond the price paid for the work, since they affect the capacity, quality, and speed of their wireless networks. An AT&T contract document obtained by ProPublica/Frontline explicitly lists over one hundred tasks related to cell tower projects and the degree to which the company seeks to have responsibility and to be consulted or informed.[37]

The Cingular/Nsoro agreement includes specific time requirements for responding to "errors or deficiencies in the Site Development Services furnished," including "(i) 4-hour response from receipt of notice for service affecting issues and (ii) 24-hour response from receipt of notice for non-service affecting issues."[38] It also includes language allowing Cingular to conduct an escalating number of quality audits.

Of course, firms at each level of the process incur costs for their services and also seek a return beyond that. At the top of the chain, the turfers claim a large share: the report found that in cases where a pricing record was available, the turfer was paid $187 to install a component on a tower, whereas its subcontractor, which actually performed the work, in turn was paid $93 (about 50% of the revenue from the job).[39] If there are multiple levels of subcontracting (common to the cases studied by Day and Knutson), each level will seek to secure a return before paying the level below it.

The availability of a large number of subcontractors willing to bid for the work drives down the market price, and therefore the amount of money available to pay for labor, equipment, training, and supervision. Not surprisingly, the wage level at the bottom of many of these chains is reportedly $10–$12 per hour (low by construction standards). As in any labor market, such low wages mean that individuals with skills, training, and experience in risky cell tower work may be unwilling to accept them. This raises the need to supervise and train the less-experienced workers doing the work, which often does not happen. Since maintenance work often requires the tower to go offline, carriers usually want this work to be undertaken by the subcontractors between midnight and 6:00 a.m., when cell use is at its lowest and maintenance least likely to be disruptive.[40]

Repercussions of Fissured Subcontracting in Cell Towers

No telecommunications carrier was under greater pressure to expand its network in the past decade than AT&T. Between its merger with Cingular and its original position as the sole carrier supporting the iPhone, the company faced enormous pressures to expand rapidly. It drew extensively on the subcontracting system described earlier to bid work for its rapidly expanding cellular network.

Among the carriers tracked by Day and Knutson, the number of fatalities linked to AT&T far exceeded those linked to other major companies like Verizon, T-Mobile, and Sprint. Between 2003 and 2011, a total of fifty people died while working on cell towers for the carriers. AT&T accounted for fifteen of those deaths (there were five deaths associated with T-Mobile, two with Verizon, and one with Sprint). Fatalities on AT&T sites were concentrated (eleven of the fifteen fatalities) during the period 2006–2008, when iPhone and demands to merge the AT&T and Cingular networks reached a fevered level.[41] In an AT&T document called "Division of Responsibilities Matrix," safety-related tasks are left unchecked, which subcontractors believed "to mean the carrier wanted no involvement with them at all."[42]

A story that played out in the contracting chain described above illustrates the impact of the pressures arising from the system as a whole.[43] William "Bubba" Cotton was working for one of two subcontractors to upgrade a 400-foot AT&T tower in March 2006. One crew was employed by the abovementioned ALT Inc. and was operating on the tower replacing antennas. Cotton was working for a second contractor, Betacom, on a concrete equipment shelter at the base of the tower. The two subcontractors were operating independently of one another. Figure 5.2 depicts the set of subcontractors on site in 2006 and their relationships.

The ALT crew was lowering an antenna from the tower structure when the rope they were using snapped. The 50-pound antenna fell 200 feet just as Wilson and coworkers were exiting the concrete structure for lunch. Wilson was crushed and died before EMTs arrived on the scene. Occupational Health and Safety Administration (OSHA) investigators later concluded that the rope and equipment used by ALT had not been adequately inspected and that the Betacom crew was not using hard hats on the site. Although OSHA standards did not preclude the practice, the investigators also noted the danger of having two crews, one working below the other, on the site at the same time.

The final point of the OSHA investigation is central: while the WesTower contract included extensive language regarding subcontractor safety, it ceded oversight to its subcontractor, ALT, which used substandard equipment. The consequences of failure to follow safety rules were that ALT lost its contract. Turnover is high among the subcontractors working for turfers—primarily because of the strict quality performance standards imposed by carriers. But there are enough subcontractors to provide sufficient replacements, just as there were enough contract miners to feed the Massey Doctrine system in that industry.[44]

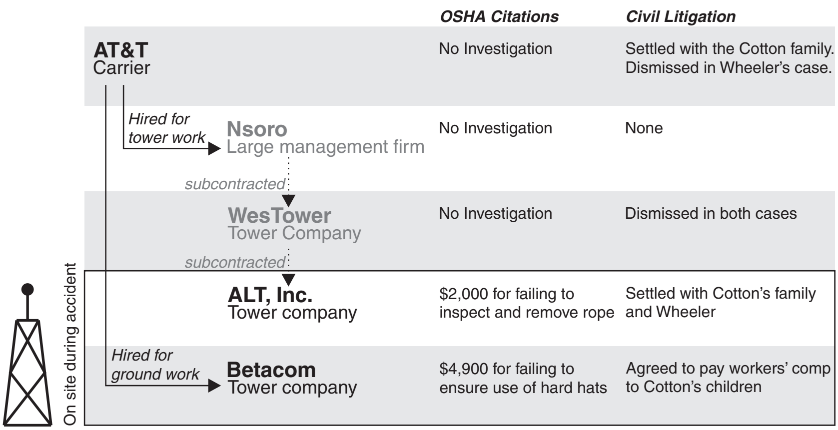

FIGURE 5.2. A fatal example of cell tower subcontracting. *Note:* AT&T was then known as Cingular. (Graphic by Dan Nguyen, ProPublica; cell tower icon by Dima and Christian Hohenfeld, from the Noun Project. Reprinted by permission.)

WesTower also had no control over the presence of a second subcontractor, Betacom, which was contracted separately by Cingular to work at the same time and below the first crew.[45] The Betacom crew failed to use proper protection, although it is unclear whether Bubba Cotton would have survived even if he had been wearing a hard hat. Most importantly, the overall fissuring of work on the tower among multiple players meant that no party coordinated the interactions, with fatal results.[46] This is particularly ironic (but typical) given the stringent audit systems in place in the master agreement between Cingular and Nsoro regarding the quality of work done by subcontractors. Charles Perrow, a renowned analyst of accidents, has shown that serious accidents and fatalities are often the result of the simultaneous failure of multiple systems with complex interactions. The turfer system increases the likelihood of such simultaneous failure across systems given the absence of a party with responsibility for overall coordination of the site.[47]

Sweet Subcontracting: The Hershey Fissured Recipe

In the summer of 2011, Tudor Ureche, a Moldovan college student working at a Palmyra, Pennsylvania, facility that packed chocolates for the Hershey Corporation, sent an email in broken English to the U.S. State Department that read, "Pleas help the miserable situation in which I've found myself cought." Ureche was one of four hundred students, representing a veritable United Nations, hailing from Nigeria, China, Ukraine, Costa Rica, Romania, and twelve other countries, employed at the packing plant and working under the auspices of the J-1 visa program designed decades ago by the State Department to give international students cultural exchange opportunities in the United States. What the students experienced instead were long hours lifting, carrying, and moving 50–60-pound boxes of chocolates in a refrigerated packing facility on shifts that began at 11:00 p.m. and continued through until the morning hours.[48]

Students in the program paid $3,500 to participate. For their work in the plant, they were paid a base rate of $8.35 per hour. Rent, travel expenses, and other charges were deducted from their paychecks, leaving many with limited funds to experience the United States beyond the packing plant environs (with what limited time they were allotted). They were even less likely to earn back the money they paid to participate in the program. Despite e-mails from Ureche and others at the Palmyra plant, it took a walkout by four hundred of the students to induce the State Department to investigate.

The students' trips to the United States were arranged by the Council for Educational Travel, U.S.A. (CETUSA), a nonprofit organization long contracted by the State Department to find jobs, arrange housing, and generally organize trips for the students. Ten years earlier, Hershey would have directly employed unionized workers to pack its products and load them into trucks for customers during the summer peak period. Now, although the chocolates packed in the facility bore the Hershey label, the plant itself was operated by a contractor hired by Hershey to manage operations at the facility that in turn hired a staffing subcontractor, which served as the employer of record for the students. Many of the students discovered that their employer was the subcontractor rather than Hershey only when they received their first paycheck.[49] One might ask how a nonprofit organization created to facilitate international cultural exchanges came to place students in such a bad environment. But even more, one might ask how a global consumer food company came to rely on a third-party staffing subcontractor to employ workers in a packing and shipping facility for its prized products that was just miles away from its headquarters in a town bearing the name of its internationally famous brand.

The answer is that the Hershey story is a poster child of the fissured workplace.

Fissuring Chocolate

Hershey was founded by Milton Hershey in 1894 in his hometown of Derry Church, Pennsylvania. After introducing the famous Hershey's Kiss and later an automated machine to wrap it, the company grew rapidly and introduced other iconic products, including Mr. Goodbar (1925), Hershey's Syrup (1926), and the Krackel Bar (1938). The company cast a long shadow over the town (often called "Chocolatetown, USA") and was known for its paternalistic and sometimes heavy-handed approach toward its employees. Following Hershey's fierce and successful battle to thwart a union affiliated with the Congress of Industrial Organizations in 1938, the Bakery and Confectionery Workers Local 464 (affiliated with the American Federation of Labor) successfully organized the company in 1940. For most of the twentieth century, Hershey directly employed a large, unionized workforce for production, marketing, product development, and distribution of its products.[50]

This business model changed dramatically when Richard Lenny was hired by the Hershey board of directors in 2001 as the first outsider to serve as CEO of the company. From the beginning of his tenure, Lenny pursued a "value-enhancing strategy" focused on shifting production and related activities away from the company via outsourcing.[51] Indicative of this effort, Hershey outsourced elements of production of its chocolate liquor—the chocolate core of products like Kisses—to other companies, leaving only final reassembly steps to its own facilities and workforce.

As a further extension of that strategy, the company announced its "global supply chain transformation" in February 2007. The official objective of the three-year program could not be a clearer statement of fissuring as applied to supply chain strategy. "The transformation program will result in a flexible, global supply chain capable of delivering Hershey's iconic brands, in a wide range of affordable items and assortments across retail channels in the company's priority markets."[52] The plan entailed further reducing the number of Hershey's own production lines, "outsourcing production of low value-added items" to other companies, and building a new production facility in Monterrey, Mexico. Sourcing production to its Monterrey facility and to other international suppliers would give Hershey "increased access to borderless sourcing [and] . . . further leverage the company's manufacturing scale within a lower overall cost structure."[53]

Hershey investors thought well of the strategy, as reflected in the company's stock price, which outperformed the market consistently over the same period.[54] By 2009 Lenny had successfully outsourced most of the production outlined in the strategy, closed six facilities in the United States and Canada, and let go an estimated 3,000 union workers. Hershey further upgraded its supply chain management system, moving cocoa beans, semiprocessed chocolate bars, and other ingredients to be made outside of the United States and Canada and reassembled and packaged by Hershey in a small number of U.S. facilities, where they could then be shipped from subcontracted distribution operations like those in Palmyra.

Subcontracting Production

One contractor for Hershey was Lyons and Sons, based in Camden, New Jersey. Cocoa Services, a subsidiary of another company, and Lyons and Sons were licensed by the city to be a warehousing operation for storage of cocoa beans and semiprocessed chocolate bars from abroad.[55] However, the two companies also had set up an unlicensed operation in the Camden warehouse to take bars of pressed, unsweetened chocolate obtained from Hershey suppliers and melt them in large vats, the contents of which were then transferred into tanks for delivery to other factories contracted by Hershey.[56] At each point, contractors in Mexico, at the Lyons and Sons warehouse, and in other contract factories in the supply chain operated under the exacting product quality standards, delivery requirements, and time and price boundaries established by Hershey.

Melting unsweetened chocolate produced elsewhere was a relatively small operation in terms of manpower requirements. Workers hired as temporary employees stood on a nine-foot-high platform set up above two large vats of molten liquid chocolate, each about seven feet wide and high. According to a report by OSHA:

> They manually drop chocolate liquor slabs into a melting tank. One employee was on each side of a pallet with a one ton box of chocolate liquor slabs, cakes are 1.5-in. by 12-in. by 18-in. One employee would hand the slabs to the other employees standing adjacent to them who then dropped them into the melting tank through the 26-in. square opening. A fifth worker operated a fork lift and would place the boxes of chocolate on an elevated platform.[57]

On July 8, 2009, at 10:30 a.m., a twenty-nine-year-old man named Vincent Smith was one of the workers on the platform. Smith had been employed only for several weeks as a temporary worker at the facility. He was tasked with tossing chocolate blocks into the melting vat for a Hershey order through an unguarded opening in the platform. After the cover to the vat was removed by coworkers below, Smith walked toward the opening in the platform. He was chatting with coworkers on the platform when he took a step forward into the opening and fell into the vat of 120-degree chocolate. Investigators of the fatality later surmised that he was most likely killed by a blow to the head from a large mechanical paddle in the mixing vat. Because of the height of the vat, his coworkers were unable to pull him out until firefighters arrived ten minutes later. OSHA investigators later found that both Lyons and Sons and Cocoa Services had committed numerous serious violations of health and safety standards, including those pertaining to proper floor and wall guarding requirements and confined space requirements.

The Hershey case, like the cell tower case, illustrates the increased likelihood of accidents and risks when responsibility for health and safety is unclear or left in the hands of parties with little incentive to take that responsibility seriously. Back in the days when Hershey produced its own chocolate, it had health and safety departments and joint health and safety committees with the union representing its workers. It directly paid workers' compensation premiums, giving it an incentive to manage risks. And, being a prominent and large employer, it had incentives to follow OSHA standards because of the chance of being inspected—a chance raised by the presence of a unionized and informed workforce.

But Lyons and Sons faced none of those incentives as a small employer flying under the screen of OSHA, workers' compensation insurers, and even local officials, who thought the facility was only a warehouse until after first responders were called. Hershey, now at arm's length from the production of its own chocolates, was not cited by OSHA for the death of Vincent Smith because it could not even remotely be deemed an employer under the structure of current employment laws.

Fissured Distribution

Historically, Hershey considered its shipping functions (managing shipment orders, and packing and loading them onto trucks) to be corporate functions. It negotiated contracts for the workers in its distribution centers, including a large operation in Palmyra that was staffed by unionized Hershey employees.

In 2002, as part of the larger effort to remove itself from the actual production of chocolate, Hershey closed most of its large co-packing operation in Palmyra. Distribution operations were then dispersed to other nonunion locations.[58] To operate a remaining facility in the Palmyra area (still owned by the company), Hershey chose Exel, a major contract logistics provider with over $4 billion in annual revenue managing over three hundred sites in the United States.[59] Exel, in turn, hired SHS OnSite Solutions, a temporary staffing provider (and part of SHS Group LP) to hire the workforce. It was SHS OnSite Solutions that then contracted with CETUSA.

This complicated relationship went largely unnoticed until the four hundred students who spent much of their three-month summer "cultural exchange" in the United States lifting boxes of Hershey's Kisses, stepped forward to protest the conditions under which they worked. After paying to participate in the State Department–sponsored exchange program, students assigned by CETUSA to the Palmyra warehouse were paid $8.35 per hour. Many of the participants in the program had their rent and other expenses directly deducted from their paychecks, leaving them with between $40 and $140 in earnings from their forty-hour workweeks. Students like Yana Bzengey from Ukraine stated that their sponsors threatened deportation in response to complaints: "I pick up boxes that are 40 pounds—I weigh 95 pounds. I complain. I say 'I want another job.' They say if I do not work here they will cancel my visa and I will go home."[60]

With the assistance of the Guest Workers Alliance, the student protest attracted the attention of the State Department, which oversees the J-1 visa program, as well as from OSHA and the Department of Labor's Wage and Hour Division. In subsequent investigations, OSHA cited Exel for violations of health and safety standards (including six willful violations) and assessed penalties of $288,000.[61] After its own investigations, the State Department debarred CETUSA from further participation in its guest worker visa program and also initiated administrative changes to the program to prevent future incidents.[62]

When the Hershey case hit the national news, the company was quick to claim that it knew nothing about the use of J-1 visa workers or of their working conditions in Palmyra. Noting that the company did not directly operate the facility, a spokesperson said, "The Hershey Company expects all of its vendors to treat their employees fairly and equitably." SHS OnSite Solutions similarly distanced itself from the facility, responding, "We don't directly hire these students so we're not really involved in the J-1 Visa Program." Even CETUSA attempted to dodge responsibility. Rick Anaya, its CEO, was quoted as saying he was surprised at the students' negative reaction to their conditions. "We can provide the environment . . . but as far as making contact with Americans, that's up to the kids. We provide the setting, but it's up to them to make the effort."[63]

The Independent Cable Guy

Many of us have waited for a cable installer to arrive. It is such an evocative moment that a movie was even written to enshrine the experience.[64] It turns out that although the installers may wear the insignia of the cable media company or of a major contractor working for it, they may be compensated as if they were working for themselves (that is, as an independent contractor). As a result, the pay they receive would be far less than if they were paid directly by the cable provider.

Time Warner Cable, a major provider of cable services in the United States, at one time would send its own workers to install cable boxes in the homes of customers. Even today, if you search FAQs on the Time Warner Cable website, you may get the impression that scheduling an appointment for installation or service would lead to a Time Warner employee appearing at your doorstep at the designated time. In fact, Time Warner has shifted this work out. In the Dayton, Ohio, area, it hired an intermediary to whom it subcontracted installation services, Cascom Inc., to be the service provider of record.

As we have seen repeatedly, fissuring often leads to more fissuring. In this case, Cascom did not pay its cable installers as employees, but instead set them up as independent contractors. In principle, that meant that each cable installer was a self-standing business that subcontracted the work from Cascom. In reality, however, Cascom determined which homes each so-called independent contractor would visit and how much the contractor could charge (a rate Cascom both set and collected). Cascom precluded installers from taking on new business independently, fined them for work judged (after the fact) to be substandard, and monitored their activities closely.[65]

The one way Cascom treated installers as independent contractors was by compensating them on the basis of jobs completed rather than hours worked. That meant an installer received the same amount of money whether a job took a short or long period of time. This, of course, created high stakes for installers to complete the work quickly (reinforced by the fact that the daily number of service calls was determined by Cascom rather than the installer). Cascom paid installers a rate directly linked to their productivity, rather than on an hourly basis where lower-productivity workers might receive compensation comparable to that of high-productivity workers.

Relying on Cascom to be its general contractor allows the cable giant to pay a far lower cost for installation while maintaining an overall business model built around access to cable content, effective customer service, and price. As the principal contractor, Cascom created its own rigid standards, monitoring, and enforcement systems to see that its subcontractors—in this case individuals employed as independent contractors—met them. By moving installation work outside to the model of contracting created by Cascom, Time Warner ultimately could pay a far lower cost per cable box installed than it would were the installers still within the cable service mother ship. It also gave Time Warner, through the auspices of Cascom, a mechanism allowing it to pay each worker a wage closer to his or her output than if employed inside the media giant.

The case is not unique: many forms of fissured subcontracting end with outer tiers of individuals hired as so-called independent contractors rather than as employees. Independent contracting can be a legitimate form of business organization, but it connotes specific things: that contractors control their own business, maintain multiple clients, are free to bring on and decline clients, and maintain their own equipment, tools, and skills. In reality, the type of independent contracting at the bottom of multilevel subcontracting models often looks like the installers at Cascom: independent in name only.

The Department of Labor's Wage and Hour Division questioned Cascom's form of subcontracting (although it did not raise the role of Time Warner in contracting installation with Cascom). In investigating the relationship between Cascom and its phalanx of individual subcontractors, the agency called into question the idea that the individual installers were truly "independent" from Cascom, given that virtually all aspects of their subcontracted services were determined by it. In an important decision, the district court of the Southern District of Ohio held in favor of the Department of Labor's position that the 250 installers were in fact employees and not independent contractors. As a result, the workers were entitled to overtime pay amounting to over $800,000 and an equal amount of liquidated damages (also paid to the affected workers).[66]

What We Have Here Is a Failure to Coordinate

Subcontracting used to be about the provision and use of specialized services by an employer that could be drawn upon for particular types of work where it would make little sense to have these activities or this expertise in the core of the organization. The external market could provide these services at lower cost and higher quality. Fissured subcontracting differs in that it applies the subcontracting model to core activities of the firm—for example, coal extraction versus blasting; cell tower expansion and maintenance versus one-off service; ongoing manufacturing operations or cable installations versus staffing for peak-demand periods. This type of subcontracting has been adapted in many ways to reflect the balancing required in different industries and to meet the particular needs of lead business organizations.

The contracts that emerge in different cases all specify work at highly detailed levels that maintain the lead firm's leverage regarding price, timing, place of delivery, and so on. And such contracts provide clear standards, guidelines, monitoring, and penalties (sometimes explicit, always implicit) about the consequences to the subcontractor if it fails to meet the guidelines. This is the glue that holds subcontractors to the outcomes that are central to the lead firm's core competency.

Subcontracting often occurs where there is a large pool of potential contractors in the secondary and tertiary markets. In some cases, an intermediary is placed between the principal and the competitive subcontractors, for example, turfers in the case of cellular towers. In other instances, subcontractors bid directly for work from lead businesses. The decision by the lead business to place an intermediary in the mix is based on its need for someone to play a coordinating role, the risk of collusion among those contractors, and the information possessed by various parties in the particular market.[67] But in most of the cases documented here, the lead business calls upon a large group of competitors through an arm's-length relationship, often allowing other subcontracting tiers to emerge under them. This setup requires the presence of a large pool of potential contractors who are willing to take work even under financially questionable terms. In most of the cases—from coal mining to making chocolate—this supply base appears to be more than adequate to fill the needs of lead businesses.

An alternative format places the lower tiers of fissuring in alignment with those of the lead business through a more inclusive business model, but one still requiring explicit detailed standards, monitoring arrangements, and penalties. That format comes from the world of franchising.

6

Fissuring and Franchising

Lead companies retain activities that are central to their competitive strategy while shedding activities where doing so reduces costs, increases flexibility, and shifts liabilities. But this decision is guided by the constant balancing of the potential impact of shedding an activity that might in the long-term undermine the core competitive strategy. Franchising is an organizational form used to connect the lead company with subsidiary organizations that provides the required glue to keep the pieces of the fissured strategy together. Franchising is an old form of business organization. It historically solved the unique problems faced by manufacturers in finding effective ways to distribute products. In more recent times, it has proved a powerful means to tap the capital and entrepreneurial drive of new business owners who seek opportunities to expand an established product or service. But, less recognized, franchising also provides a way to glue the two pieces of the fissured strategy together.

Franchising potentially provides a lead business with a method of preserving the benefits of a strong brand while controlling labor costs (particularly important for service businesses, where labor represents a significant share of costs). It has become a pervasive form of business organization in a wide variety of industries, spanning fast food, hotels, car rental, home health care, and janitorial services. Since it also allows lead companies to focus on enhancing the gains of branding while using fissured employment to lower labor costs, exploring its use and consequences helps illuminate the broader effects of fissuring.[1] We explore examples of franchising as an organizational form that leads to fissured workplaces in three different settings: fast food, janitorial services, and the hotel/motel industries.

First Principles for Fissured Franchising

Build the Brand

In many of the industries where fissured workplaces have become common, major companies have sought to enhance the value of their products and services to increase revenue streams. Brand-focused competencies enable businesses to create a distinctive bond between customers and the products and services they consume. Successful branding allows a company to differentiate its products in the minds of consumers, who, over time, become willing to pay a higher premium for them. Branding acts on the revenue side of profitability: the more successful the brand, the greater the ability of the business to charge a premium and expand and retain its customer base. Once established, the benefits arising from branding can be expanded by broadening product offerings and managing the expectations of the brand's devoted customer base.[2]

Branding is particularly important in industries where perceptions of the quality, consistency, and variety of the product are critical to competitive performance—that is, in areas where the product or service is not viewed as a commodity.[3] By establishing a brand, a company can differentiate its product and create a large and loyal customer base. Return business for a company and the willingness of customers to pay a higher price are based on a variety of product or service attributes that companies can control through production, by influencing customer perceptions, or both. A branded competency involves major investment in the creation of the brand identity on the production/delivery side and in the realm of marketing. It also requires huge investments in protection of brand image over the long term given that investment. Brand core competencies also require an ongoing ability to manage and expand the brand, in response to competitive brands, threats from new entrants, or the inevitable product fatigue that a consumer group may develop over time.

In the fast-food industry, return business is based partly on the customer's belief that the experience will be the same in any outlet of the company visited.[4] The investment in brand name and protection of its image is therefore a central part of the competitive strategy of national chains and an integral part of the way they make operational decisions.[5] As a result, franchise agreements begin with statements about the importance of adhering to the chain's basic standards. For example, the franchise agreement with Taco Bell states, "You must operate your facilities according to methods, standards, and procedures (the 'System') that Taco Bell provides in minute detail." Not surprisingly, the methods, procedures, and guidelines regarding the creation of a good or the provision of a service are the "crown jewels" of a branded business. The books of standards associated with fast-food or hotel/motel brands are highly confidential documents that are provided only to franchisees who have been approved. Monitoring mechanisms, contract terms, and high-powered incentives (including, in the worst case, loss of the franchise) are associated with adherence to those standards.

One of the key operational decisions made by companies is how to expand. In service industries like eating and drinking establishments, hotels and motels, and rental cars, companies expand by adding outlets. This can be accomplished in a franchised structure in one of two ways. The first way is by opening new outlets that are both owned and operated by the franchisor itself. Expansion through the creation of company-owned outlets is an attractive option because the branded company (or "franchisor") retains control over operational decisions and can therefore be better assured that brand standards are maintained. However, expansion through company ownership entails using the franchisor's capital directly and introduces managerial challenges about ensuring efficient operation of the outlet.

The second way a company can expand is by offering outside investors the opportunity to franchise. Strong brand identity benefits franchisees: by purchasing or operating a franchise of an established brand, a franchisee gains a proven business strategy with a known and trusted name. At the same time, franchising allows for expansion by tapping into the capital of franchisees, potentially expanding the opportunities for growth of the brand. Franchisors receive revenue streams both in the form of upfront fees by franchisees to purchase the franchise and as ongoing payments based on sales. Under a typical franchise agreement, the franchisee purchases the right to own and operate an establishment using the franchisor's brand name and products for a set period of time. In return, the franchisee pays an upfront fee and agrees to provide a portion of revenues (typically around 6%, although it may go as high as 12% in the case of McDonald's) to the franchisor.[6]

Franchising is also an attractive ownership form for geographically dispersed, labor-intensive, and service-based industries. In such an industry, an enterprise's profitability is closely tied to the productivity and service delivery of its workforce. Assuring workforce productivity, in turn, requires effective management, including careful monitoring of the workplace. A large company with geographically dispersed outlets can therefore use franchising—rather than relying on company-owned and -managed outlets—to better align the incentives of the franchisee, whose earnings are linked to the outlet's profitability. For these reasons, restaurants represent the most highly franchised industry in the United States.[7]

Gaining Access to Capital for Second-Tier Firms

Franchising provides a means for the branded company to expand, drawing in large part on the capital provided by individual franchisees. One reason franchising has grown and expanded in scope is the expansion of capital sources for franchisees.

In the developed franchise model found in fast food, part of that start-up capital comes from the franchisor itself. Franchisors provide capital not out of altruism but as an additional source of revenue: by loaning money to franchisees at a higher interest rate than they can access capital for themselves, they earn a nice spread. In many cases, this represents a legitimate way for the franchisor to arbitrage risk itself, benefiting both parties. However, in some cases (such as with janitorial franchising, as we shall see) it represents a pernicious way for franchisors to take advantage of unsophisticated franchisees.

In the hotel/motel industry, with its far higher requirements for capitalization, franchisees draw on more sophisticated sources of capital, including, increasingly in recent years, private equity providers like Nobel Investment Group and Blackstone. A second source of capital is real estate investment trusts (REITs), an investment vehicle expressly developed by Congress for industries like hospitality that allows multiple investors to pool their capital and receive tax benefits from real estate investment.[8]

The other capital market option for franchised industries with lower up-front capitalization requirements such as janitorial services and home health assistance (and, in general, for lower tiers of many fissured structures) is relatively high-interest sources of financing like personal and business credit cards. Small businesses are particularly reliant on credit cards as a source of capital. In 2003 almost 90% used some form of credit. While 60% of small firms used six traditional types of loans, such as credit lines, mortgage loans, and others, about 80% used nontraditional sources such as owners' loans and personal and business credit cards.[9] Nontraditional sources like business credit cards expose small second-, third- and lower-tiered businesses to even more cost pressure and risk, further exacerbating the negative employment consequences of fissured workplaces.[10]

Fissured Fast Food

Although franchising acts as an organizational glue, tensions between franchisors and franchisees still arise in franchise structures. Because franchisees pay royalties that are linked to revenues as opposed to profits, the franchisor benefits financially from increased sales (revenue), while the franchisee seeks to maximize profit (revenue less cost). This can lead to differences in terms of pricing, promotion, and cost control strategy.[11] In addition, although the franchisee has a stake in brand reputation, its stake is not as great as that of the franchisor. A franchisee has incentives to "free ride" on the established brand and may be willing to cut corners to reduce costs or improve its individual bottom line, even if such actions have negative consequences for the branded company.[12] This means that franchisees may be more willing to violate consumer, workplace, or environmental regulations in order to reduce labor costs than would be the case for company-controlled units.

Brand investment by the franchisor also makes investments by potential franchisees attractive. Franchisees, through the agreements signed with the franchisor, must adhere to standards and procedures that maintain the integrity of the brand. But because their profits are determined by the percentage of revenues kept after payment to the franchisor minus their costs, they face incentives to manage costs carefully (if not aggressively).

From one perspective, this puts the franchisor in a position to attempt to "appropriate" (in economics jargon) as much of the profits as possible, leaving franchisees only the bare minimum return to justify their investment. On the other hand, if franchisors are too greedy and take all of the spoils, they will be unable to attract other franchisees and potentially will lose existing ones as well. From a long-term perspective, it makes sense for the franchisor as the lead player to share (although certainly not everything).[13]

As anyone with young children knows, learning how to share is difficult. Not surprisingly, one finds a spectrum of franchisor/franchisee sharing behavior. At one end of the spectrum is the grandfather of fast-food franchising, McDonald's. McDonald's has some of the highest hurdles faced by would-be franchisees in terms of screening, approval, qualifications, and upfront payments. These high performance standards continue after a firm has entered into a franchise relationship, and franchisees pay one of the higher royalty payments (percentage of royalties on revenues) of any fast-food company.

But the company leaves money on the table for its carefully screened franchisees. In a rigorous analysis of the economic profitability of franchising, Kaufmann and Lafontaine show that McDonald's franchisees earned an estimated economic profit of close to 6% on revenues. They conclude that this represented a return above and beyond what a franchisee might receive from a comparably risky investment if they had not become a franchisee.[14] The authors do not provide a comparable estimate of the economic profits of the franchisor side of McDonald's operations, however.

On the other end of the spectrum, many franchisees complain that franchisors do exactly what a self-interested lead firm might be feared to do: take as much profit as possible from franchisees while continuing to reap the economic profits from investment in a national brand reputation. In the early 1990s, this was a common complaint among franchisees of Subway, who complained that the sandwich company was perfectly happy to cycle through failed franchisees as long as it received its upfront payments and at least enough royalty payments to keep the Subway brand on the street. Other examples of franchisors benefiting at the expense of franchisees include a series of suits brought by franchisees of Quiznos.[15]

It's Good to Be the (Burger) King

In a fissured workplace, one would expect the returns to the lead company (here a franchisor) to have higher profitability than a subordinate unit operating at an outer orbit (a franchisee). It is difficult to directly compare the rates of returns of franchisees and franchisors using publicly available information because most franchisees are privately held and because of the difficulty of attributing costs that are often pooled in income statements to either the franchisor or the franchisee.[16] It is still useful to compare profitability to illustrate the differing financial pressures faced by the parties in a franchise agreement. Table 6.1 compares two measures of profitability—return on assets

Table 6.1 Comparative profitability between franchisors and franchisees, Yum! Brands and Burger King Corporation

Company	Brand(s)	Franchisee or franchisor	Return on assets (%)[a]		Return on revenues (%)[b]	
			2007	2008	2007	2008
Yum! Brands (U.S.)	Pizza Hut, KFC, Taco Bell, Long John Silver's, A&W	Franchisor	16.5	19.6	11.4	11.4
NPC International Inc.	Pizza Hut	Franchisee	1.1	1.2	1.3	1.5
Morgan's Foods Inc.	KFC, Taco Bell, combination stores	Franchisee	7.0	1.4	4.0	.8
Burger King Corp.	Burger King	Franchisor	10.6	10.5	11.2	11.4
Carrols Corp.	Burger King	Franchisee	4.8	4.5	2.9	2.5

Sources: United States SEC Form 10-K: Yum! Brands Inc., FY 2007, 2008; NPC International Inc., FY 2007, 2008; Morgan's Foods Inc., FY 2007, 2008; Burger King Holdings Inc., FY 2007, 2008; Carrols Corporation, FY 2007, 2008.

a. Net income before taxes divided by total assets.

b. Net income before taxes divided by total reported sales from all sources.

and return on revenues—for two major franchisors with the returns for some of their publicly held franchisees. The table compares both measures of profitability in 2007 and 2008, the years immediately before the Great Recession.

The Yum! company, which owns Pizza Hut, Taco Bell, KFC, and other brands, had return on assets of 16.5% in 2007 and 19.6% in 2008 and return on revenues of around 11% during those years. This compared to return on assets and on revenues of about 1% for NPC International, one of the largest U.S. franchisees (which owned 1,098 Pizza Hut restaurants in 2008). Morgan Foods, another large Yum! franchisee that operates KFC and Taco Bell outlets, had somewhat better performance, with return on assets of 7% in 2007 and 1% in 2008 and return on revenues of 4% in 2007 and a little under 1% in 2008. But these were still far below the level of profitability of its franchisor.

Similar gaps in profitability are apparent for Burger King and one of its franchisees, Carrols Corporation. In 2007 and 2008 the return on assets and return on revenues for the Burger King Corporation ranged around 11%. For Carrols Corporation, the comparable rates of return were around 4.5% (return on assets) and just under 3% (return on revenues). Notably, Carrols Corporation was one of Burger King's largest franchisees.

Since Yum! and Burger King, like most franchisors, encourage growth among their most successful franchisees, it is likely that the rates of return in Table 6.1 among the franchisees represent the higher end of profitability among franchisees of those companies.[17] This would make the franchisee estimates an upper bound, meaning that the gap between the profitability of franchisors relative to franchisees is even larger. To paraphrase that great economist, Mel Brooks, "It is good to be the [Burger] King."

Effects of Fast-Food Franchising on Workplace Labor Standards

The eating and drinking industry employs over 10 million individuals. It is composed of two distinct sectors: full-service restaurants and limited-service (or fast-food) eating places. The limited-service sector accounts for about 37% of employment in the industry, or about 3.3 million workers. The vast majority (88%) of jobs in the industry are low-skilled and relate to food preparation and service. Employment is concentrated in small establishments, which average about seventeen workers per outlet.[18] Average hourly earnings for food preparers and servers in 2006 were $7.23, with a median wage of $7.02 and a tenth percentile wage of $5.79—both well below the current federal minimum wage of $7.25.[19] The large number of low-wage jobs makes the industry particularly prone to minimum wage and hours of work violations.

An estimated 18.2% of workers in the sector experienced minimum wage violations, 69.7% overtime violations, and 74.2% off-the-clock violations.[20] Estimated violation rates were similar for one key occupational group within the sector—cooks, dishwashers, and food preparers: 23.1% experienced minimum wage violations, 67.8% overtime violations, and 72.9% off-the-clock violations. The estimated amount of annual back wages owed by the industry is also sizable: the average amount of back wages recovered during the 2003–2008 period was $12.9 million per year.

Franchisees, who typically own and manage their own outlets, seek to maximize the profit of only their own units whereas the franchisor benefits from increases in sales of all outlets in the chain, whether franchised or company-owned. Franchisors are therefore more concerned about the deterioration of brand reputation, because it potentially affects sales in all units. Given this, a franchisor has a greater incentive to comply with laws that affect consumers' perceptions of the brand. As a result, company-owned units have a greater incentive to comply with workplace regulations relative to franchisee-owned units, which are likely to exert relatively less effort to comply given their incentive to maximize profits only at their own outlets.[21]

A comparison of outlet-level compliance with federal minimum wage and overtime laws between franchised and company-owned enterprises in the top twenty U.S. fast-food companies illuminates the consequences of franchising as a form of the fissured workplace. There are many reasons franchisee-owned outlets might have higher noncompliance than company-owned outlets that have little to do with franchise status itself. In this view, the comparisons are unfair in that they involve outlets that might be very different in other respects, leading one to incorrectly attribute the differences to franchising. For example, franchisees might be more common in areas where there is greater competition among fast-food restaurants. That competition (and franchising only indirectly) might lead them to have higher incentives to not comply. Alternatively, company-owned outlets might be in locations with stronger consumer markets, higher-skilled workers, or lower crime rates, all of which might also be associated with compliance.

To adequately account for these problems, statistical models that consider all of the potentially relevant factors, including franchise status, are generated to predict compliance levels. By doing so, the effect of franchising can be examined, holding other factors constant. This allows measurement of the impact on compliance of an outlet being run by a franchisee with otherwise identical features, as opposed to a company-owned outlet.

Figure 6.1 provides estimates of the impact of franchise ownership on three different measures of compliance for the top twenty branded fast-food companies in the United States.[22] The figure presents the percentage difference in compliance between franchised outlets relative to otherwise comparable company-owned outlets of the same brand.[23]

Compliance differs dramatically between franchisees and company-owned outlets. The probability of noncompliance is about 24% higher among franchisee-owned outlets than among otherwise similar company-owned outlets. Total back wages owed workers who were paid in violation were on average 50% higher for franchisees, and overall back wages found per investigation were close to 60% higher.[24] Not only do these results suggest that franchisees, faced by more competitive conditions and holding less of a stake in the brand than the lead company (the franchisor), are significantly more

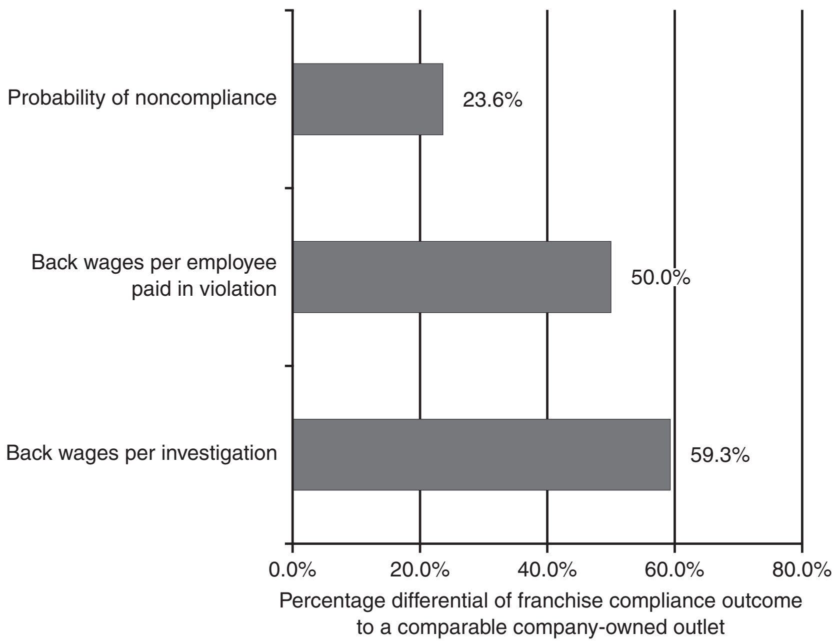

FIGURE 6.1. Effects of franchising on employer back wages and compliance, U.S. fast-food industry, top twenty brands, 2001–2005 (in 2005 dollars). *Source:* Ji and Weil 2012.

likely to fall out of compliance, but they also show that workers directly employed by the lead companies are much more likely to be paid according to the law. Indicative of this is the fact that one-half of the top twenty brands had *no* violations and owed no back wages at *any* of their company-owned outlets even though the franchisees in those same companies often owed substantial back wages to employees.[25]

Franchising and Fissuring in Janitorial Services

For the majority of janitorial service workers, wages are low and benefit coverage minimal. Conditions on the job subject them to workplace injuries and illnesses as well as the ups and downs in employment that are basic to market economies. The janitorial services sector usually ranks high on lists of workplaces with widespread violations of labor standards. In 2009 an estimated 22% of surveyed workers in the security, building, and grounds industries had not received minimum wage payments, and 63% had not received pay for overtime. Based on an occupational rather than industry definition, building services and grounds workers experienced minimum wage violation rates of 26% and overtime violation rates above 71%. Far more than half of workers in this industry and occupation classification failed to receive required meal breaks. An equally high percentage were not compensated for work done at the beginning or end of their shift (that is, off-the-clock violations), such as being asked to clean an area before officially punching in or out for work.[26]

As in other industries, it is not useful to simply attribute high violation rates to the malevolence or venality of specific employers. Instead, they can be traced to the structure of markets and competition arising from the widespread outsourcing of maintenance activities, the consequent creation of a competitive market to provide janitorial services to those organizations, and the emergence of specific types of business models that set market prices and the conditions in which wage policies are set.

Creating the Janitorial Services Market

Like many other business functions, cleaning and maintenance of facilities have been shed by many organizations—public, private, and nonprofit. This outsourcing of maintenance and janitorial services has a logical rationale: a hospital, law practice, software developer, or insurance company does not have comparative advantages in managing cleaning and property maintenance services.[27] The outsourcing of cleaning and maintenance functions to outside companies gave rise to what is now a very large supply base of companies providing janitorial services. In 2007 the sector was comprised of 50,325 firms employing over 940,000 workers and took in $34.7 billion in revenue.[28]

Firms in the industry range in size and organizational structure. At one extreme are large corporations that provide maintenance services for major companies and for venues like convention centers. A small number of very large firms with annual revenues exceeding $100 million (eighty-six companies representing less than 1% of all firms in the industry) account for about 25% of industry employment.[29] These include companies like ABM Industries, a $3.5 billion maintenance, security, and janitorial company with a client list that once included the World Trade Center and now includes major companies like Cisco Systems as well as large organizations like the government of Sonoma County, California, and major school districts in Arizona.

At the other end of the spectrum, thousands of cleaning companies serve small business customers in local markets. Although these very small entities, with annual revenues below $500,000, represent 83% of all firms in the industry, they account for only 19% of industry employment.[30] Small entrepreneurs are drawn to the industry because of the modest capital and formal business requirements, the large potential customer base, and the ample supply of low-skilled labor (often from an immigrant workforce).

In between the large-scale players catering to major clients and the small-scale businesses serving small customers are the bulk of employers, with revenues above $500,000 but below $100 million. This group accounts for 17% of firms but 56% of all employment.

Franchising has become a common form of business organization in this tier of the janitorial services industry, and a growing number of janitorial service companies use franchising as the primary mechanism of business expansion.[31] Franchised operations serve clients through a form of organization that combines common components of franchising with unique features that place particular competitive pressure on their owners as well as the market as a whole.

How Janitorial Franchising Works

There are a number of franchised companies operating across the United States. Examples include Coverall North America, Jan-Pro Franchising

International, CleanNet USA, and Jani-King International.[32] One of the largest franchised firms is Coverall, whose revenues equaled $224 million in 2008. Coverall had over 5,400 franchised outlets at the end of that year, operating in almost half of all U.S. states.[33] Franchisees of the company provide cleaning services to general office facilities; fitness centers and health clubs; child care, health care, and educational institutions; retail, manufacturing, government, and warehouse facilities; auto dealerships; and restaurants. As a franchised company, Coverall advertises a unique system of cleaning to prospective owners.[34] Presumably the distinctive approach gives an interested entrepreneur a leg up in entering the business.

A franchisee in the janitorial service sector pays the franchisor initial fees to acquire a franchise and ongoing fees linked to revenues. The initial franchise fee is related to the size of customer base the franchisee will be provided upon start-up. For example, the initial fee for Coverall franchisees ranges from $10,000 to $32,000 depending on the size of the customer base being "purchased." Janitorial franchisees must also pay the franchisor a fee based on customer revenues, usually broken into a royalty and a management fee; for Coverall, the royalty fee is 5% and the management fee is 10% of gross revenues. The franchisor also earns revenues through the sale of cleaning materials to its franchisees, but revenues from this source are modest. In exchange for the initial and ongoing fee payments, the franchisor provides franchisees with (1) an initial customer list; (2) training in the franchise's method of cleaning; (3) starter supplies and equipment; (4) advice and counseling; and (5) a "brand."

Most janitorial franchisees are organized in geographic tiers. For example, at Coverall, beneath the franchisor are regional or master franchisors who, in turn, sell franchises on a "unit" or territory basis. Unit franchises provide services to a specified list of customers supplied by the company.[35] Most provide the franchisee with a guarantee of this business for a time-delimited period. However, those guarantees are highly contingent on the reasons clients were lost.[36]

The Business Model

Although some of the features described above are standard components of franchising in any industry (for example, fees based on revenues received), others are more distinctive to the janitorial sector. First, the company provides its franchisees with an initial customer base as part of the basic franchise package. This takes the form of a list of customers for the franchisee that together provide revenues equal to the value of the package purchased by the franchisee.[37] In principle, this gives the new business an immediate customer base to serve. However, if the franchisee does not wish to provide services to a customer on the list (due to geographic distance, time required for the work, or other reasons), the franchisor is under no obligation to replace it with another client or clients. That burden falls to the franchisee.

Second, although franchisees work for clients, the primary relationship remains that between the client and the *franchisor.* Most striking, the price for a job is negotiated and set by the franchisor, not the franchisee. The franchisor receives payment for work completed and then forwards the remaining amount (gross revenues less royalty and management fees) to the franchisee. Jan-Pro's franchise agreement, for example, states:

> Each month we will bill your Customers for the services you provide. We will collect the monies we receive on such billings and pay you on a monthly basis on the last day of each month the net amount due to you after deduction of our Royalty Fee, Management Fee, Sales & Marketing Fee, payments due under a Promissory Note, and any other amounts due to us.[38]

Even if a franchisee finds new clients, it must refer them to the franchisor, which then sets terms and conditions for the franchisee.[39] It is not clear how involved the franchisee is in those discussions (which might vary according to the history, size, and relationship among Coverall, the master franchisee, and the unit franchisee). The overall janitorial franchising relationship is depicted in Figure 6.2.

The dominant role of janitorial franchisors in setting the terms and conditions of the relationship in some senses is similar to other franchise settings. Burger King or McDonald's, for example, set most terms regarding how stores function, the menu, and, to a more contested degree, prices for products. But the janitorial model is more intrusive, particularly in that actual revenues flow first to the franchisor and then back to the franchisee.

These relationships potentially set up conflicts of interest between franchisors and franchisees. This can be seen most strikingly in the impact of a franchisee losing a client's business. For the franchisee, customer loss has a detrimental impact on financial operations, for obvious reasons. For the franchisor,

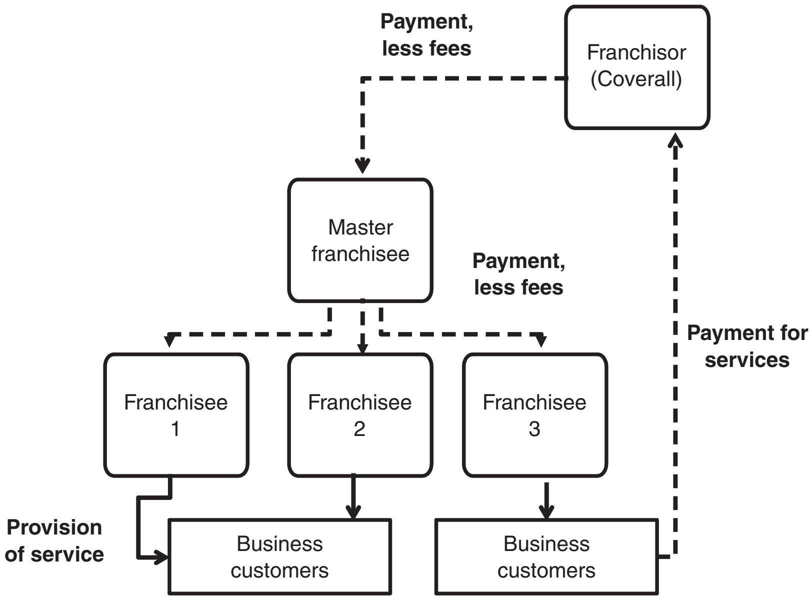

FIGURE 6.2. Janitorial services franchising.

however, if one franchisee loses a client, it becomes available for another franchisee in the system (provided the customer is still willing to work with that franchisor). As noted above, the franchisor has no obligation to find a replacement client under these circumstances. In fact, a client lost by one franchisee provides the franchisor with an opportunity to resell it, along with other clients, to a new franchisee, thus earning additional initial franchisee fees for the franchisor.[40]

Can a Janitorial Franchisee Be Financially Viable?

Can a janitorial franchisee hope to make a reasonable return to compensate himself or herself for the upfront investment in franchise fees[41] and the ongoing payment of royalties? The answer depends in large part on the fees the franchisor negotiates with clients for its franchisee's services. Since the janitorial service market is large, competitive, fractured, and easy to enter and exit, the downward pressure on price—particularly for services to midsized businesses and organizations—is fierce.

Suits and complaints/stories on industry blogs paint a picture of widespread discontent about the revenues franchisees allege they were promised to earn in the business. Although it is difficult to document these promises in writing, they are frequently cited in legal actions brought by discontented franchisees. Similarly, many of the blogs and websites promoting franchising cite figures that average around $25 per hour in terms of what a franchisee can expect to charge a typical client.[42] If franchisees received this level of compensation for their services, our financial models indicate that they could service contracts, pay workers according to legal requirements, and make a reasonable rate of return (see below).

The reality, however, appears very different. A variety of news stories on the sector offer franchisee accounts of earning less—far less—than $25 per hour for services. For example, a 2005 *New York Times* article recounts the case of a Boston-based Coverall franchisee who reported working 280 hours per month and earning $1,262, implying hourly earnings of $4.50. A 2009 report included a similar story of a Coverall franchisee who was assured of receiving between $18 and$20 an hour, but whose actual price turned out to be under $11 per hour.[43]

One reason the hourly figure often quoted to potential and current franchisees is above the actual price paid to franchisees is that clients sign contracts based on a price for service provision, without an explicit statement of hours. As noted, since the terms of contracts are negotiated between the franchisor and the customer (and not the franchisee), the franchisor has less of an incentive to consider the total time required for completion of the service in setting the price.[44]

Hourly prices for basic janitorial services based on prevailing contract rates can be estimated drawing on a variety of sources regarding the terms of contract payment, the number of visits required by a cleaning agreement, the typical service provision (that is, what cleaning services would be provided), and a conservative estimate of the number of hours required to provide services for that type of contract.[45] The resulting estimates are summarized in Table 6.2.

For a small client who requires very basic janitorial services, contracts are often bid on the basis of a price per service visit. A typical price for basic service at a small office (vacuuming, dusting, trash removal, bathroom cleaning) is $25–$30 per visit. The minimum time required for basic services of this

Table 6.2 Hourly pricing for basic janitorial services, market surveys, 2009

	Small office/ facility, minimal service	Small office/ facility, basic service	Medium office/ facility, daily service	Large office/ daily service
Contract term	$20–30 per visit	$150–250 per month	$500–$700 per month	$2,000–$4,000 per month
Number of visits	Single visit	8 per month	20 per month	20 per month
Cleaning activities[a]	Vacuuming, dusting, trash pickup and removal, bathroom cleaning	Vacuuming, dusting, trash pickup and removal, bathroom cleaning	Vacuuming, dusting, trash pickup and removal, bathroom cleaning	Vacuuming, dusting, trash pickup and removal, bathroom and kitchen cleaning
Time per visit	1.5 hours	2 hours	2 hours	8 hours
Site characteristics[b]	1–2 offices and restroom	2–3 offices, common space, restroom	2–3 offices, common space, restroom	20,000-square-foot office, restrooms, and kitchenette
Estimated price per hour	$16.67	$12.50	$15.00	$16.67

Sources: Based on pricing, contract term, time, and square-foot estimates from the following sources: Cleaning Management Institute, "2009 Kaviac Inc. Contract Cleaning Benchmarking Survey Report," CMI/NTP Media, 2009 survey; "Office Cleaning Costs: What People Are Paying," Costhelper.com (http://www.costhelper.com/cost/small-business/office-cleaning.html); "Commercial Cleaning Services—Buyer's Guide" (http://smallbusiness.yahoo.com/advisor/commercial-cleaning-services-buyers-guide-144201040.html).

a. Based in part on work hours devoted to particular tasks; CMI/NTP Media, 2009 survey.

b. Based on cost estimates for office tasks and square footage of office area.

kind is around 1.5 hours per visit, leading to an average price for services of $16.67 per hour.

More commonly, customers contract on the basis of monthly rates for the provision of a specific level of janitorial services (for example, $500 per month to clean a branch bank five nights a week). Very basic janitorial service for a medium-size property can run between $100 and $200 a month, assuming eight visits each month, which translates into an hourly rate between $8.33 and $16.67. For a client requiring nightly cleaning services, payment can range between $500 and $700 per month (assuming a conservative two hours for basic cleaning), which implies an average payment of $15 per hour. Basic nightly service for a large office (for example, a 20,000-square-foot property), requiring the use of several cleaners, is priced in the $2,000–$4,000 monthly range. Once again, very conservative assumptions regarding time required for this work implies an hourly rate of around $15.

These estimates therefore suggest hourly payments well below the $20–$25 often quoted to franchisees, and probably closer to a rate of $15 per hour. Although rates vary according to geographic area, quality of service, desire for specialty cleaning requirements (for example, carpet cleaning and special surface cleaning), the figures in Table 6.2 provide conservative estimates for basic service provision.

The Bottom Line: It Pays Not to Comply

As a tool to examine the pressure to not comply with labor standards (and presumably other public policies) given prevailing market prices and the costs facing franchisees, a simplified model of the financials for a franchised janitorial services contractor can be created. The model can be constructed using information from franchise disclosure documents (FDDs)[46] filed by Coverall as inputs for the operational requirements of a typical franchisee in 2009 and, to the extent possible, using estimates and assumptions directly from the company's FDD.[47]

Assume that a franchisee is operating at a scale of more than $500,000 per year in gross revenues. By setting an average price level for services at different hourly rates, and then calculating the franchisee's economic profit, the average rate of pay for employees (given the hours required to complete the work) can be calculated, given the assumption that the franchisee simply seeks to break even on an ongoing basis.[48]

An entrepreneur would find it difficult to break even (pay expenses and a reasonable compensation to him- or herself) and comply with minimum wage laws if the gross hourly price for services falls below $15 (see Table 6.3). If the franchisee seeks to make a positive economic return, the downward pressure on labor costs intensifies further.

These results, coupled with the pricing data reviewed in Table 6.2, imply that the franchised portion of the industry, as currently structured, has a built-in bias toward noncompliance given prevailing conditions for janitorial services in many markets. In essence, a franchisee cannot service the contracts provided by the franchisor at the market prices prevailing in many cases and still comply with labor standards without going into the red. The landscape of compliance becomes tilted toward violations of labor standards (as well as cutting corners in any other way to minimize costs).

But if janitorial franchising is inherently not profitable, why has it persisted—indeed, grown significantly—in recent years? The answer is twofold. First, the above suggests that franchising cannot be profitable *if* the franchisee adheres to wage and hour laws as well as, presumably, meeting its basic legal obligations (for example, workers' compensation, unemployment, and Social Security payments). Hence the incentive for noncompliance.

Second, the above analysis suggests that a company that does pay workers according to the law—whether because of a desire to obey the law or arising from tight labor market pressures—will have a hard time surviving. This would lead one to predict high rates of turnover among franchisees. In fact, a

Table 6.3 Maximum wage for Coverall franchisee given profit targets

Profit for franchisee (given $500K annual revenues)	If the hourly price for janitorial service is:		
	P = $20	P = $15	P = $12.50
Break even (0)	$11.39	$7.77	$6.02
$25,000	$10.43	$7.07	$5.44
$50,000	$ 9.47	$6.37	$4.86
$75,000	$ 8.51	$5.66	$4.28

Note: Based on model using franchisee royalty and operating fees and information from Coverall franchise disclosure documents; typical amount of debt for upfront franchise payment and baseline assumptions about economic profits based on alternative employment of franchisee at $30,000 annually.

review of data from FDDs reveals such high turnover. The high level of turnover among some of the leading janitorial franchisees relative to franchisees in the fast-food industry is depicted in Table 6.4. The figures not only indicate high annual turnover—15%—from franchisees exiting the industry (compared with about 3% at KFC, one of the major fast-food franchisors), but also the large number of incoming franchisees (leading to an overall increase in the number of franchisees). The significant supply of prospective franchisees to replace those unable to make the business model work allows franchising to persist (and to benefit the franchisor).

Finally, it should be remembered that while being a law-abiding franchisee in many markets does not offer sustainable profits, this does not imply

Table 6.4 Turnover among janitorial services franchised companies, 2006–2009, and fast-food benchmarks

Franchised janitorial services company	Exits: terminations, nonrenewals, reacquired by franchisor, and ceased operations		Entries: new franchisees (outlets opened)		Net change (average)
	Average no.*	% of franchisees**	Average no.*	% of franchisees**	
Coverall[a]	589	12.4	715	15.1	+126
Jani-King[b]	1,619	16.5	1,255	12.8	–364
CleanNet USA[c]	233	7.3	563.3	17.5	+330.3
KFC[d]	162	3.8	162	3.8	0

Sources:

a. Coverall North America Franchise Disclosure Document, May 2009, p. 39. Accessed through the California Electronic Access to Securities Information and Franchise Information, http://134.186.208.233/caleasi/pub/exsearch.htm.

b. Jani-King of Boston Inc. Franchise Disclosure Document, April 30, 2010.

c. CleanNet of Southern California Franchise Disclosure Document, March 19, 2009, p. 33. Accessed through the California Electronic Access to Securities Information and Franchise Information, http://134.186.208.233/caleasi/pub/exsearch.htm.

d. KFC Franchise Disclosure Documents, September 23, 2010.

* Average annual exits/entries over the period 2006–2008 (Coverall; CleanNet USA; KFC); 2007–2009 (Jani-King).

** Percentage of exits/entries versus the reported number of franchised outlets at the beginning of the relevant calendar year.

that such profits are not attainable for the *franchisor.* Since the franchisor receives payment from royalties linked to revenues but does not face the direct costs of employing workers or the other costs of cleaning, it can still earn reasonable returns even given tough market conditions and downward pricing pressure. In the above models, franchisor profitability (defined as operating income as a percentage of gross revenues) ranged from a low of about 3% for Coverall to 41% for Jan-Pro, with other franchisors in the 8%–10% range.[49]

The large demand for services and the elastic supply of janitorial service providers create market conditions that push prices for services down toward the lowest costs of the existing supply base for a given quality tier. The ready supply of would-be franchisees therefore drives prevailing market prices down toward a level below that necessary to meet basic labor standards required by the law. In effect, by being the lowest-cost suppliers in many commercial markets, franchisees set a baseline price for services, which in turn leads them to be unable to sustain their businesses within state or federal wage and hour requirements (and undoubtedly other requirements such as workers' compensation, unemployment insurance, and even payroll taxes owed to the state and federal government). As a result, the high rates of noncompliance arise from the interaction of the competitive conditions driving the market for janitorial services and the role that a pervasive form of business organization plays in the behavior of individual players and, in turn, the market price on the margin.

Hybrid Fissuring in the Hospitality Industry

Hospitality Staffing Solutions is an Atlanta-based company operating in thirty-six states and more than seventy markets that provides hotel properties with housekeeping, janitorial, stewarding (dishwashing and kitchen support), laundry, food and beverage (waiters and waitresses and banquet help), and grounds maintenance staff. The company summarizes its core strategy succinctly: "Our value proposition is simple: provide the same motivated, reliable workers every day at a lower cost. Hospitality Staffing Solutions© delivers through highly selective grassroots hiring, employee compliance, and inclusive pricing which saves our customers on average 12% on personnel costs." In so doing, Hospitality Staffing Solutions offers to provide hotel clients with "the continuity of full time employees with the scalability to meet their changing needs—from a handful of associates to entire departments." Given the importance of service to both hotel chains and owners of properties, the company assures clients that its staff will meet the particular standards and quality levels of each brand, noting that the hotels it serves "consistently score in the top 20 properties in guest satisfaction for their brands."[50]

In the summer of 2009, Hyatt Hotels Corporation fired ninety-eight housekeepers who worked at its Hyatt Regency Boston, Hyatt Regency Cambridge, and Hyatt Harborside at Logan International Airport properties. The fired employees earned between $14 and $16 per hour with health and other benefits. Most had worked for Hyatt for years—some having more than twenty years of seniority. The employees were replaced by workers from Hospitality Staffing Solutions who were paid $8 per hour and received no benefits. Employees at the Hyatt properties trained the new workers before they were told that they would be replaced by them, on the pretext that the new workers were being brought in to fill in for staff when they were on vacation or out sick (an allegation the company contested). "Everyone was shocked. A lot of people were crying." Lucine Williams, one of the longtime Hyatt employees who lost her job, said to reporters.[51]

In its public statement, Hyatt argued that the "difficult decision to outsource the housekeeping function at our Boston properties was made in response to the unprecedented economic challenges those hotels are facing in the current business environment."[52] Media accounts of the Hyatt decision, however, puzzled over why a company would suddenly treat a trained and devoted workforce so callously. Why change from a beneficent employer to what was portrayed as a heartless penny-pincher? Rather than revealing a sudden change of heart, the Hyatt story illustrates the complex way franchising has combined with third-party management and labor contracting in the hotel and motel industry and its resulting impact on the workforce.

Catering to the Discerning Traveler

Brands have become an increasingly important part of competitive strategy in the hotel industry. Whether for business or vacation travelers, a successful brand creates an image in a customer's mind regarding the quality, standards, amenities, and value of a hotel. Since consumers searching for hotels in most locations have many options, the brand can be extremely valuable if it narrows the consumer's search to a subset of hotels or, even better, to a single brand. As with fast food, travelers typically want to know that they will receive service that is consistent with their past, hopefully positive experience. Once again, a successful brand does this. As a result, at the end of 2007 more than half of U.S. hotel/motel properties were part of a branded company chain, concentrated particularly among twenty-five top brand names (see Table 6.5).[53]

The hospitality market is divided up in terms of customer niches, from economy to high-end users. Major hotel parent companies in the industry own and manage a portfolio of brands representing different customer groupings. Due to industry consolidation, approximately ten parent companies control the vast majority of the major brands in the United States. Table 6.6

Table 6.5 Branded versus independent hotels, United States, 2007

	No. of properties	% of total*	No. of rooms	% of total*
Independent only	22,177	44.8	1,482,421	32.5
Branded only				
Top 5*	6,398	12.9	703,906	15.4
Top 10	11,790	23.8	1,229,363	27.0
Top 25	17,937	36.3	2,020,521	44.3
All major brands	22,142	44.7	2,512,969	55.1
Nonmajor brands	5,167	10.4	563,697	12.4
Total	49,486	100.0	4,559,087	100.0

Source: Analysis by Smith Travel Research (STR), "U.S. Lodging Census Database," based on year-end data, December 31, 2007.

Notes: Top 5, 10, and 25 ranked by number of rooms.

Top 5 STR brands: Best Western, Days Inn, Holiday Inn, Marriott, Holiday Inn Express Hotel.

Top 10 STR brands: Top 5 plus Super 8, Comfort Inn, Hampton Inn, Courtyard, Hilton.

Top 25 STR brands: Top 10 plus Motel 6, Quality Inn, Sheraton Hotel, Residence Inn, Hyatt, Econo Lodge, Hilton Garden Inn, Fairfield Inn, Embassy Suites, Doubletree, Ramada, Extended Stay America, Americas Best Value Inn, Crowne Plaza, Westin.

* Calculated as the percent of hotel type (for example "Top 5") divided by total for the column. Note that the overall total equals the sum of "independent only," "all major brands," and "nonmajor brands" ("Top 5," "10," and" 25" are subsets of "all major brands"). Total may not equal 100% due to rounding.

lists the brands held by major brand operating companies. For example, Hilton Worldwide held five major brands ranging from Hampton Inn at the lower end of the business market to premier hotels in its core Hilton brand.

Table 6.6 points to a more fundamental change in the industry. The core product of the parent hotel/motel companies is not the properties they own and manage, but the portfolio of brands, each representing (if executed effectively) a replicable bundle of quality, pricing, amenities, and reputational characteristics, focused on different markets. If you are a business traveler on the road looking for value and Wi-Fi, Marriott can offer you Courtyard.[54] If, instead, you are an upscale consultant looking for style and less concerned about price, try Starwood's W Hotels and Resorts. And the harried parent looking for a clean room at a low price for her family's vacation? Accor's Sofitel is for her. Hilton, Marriott, Starwood, Accor, and other hotel parent companies' share prices reflect their acumen in acquiring, developing, and maintaining a portfolio of brand experiences across markets, not their

Table 6.6 Major brand operating companies and the brands they control (brands held as of March 2011)

Brand operating company	Brand(s)
Wyndham Worldwide Corp.	Baymont Inn & Suites, Days Inn, Hawthorn Suites, Howard Johnson, Knights Inn, Microtel, Ramada, Super 8, Travelodge
Accor North America	Motel 6, Sofitel
Choice Hotels International	Clarion Hotel, Comfort Inn, Econo Lodge, Mainstay Suites, Quality Inn, Rodeway Inn, Sleep Inn
InterContinental Hotels Group	Candlewood Suites, Holiday Inn, InterContinental Hotels & Resorts, Staybridge Suites
Hilton Worldwide	Doubletree, Embassy Suites, Hampton Inn, Hilton, Homewood Suites
La Quinta Management LLC	La Quinta
Marriott International Inc.	Courtyard, Fairfield Inn, Marriott Hotels and Resorts, Renaissance, SpringHill Suites
Carlson Hotels Worldwide	Country Inn & Suites, Radisson Hotel & Resorts
Starwood Hotels & Resorts Worldwide Inc.	Aloft, Four Points, Sheraton, St. Regis, W Hotels & Resorts, Westin
Global Hyatt Corp.	Grand Hyatt, Hyatt Hotels & Resorts, Hyatt Park, Hyatt Regency, Summerfield Suites

skill in providing clean rooms, cheery front desk staff, or prompt curbside service.[55] Scrutiny of those tasks falls to other actors.

Franchising the Brands

Branded parent companies in the hotel/motel industry have largely abandoned the business of owning and managing their properties, turning instead to franchising as the major form of ownership. In 1962 only 2% of U.S. motels were franchised. By 1987 that share had jumped to 64%. Today, more than 80% of hotel properties in the United States are franchised.[56] In 2011 Hilton owned and managed only 22 of its 258 U.S. properties, and Marriott Hotels and Resorts owned and managed only 1 of the 356 properties operating under one of its brands.[57]

Through franchising, major hotel chains are able to expand rapidly, especially in growth markets. Franchising allows the brand to tap capital, expand in multiple markets simultaneously, and draw on geographic expertise of local owners and independent management operators. Brands have expanded their access to capital through franchising in much the same way companies in other industries—notably restaurants—have adopted franchising as the major form of ownership and business expansion.

The attraction of franchising has led entire chains to flip from company ownership to franchising. Choice Hotels, for example, which owns the Clarion, Comfort Inn, Quality Inn, and Rodeway Inn brands, franchised all of its 4,884 hotels in 1999. Also in 1999, Wyndham, which owns the Ramada, Howard Johnson's, Super 8, and Days Inn brands, franchised all of its 6,383 properties.[58]

A distinctive brand image in the hotel/motel industry arises from a combination of architectural and design investments that affect the look of properties; administrative investments that affect the marketing, pricing, and "backroom" practices of properties; and operational investments that directly affect the "customer experience," including how visitors are greeted at the front desk, the range of services available to hotel patrons, and the way rooms are cleaned and facilities maintained. Table 6.7 provides examples of these standards from a variety of hotel brands. Developing and implementing this set of practices is both complicated and costly. But it is the core to assuring that the central branding strategy results in customers' receiving the "experi-

Table 6.7 Franchise agreement statements regarding compliance with brand standards: Hotel and motel industry, selected examples

Hotel/motel brand	Excerpt from franchise agreement
Days Inns	When a licensee buys a franchise from DIA (Days Inns of America), he buys the "Days Inn System," a comprehensive "hotel operating system" that sets hundreds of mandatory "System Standards" that control the manner in which a Days Inn must be operated . . . As the Statement of Undisputed Facts shows in exhaustive detail, the mandatory Days Inn System and DIA System Standards, which DIA can change at any time, address all aspects of the operation of a Days Inn, including: operating policies that "must be strictly observed by each property in the Days Inn System" and requirements for grooming and attire for hotel employees, employee uniforms, hours of operation of the front desk, services that must be provided to guests, the forms of payment the hotel must accept, guest safety and security, swimming pools, restaurants, free continental breakfasts, supplies and furnishings in guest rooms, the responsibilities of the hotel's general manager, employee relations, employee performance, housekeeping, and maintenance.[1]
Microtel Hotels	You operate the Microtel Hotel under the Hotel System. The Hotel System means the concept and system associated with the development and operation of Microtel Hotels. The Hotel System may be periodically modified by us. The Hotel System includes, among other things, (i) the trademarks, service marks, logos, slogans, trade dress, domain names and other source and origin designations that we or USFS periodically designate for use with the Hotel System (collectively, the "Proprietary Marks"); (ii) copyrightable materials that we periodically develop and designate for use with the Hotel System including prototypical architectural plans, designs, layouts, building designs, and a set of confidential constructions/operations manuals (the "Manual"); (iii) a central reservation system (the "CRS"); (iv) a unified platform property management system, management and personnel training, operational procedures and marketing, advertising and promotional programs; (v) all confidential information (see Item 14) and (vi) standards, procedures, policies, specifications and rules associated with the construction, operations, marketing, furnishings and equipment that we introduce and implement for the Hotel System which are described in the Manuals or in other written (electronic or otherwise) directives and which we may periodically modify. We designed the Hotel System for the operation of "super budget" and "hard budget" hotels, and we expect that each Microtel Hotel will comply with Hotel System standards to achieve a relatively uniform and standardized package of services and amenities that are offered to guests consistent with the economy budget sector of the hotel industry.[2]

(*continued*)

Table 6.7 (continued)

Hotel/motel brand	Excerpt from franchise agreement
Motel 6 Hotels	The terms, conditions, and obligations under which you operate the Motel are described in a franchise agreement that you and we sign before you begin operations (the "Franchise Agreement"). You must also sign a Software Agreement with Motel 6 OLP for the Software used in operating the Motel. Before signing a Franchise Agreement of the Software Agreement, you must sign and submit a franchise application (the "Application") to us. The Application, the Franchise Agreement, and the Software Agreement are referred to in Item 22 below, and copies of the documents are attached as exhibits to this disclosure document. To promote uniform Standards of operation under the System, we have prepared a set of confidential operating manuals, which may include more than one volume and periodic supplements (the "Manuals") and which contain mandatory and recommended procedures for operating your Motel.[3]
Omni Hotels	Each OMNI HOTEL operates pursuant to unique methods, systems and programs of operation (the "Method of Operation"). These relate to the establishment, development and operation of OMNI HOTELS that offer distinctive high quality hotel services. The characteristics of the Method of Operation include exceptional décor, design, layout and color scheme; exclusively designed signage, decoration, furnishings and materials; the Omni Hotels Reservation System; hospitality service procedures and techniques; operating procedures for cleanliness and maintenance; other confidential operating procedures; methods and techniques for inventory and cost controls, record keeping and reporting; personnel management and training, purchasing, marketing, sales promotion and advertising.[4]
Red Roof Inns	You will own and operate a Red Roof Inn or Red Roof Inn & Suites lodging facility. A Red Roof Inn lodging facility offers low cost accommodations to all sectors of the traveling public. A Red Roof Inn is generally located at places that attract both business and leisure travelers, such as major highway exit ramps, major intersections, airports, tourist destinations, and business centers. You will operate the business according to our business system and standards, and under the Red Roof Inn trademarks. You will use our prototype architectural plans and drawings in building a Red Roof Inn, or in renovating an existing building to be a Red Roof Inn. A typical Red Roof Inn does not offer full service and management intensive facilities or services, such as in-house restaurants or cocktail lounges, conference rooms,

> room service, or banquet centers. However, to meet the needs of guests in certain markets, we offer a Red Roof Inn & Suites lodging facility with enhanced amenities, such as more spacious rooms with refrigerators and coffee makers, exercise facilities, or meeting rooms.[5]

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1. Plaintiff United States' Memorandum in Support of Its Motion for Summary Judgment, *United States of America v. Days Inns of America, Inc.*, October 27, 1997.

2. Microtel Inns and Suites Franchising Inc.: Microtel Franchise Disclosure Document, March 28, 2008. Filed and accessed through the California franchising database, http://134.186.208.233/caleasi/pub/exsearch.htm.

3. Accor Franchising North America LLC: Motel 6 Franchise Disclosure Document, March 6, 2008. Filed and accessed through the California franchising database, http://134.186.208.233/caleasi/pub/exsearch.htm.

4. Omni Hotels Franchising Company LLC: Omni Hotels Franchise Disclosure Document, April 18, 2005. Filed and accessed through the California franchising database, http://134.186.208.233/caleasi/pub/exsearch.htm.

5. Red Roof Franchising LLC: Red Roof Inns Franchise Disclosure Document, October 1, 2008. Filed and accessed through the California franchising database, http://134.186.208.233/caleasi/pub/exsearch.htm.

ence" that will lead to repeat visits and the ability to maintain price premiums for the franchisor's brands.

Just as with fast foods, the detailed standards for hotel brands are central features of contracts with franchisees, treated with grave secrecy and enforced vigorously. However, because of the complexity of hotel/motel operations, franchising is increasingly accompanied by the hiring of management companies to oversee the operation of properties. In some cases, the brand explicitly requires potential owners to hire other organizations to undertake management activities as a means of ensuring that brand standards are maintained. Parent companies often require management companies to invest in the properties they manage, thereby making them partial "equity partners" and more closely aligning their interests with those of the brand holder.

May I Be of Service?

The competing needs of building brand equity, finding capital for expansion, and maintaining standards require brand operating companies to maintain a complicated balancing act. Creating mechanisms to achieve that balance gives rise to a complicated range of business arrangements that operate "under the hood." As shown in Figure 6.3, when a customer walks into a Courtyard by Marriott, Sofitel, or Doubletree Suites hotel, multiple organizations are responsible for creating the particular customer experience.

A Courtyard hotel could be managed by an independent operating company that is not at all affiliated with the brand. Marriott International could manage but not own the property: the owner may have asked the brand parent company to manage the property or, as a condition of the franchisor or the lender, the owner may have been required to make the brand parent company the manager.

The decision on which organizational form to use is based on balancing the core elements of fissuring: benefits arising from the brand versus benefits from shifting out employment to other entities. The lead enterprises in the hotel industry often choose to manage and sometimes own their premier, full-service hotels. Starwood Hotels and Resorts Worldwide Inc., for example, requires that Starwood manage all W hotels and St. Regis higher-end branded hotels.

Some parent companies have divisions or subsidiaries that act as brand operating companies. For example, Hilton Management Services manages

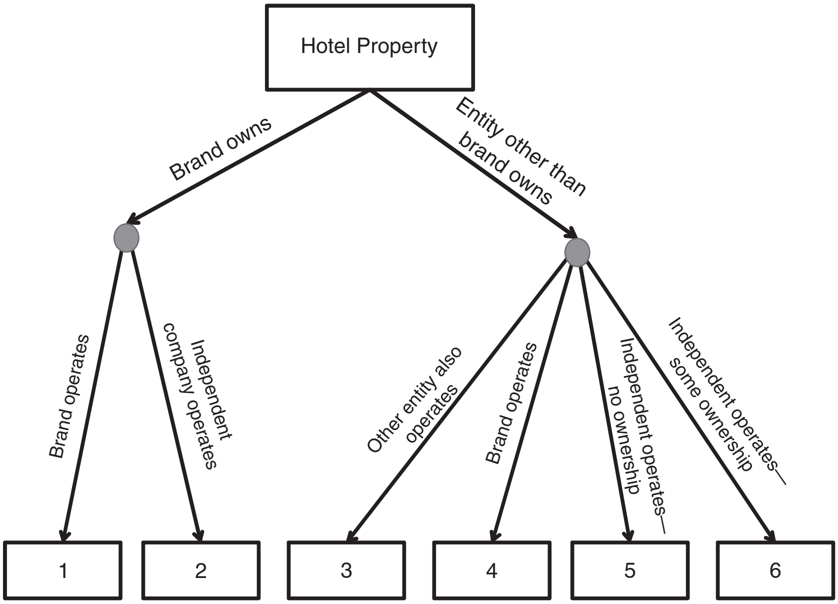

FIGURE 6.3. Branded hotel industry organization.

Hilton brands, and Hotel Management Group manages InterContinental brands. Under such an arrangement, a hotel property carrying one of the Hilton brands might be owned by a private equity firm but choose Hilton Management Services to manage the property. This might be particularly important for a premier Hilton property where concern over adherence to brand standards might be particularly important.

In contrast, an *independent operating company*—sometimes referred to as a management company or third-party management company—provides management and operating expertise to branded properties that are usually owned by an entity other than the brand parent company. The reduction in the number of parent company–owned hotels has shifted many properties into management contracts with independent operating companies. Between 1970 and 2006, the number of management contracts increased dramatically, from 22 to 4,370. A number of major companies have emerged in the national market, with the top ten companies managing 1,192 properties and over 200,000 hotel rooms.[59]

An independent operating company may therefore manage a branded franchised property owned by a real estate investment trust, private equity company, or local group of investors. It is also possible for an independent operating company itself to own or hold an ownership stake in some or all of the properties it manages. In fact, some brands require a partial investment by the operating company in order to increase the latter's commitment to the financial performance of the properties it manages.[60]

More often than not, the independent operating companies are operating hotels with many different brand affiliations and possibly belonging to multiple brand parent companies. This requires them to attend to the provisions of many different management agreements. While those agreements might be similar, it could be the case that the same operating company is more (or less) attentive to certain aspects of hotel management at some properties it manages than at others (as a result of differences in the contracts signed with brand parent companies).

The independent-operator, third-party management scenario (depicted as numbers 5 and 6 in Figure 6.3) is an increasingly common arrangement for several reasons. First, as owners and lending institutions have become more knowledgeable about the hospitality industry, they have become more concerned about the quality of property management where they have a stake. This may lead them to hire a management operating company while still ensuring investment in their ability to implement key brand standards. Second, operators want to expand market share in order to sustain earnings growth in excess of growth in demand, thereby requiring greater management expertise; brands are capturing a large share of contracts for first-class, full-service properties in prime locations, increasing the demand for sophisticated management services. Once again, how much ownership is required of the management company reflects the larger balancing of the fissured recipe.

One Tier More

But the multiple layering of the hospitality industry does not end with the brand or independent hotel management company. In many cases, those operating companies will contract out the staffing of the actual jobs—housekeeping, janitorial, food and beverage—to yet other companies. These may be local staffing businesses offering temporary employees for peak activities or, increasingly, large regional or national companies like Hospitality Staffing Solutions.

Major hotel staffing companies take on the complete set of human resource functions for particular types of jobs: they recruit, screen, and hire workers and then compensate, manage, promote, and terminate them if required. Companies promote their strength in taking on these functions for a workforce (particularly at the low end of pay scales) that might have high levels of turnover and limited experience in the hospitality industry—or in the labor market generally. In so doing, they remove the employment problem from the hands of property owners/franchisees or from the third-party management companies who assume the role of general manager with few employees of their own.

Staffing companies provide workers for multiple brands and properties in an area, usually through a tiered management structure of area managers in charge of building relationships with hotel brands and owners in a geographic area; area supervisors recruit workers and provide day-to-day supervision of workers in different locations.[61] Most employees provided by staffing companies work in the area of housekeeping (cleaning rooms), but these companies also provide janitorial and maintenance workers, waiters and waitresses, kitchen staff (dishwashers and food preparation workers), and laundry staff. Although staffing companies originally focused on providing temporary workers during peak demand periods (for example, at resort properties during holidays), they have gradually grown to provide staffing for entire functions for their clients.

Staffing companies also recognize the importance to their customers—whether property owners or brand or independent operating companies—of providing a workforce that adheres to brand standards. Selection, training, and supervision are guided by the particular standards of the brands and properties to which the staffing company is contracted. For example, Hospitality Staffing Solutions highlights its expertise in regard to its staffing of different functions:[62]

> *Room Attendants:* We're proud to note our room attendants are consistently listed at the top of posted room inspection scores. Your guests will see a difference in sparkling clean rooms that are ready when they check in—a major factor in higher guest satisfaction scores and repeat stays.
>
> *Janitorial:* Hospitality Staffing Solutions© Janitorial focuses on the typically difficult-to-staff and manage third-shift operation . . . [We] provide turnkey operations including all chemicals, supplies and equipment, as well

as professional uniforms for each janitorial team member. Hospitality Staffing Solutions© will create standardized cleaning procedures to fit your property specifications . . . Associates are trained to specialize in the daily detailing of your kitchen operations.

Laundry: Hospitality Staffing Solutions© employees follow your procedures so your linens are handled properly. Area supervisors ensure we consistently meet your expectations.

The use of staffing companies to provide the workforce for different functions results in yet a further tier in employment at hotel properties. And there could be several staffing companies present at one property, operating under a common set of brand standards but each supervised and paid by different business entities (and seeking to meet their own bottom lines). As in other fissured workplaces, the commitment to adhering to quality standards from the lead businesses (the parent hotel brand) is usually accompanied by an effort to devolve responsibility for adherence to the workplace standards required by law to the outermost orbit of business.

Inhospitable Conditions?

Most workers in the hotel industry earn low wages. About 22% of workers in the leisure and hospitality industry earned at or below the minimum wage in 2011.[63] If one uses the common benchmark for low wages as those falling below two-thirds of the median wage (which equaled $11.61 per hour in 2011), about 55% of workers in the hotel/motel industry earned low wages in 2010. The 1.86 million workers employed in the industry comprised about 1.25% of total employment but accounted for 2.4% of all low-wage workers.[64] Almost three-quarters of those surveyed in a three-city survey of workers in 2009 had been paid off the clock at some point (that is, not compensated for some of the hours they worked) in the prior week, and about two-thirds had not received the overtime compensation to which they were entitled.[65]

The operations of hotels are buffeted by multiple incentives arising from the different businesses in orbit around the hotel brand, as depicted in Figure 6.3. This creates conditions where contradictory incentives are present in terms of assuring adherence to quality standards (brands); finding managerial expertise to operate properties (franchisees/investors); and seeking to expand business operations by ratcheting down costs but not fully facing the consequences of those cost-cutting actions (operators).

The fissured structures that have emerged in hotels lead to significant problems in assuring compliance with basic labor standards such as overtime and minimum wages. Table 6.8 presents information about Fair Labor Standards Act (FLSA) violations for major hotel/motel chains during the period 2002–2008, using four different measures of compliance. Among this group, only 31% of all investigated properties were in compliance with FLSA provisions. Compliance rates ranged from a low of 18% (Quality) to a high of 58% (Marriott Hotels and Resorts). Average back wages (representing the difference between wages received by workers and what they were entitled under the law) owed per employee paid in violation of standards were $435. This also ranged considerably across the chains, with much higher rates at Marriott Hotels and Resorts and Holiday Inn branded properties, and relatively lower back wages owed at Fairfield Inn (another brand owned by Marriott International).

Compliance is further affected by the combination of parties that together create fissured hotel workplaces. In particular, properties managed by the top fifty independent hotel management companies violate the Fair Labor Standards Act at far higher rates than otherwise comparable hotel properties managed by franchise owners or brand operating companies.[66] Back wages were about $2,500 higher in properties operated by one of the top fifty independent companies versus comparable properties not managed by the top fifty. Properties with a branded operating company serving as the manager tended to have better relative compliance levels, in part reflecting closer alignment of the brand with the management of the property.

All of this brings us back to the Hyatt story. Although the workers at all three Hyatt properties in Boston were nonunion, the union for hotel workers, UNITE HERE!, brought attention to the situation facing the fired workers and orchestrated a public campaign against Hyatt. Daily protests in Boston, coverage in local and national media outlets, and outreach to Massachusetts political leaders kept the story in the public eye. Hyatt workers in Chicago and some of the fired employees from Boston protested at the company headquarters. Three weeks after the firing, Governor Deval Patrick of Massachusetts encouraged state employees to boycott Hyatt hotels unless the company reinstated the workers.

Table 6.8 Compliance among top hotel/motel chains: Investigations 2002–2008 (brand parent companies in parentheses)

U.S. brand	Number of investigations	Total employees paid in violation	Employees paid in violation per investigation	Back wages per employee paid in violation	Percentage in compliance
Holiday Inn Hotels & Resorts (InterContinental Hotels Group)	99	826	8.3	$602	26.2
Best Western (Best Western International)	183	1,009	5.5	$390	31.3
Hampton Inn/Hampton Inn & Suites (Hilton Hotels Corp.)	91	430	4.7	$395	32.9
Holiday Inn Express (InterContinental Hotels Group)	126	854	6.8	$318	20.6
Marriott Hotels & Resorts (Marriott International)	31	121	3.9	$768	58.0
Days Inn (Wyndham Hotel Group)	246	1,386	5.6	$498	22.7
Comfort Inn (Choice Hotels International)	166	1,027	6.2	$415	23.4
Super 8 (Wyndham Hotel Group)	187	795	4.3	$480	24.5
Hilton (Hilton Hotels Corp.)	23	284	12.3	$427	47.8
Motel 6 (Accor)	28	92	3.3	$205	35.7
Quality (Choice Hotels International)	83	692	8.3	$364	18.0
Ramada (Wyndham Hotel Group)	93	800	8.6	$457	23.6
Econo Lodge (Choice Hotels International)	74	352	4.8	$458	29.7
Fairfield Inn (Marriott International)	21	93	4.4	$313	38.0

Source: Violations of the Fair Labor Standards Act for major hotel/motel chains during the period 2002–2008, based on author analysis of closed investigation data from the U.S. Department of Labor, Wage and Hour Division.

In late September 2009, Hyatt offered the ninety-eight fired employees health coverage through the following March and full-time positions with United Service Companies (a Chicago-based staffing organization that the hotel chain used for contract labor) through the end of 2010 at wages comparable to the ones they had lost.[67] Notably, however, Hyatt continued with its agreement to use Hospitality Staffing Solutions for staffing the positions. Despite the unfavorable publicity over its role at Hyatt, the staffing company's Boston area market continued to blossom, and in early 2013, Hospitality Staffing Solutions advertised for a number of entry-level managerial positions for the area.[68]

Franchising and the Workplace: Having It Both Ways, Again

Fast food represents franchising at its most developed: a sophisticated system to align the interests of major brands with individual owners in order to allow both parties to benefit from a branding core competency. Yet tensions in incentives have repercussions on the cost side of the ledger. The result is decidedly different profiles in compliance with workplace laws like minimum wage and overtime between the lead company's own outlets and those run by franchisees.

Franchising in the janitorial services industry is more pernicious. The presence of a tier of franchised janitorial service providers that in many markets cannot be financially viable without cutting corners. Wide-scale noncompliance with labor standards results. Franchising in the hotel/motel industry takes a more complicated form. Because of the significant capital investment in the industry, investors, brands, and managers all have a stake in the management of hotel properties. This has given rise to a complicated mix of organizations with hands-on roles in day-to-day hotel operations. A given property may have four or more businesses with some impact on how work is organized, managed, supervised, and compensated. This complexity leads to downward pressure on wages and benefits (the multiple margins problem found in subcontracting), coordination diseconomies, and contradictory incentives. For the workforce, this can mean at best confusion over who is minding the store and at worst significant violations of workplace labor standards.[69]

Many of the attributes of franchising have beneficial aspects for consumers and investors. A well-structured franchise agreement creates incentives for the owner to provide service and achieve standards that customers expect and from which they benefit. A well-structured franchise agreement solves some of the problems arising from managing large and geographically dispersed operations. And franchising brings to the table new sources of investment capital—such as individual entrepreneurs who wish to start new businesses but may not be ready to create new brands or business models—that may benefit entrepreneurs, franchisors, and their customers.

But franchising also creates social costs, arising from incentives that leave franchisees less committed to compliance than their franchisors; from the pernicious use of the model in the janitorial sector; or from the sheer complexity of the crosswinds of incentives created in its application to the hotel industry. Our workplace laws fail to recognize the complexities created by franchising: as will be seen in Chapter 8, workplace statutes and legal interpretations of them usually hold the franchisor harmless for the actions of franchisees when it comes to employees, even as franchise and commercial law protect the franchisor's right to impose standards on every other aspect of business decision. This creates the fundamental dilemma of the fissured workplace by allowing lead companies (in this case franchisors) to have it both ways: creating, monitoring, and enforcing standards central to business strategy while at the same time ducking responsibility for the social consequences of those policies when it comes to the workplace.

Any effort to improve labor standards compliance in franchised industries must recognize that organizational form's role in creating fissured workplaces. Traditional approaches to enforcement—focusing on the individual enterprise—may bring to light widespread violations of minimum wages, overtime pay, and off-the-clock work. But if not wedded to a larger strategy that attempts to change the forces that drive this behavior, enforcement will be effective only at the margin.

7

Supply Chains and the Fissured Workplace

Manufacturing supply chains are composed of the network of businesses companies draw on for the components used in making products. Retail supply chains are composed of the broad network of manufacturers that sell their products through retailers. Strictly speaking, the firms making up a supply chain relate through market transactions: suppliers provide parts, assemblies, and inputs to their customers: retailers or manufacturers. Characterized in this way, supply chains are a very old phenomenon: most producers rely on purchases of inputs from other companies. And, going back to the Phoenicians, these supply relationships often existed internationally as well as within national borders.

What has changed is the degree to which lead companies have shed internal pieces of the production process to other companies and, for reasons described in Chapter 3, the extent to which those companies have increased the degree they specify, monitor, coordinate, and choreograph the activities of suppliers in the network. In manufacturing, the relationship is much closer than arm's-length market transactions because it is often composed of work formerly done within corporate boundaries: this is outsourcing (moving jobs outside the company, but to domestic sources of supply) and offshoring (moving jobs outside the company to firms providing the service in other countries).

Even where work has traditionally been done by other suppliers, the need for greater coordination has increased as products have become more complex, quality standards more demanding, time-to-market demands tighter, and management of inventories more critical. In retailing, information technologies have also transformed arm's-length supplier relationships, allowing retailers to manage an ever-growing scope of products while substantially reducing their exposure to inventory risk.

Consequently, supply chain management results in the pressures that create fissured workplaces and their often deleterious impacts on the people working within them. This chapter focuses on supply chains as a form of fissured employment. The chapter starts by looking at how the core of supply chain operations—logistics—has been changed in distribution centers. Though coordination represents a highly valued core competency for lead businesses in both manufacturing and retail industries, the actual work is done through complex webs of contracted work. The chapter then turns to the intersection of fissured employment and the phenomena of outsourcing and offshoring and examines their close relationship and implications for employment domestically and internationally.

Fissuring Squared in the Logistics Industry

Lean manufacturing is a core production strategy famously developed for the auto industry by Toyota and then widely diffused across the sector.[1] Its objective is to reduce the amount of in-process and final inventory in a production system, carefully matching real-time demand for final products with the quantity of goods moving through the manufacturing and assembly process. In a complex manufacturing system like auto production, this requires high levels of coordination at each step in the process, careful management of capital and labor, attention to quality and factors that affect throughput, and an overhaul of management support systems, from accounting, to inventory management, to compensation.

It also requires a different way of handling logistics—the movement of goods—within a manufacturer, between the manufacturer and its suppliers, and between the manufacturer and the end retailer of goods. As lean manufacturing spread to industries beyond the autos and into the retail sector, the importance of logistics as part of competitive strategy rose as well.

The change is best seen in the evolving activities in a manufacturer's warehouse. If you pay little attention to in-process and final inventory, large stocks of parts accumulate at each stage and in final production. A warehouse is simply the place where you store that inventory—and where that inventory can sit for long periods of time. Warehousing requires tracking and managing where things have been left (perhaps a bit more systematically than in a typical person's basement). It does not require a lot of attention to how quickly those things can be accessed and moved once needed.

In the modern age of lean manufacturing, the warehouse becomes a distribution center—a place where intermediate or final products are efficiently tracked, processed, and moved. In one type of distribution center, a modern cross-docking facility (critical to both manufacturing and retailing), the layout reveals its central role as a means to move, not store, goods. Typically, cross-docking facilities have a rectangular footprint, with one long side devoted to incoming trucks (from suppliers) and the opposite long side to outgoing trucks, destined either for the final assembly facilities or for retail outlets. Between the two walls is a capital-intensive maze of automated conveyance systems, governed by an incoming flow of data regarding incoming shipments (types, quantities, and costs) and outgoing destinations.[2]

For logistics providers—UPS, Federal Express, DHL—and for companies with logistics central to their function—retailers like Walmart, Target, Safeway, and Kroger—operating logistics is the core competency to be nurtured, perfected, and safeguarded. But fissuring has come to logistics. It has popped up in a variety of ways.

Perhaps best known is the case of FedEx. FedEx has long treated drivers servicing its routes as independent contractors.[3] Drivers are paid by the delivery, based on a schedule from the FedEx package terminal where they receive a listing of packages each day. They are given a window of time for drop-offs and can be docked if packages arrive outside of it or if the company receives complaints from customers. As an independent contractor, the driver is required to purchase a truck (as specified by FedEx) that bears the company logo. In addition to financing the vehicle, the driver must pay all expenses (gas, insurance, maintenance). A driver's income is therefore based on the difference between the fees paid per delivery and the costs incurred for servicing the route, rather than on a salary or hourly rate.

As independent contractors, drivers are not covered by overtime or other labor standards or protections against discrimination, health and safety laws, or provisions that would allow them to take leave to care for a sick child or family member. Contributions for Social Security and Medicare taxes fall entirely on the driver, and because drivers are in business for themselves, they are not eligible for unemployment insurance or workers' compensation.

Not surprisingly, FedEx has been the target of state litigation for misclassification of workers by state tax and workplace authorities. Independent contracting status was also the subject of a major IRS audit of FedEx. But in most cases to date, the FedEx position has been upheld: FedEx, as a branded, logistics juggernaut for which time to delivery is central to customer value, need not directly employ the workforce central to that mission.

FedEx is not alone in its use of fissured workplace arrangements for logistics, the centerpiece of modern supply chains. More and more distribution centers are adopting an organizational form where third-party management has been married to subcontracting. Since supply chain management has elements that create many of the preconditions of the fissured workplace, the increasing use of subcontracting and temporary staffing companies within logistics can be considered fissuring on top of fissuring—fissuring squared.

Lean Retailing and the Modern Distribution Center

Like lean manufacturing, lean retailing takes advantage of information technologies, automation, industry standards, and management innovations to align orders from suppliers more closely with what consumers are buying in the store (rather than what purchasing agents, months in advance, think consumers might buy). By using sales information collected through millions of scans of bar-coded labels, retailers reduce their need to stockpile large inventories of products, thereby reducing their risks of stock-outs, markdowns, and inventory carrying costs. The companies that have adopted lean retailing principles now dominate major retail segments, from mass merchants like Walmart and Target to department stores like Macy's.

Core competencies of a modern retailer depend on a combination of traditional practices with the benefits arising from lean retailing. Like traditional retailers, companies using lean retailing must provide their customers with a changing variety of products that lure them into the store. But as lean retailers, they do so while minimizing the inventory they need to hold to service that demand. In contrast to the infrequent, large bulk shipments between suppliers and retailers that characterized traditional retailing, lean retailers require frequent shipments made on the basis of ongoing replenishment orders. These orders are made based on real-time sales information collected at the retailers' registers via bar-code scanning. SKU-level sales data are then aggregated centrally and used to generate orders to suppliers, usually on a weekly basis for each store.

Lean retailing changes the relationship between a retailer and its supply base. Suppliers must replenish orders in three days or sometimes less. Retailers like Saks Fifth Avenue create standards that require frequent replenishment and demand that shipments meet standards concerning delivery times, order completeness, and accuracy.[4] Any disruptions to the weekly replenishment of retail orders by apparel suppliers constitute a major problem for retailers. Not surprisingly, the implementation of standards by suppliers to companies like Saks is carefully monitored (also in real time). And failure to adhere to them can lead to substantial penalties or, even worse, result in canceled orders or cutting off the supplier altogether.

Walmart: Shedding Distribution?

Walmart was a pioneer in lean retailing. More than any retailer of its era, it discovered the importance of managing inventory inside and outside its corporate walls. Its success at using real-time customer information collected at the register, information systems on the status of inventory and orders, automated distribution centers, and sophisticated logistics relations with its customers was (and is) central to its ability to lower the costs of providing products to customers.

But just as hotels gradually turned even core functions over to others, Walmart has begun to do so with logistics. This shift in policy is reflected in the case of distribution centers operating in Mira Loma, California, in the so-called Inland Empire region of Southern California.

Schneider Logistics, headquartered in Green Bay, Wisconsin, provides a wide variety of logistics and transportation services to its customers.[5] Its parent company, Schneider National, was one of the first trucking companies to invest in two-way satellite communications systems for its trucks and to use electronic data interchange (EDI) to handle transactions in the mid-1980s. This coincided with the adoption of similar technologies in retailing (by Walmart and others) to transform how those companies handled information and coordinated logistics.[6]

Schneider Logistics was launched in 1993 to focus on the rapidly growing business of handling the flow of products and materials in the manufacturing and retail sectors, winning a contract to provide General Motors with logistics support for its part suppliers in 1994.[7] It used its access to its own network of trucks, trailers, and drivers, major intermodal facilities and equipment, and sophisticated communication systems. Its core competency, which makes it attractive to customers like Walmart, is its expertise in handling imported goods arriving in shipping containers from ports and processing those goods so that they can be efficiently shipped to retail stores.[8]

With the rapid growth in goods arriving from offshore in the 1990s, retailers like Walmart needed to find efficient means to process, transport from docks, and unload that stock from shipping containers used for ocean transportation, and then sort, record, repack, and load those goods for transportation to regional distribution centers or directly to stores. The work of unloading and processing goods from containers (called "lumping") is more labor-intensive than the typical operations in distribution centers. Schneider Logistics directly employs workers in its distribution centers to do lumping. But it also uses subcontractors—sometimes several layers of them—who often employ temporary workers to undertake these operations. Temp employees working for subcontractors are used to handle increased volumes during peak retailing periods (particularly the run-up to the holiday season). But they have also become a growing share of the main workforce in these operations, representing up to a third of the workforce in nonpeak times and much more in peak periods.

As with cell towers, discussed in Chapter 5, the agreements between Schneider as logistics service provider and subcontractors are very informative about the larger fissured subcontracting structure in play. In the case of the Mira Loma facility servicing Walmart, Schneider contracted with three companies: Premier Warehousing Ventures LLC (PWV), Rogers-Premier Unloading Services, and Impact Logistics Inc. The agreement between Schneider and PWV is typical. In its contract, Schneider explicitly specifies that PWV will provide services for Schneider's Walmart account. The contract states that while Schneider operates warehousing and transloading facilities, the company "desires to concentrate its efforts and expertise on the internal warehouse operations while contracting for trailer loading services."[9] The contract makes clear that PWV will be compensated on the basis of the number of trucks loaded, not on an hourly basis or on the basis of the number of workers used to achieve output targets. It also makes clear that the relationship between the two organizations is a principal/vendor one, where "PWV will, at all times, remain the sole and exclusive . . . employer of any personnel utilized in providing the Services and the Principal of any subcontractor it may elect to utilize."[10] This and other provisions regarding indemnification attempt to establish market-relation distance between the parties.

However, other features of the agreement imply a fuzzier boundary between the responsibilities of the two companies. Section 2 describes in considerable detail the standards to which Schneider holds PWV and the mechanisms it will use to monitor compliance with them. Section 2.06, for example, describes a variety of audit-based performance metrics that PWV will periodically provide to Schneider (at no cost to the latter) regarding average number of cases loaded per hour; number of trailers loaded per week; trailer loading accuracy (a critical dimension for Walmart); and average cubic meters packed in trailers per week. These measures serve as the basis of compensation and for ongoing evaluation of PWV's performance as a contractor. Although PWV is required to provide on-site management of its workers, the agreement also gives Schneider audit rights for performance with the provisions of the contract and requires that PWV rectify any problems within thirty days. It also makes PWV liable for any damages to merchandise in the process of handling it.

The blurred lines of actual employment between Schneider and PWV become evident in section 2.12. The contract notes that Schneider (referred to as SLTD)

> will notify PWV of any problems regarding the Personnel. In the event SLTD is dissatisfied with the performance or conduct of any Personnel, SLTD may request PWV to remove such person from the premises and from their assignment with SLTD immediately. SLTD will not be responsible for the payment of any amounts with respect to such Personnel so removed for that day's assignment or any future assignment of that specific Personnel unless approved in advance by SLTD.[11]

Schneider also reserves the right to audit the immigration status of any of PWV's workforce, in conformance with Walmart's concern that all contractors working for them be in compliance. But the agreement states (in capital letters) that "PWV further acknowledges that SLTD's said audit is in no way intended to waive or release PWV's I-9 compliance obligations . . . or alter the independent contractor relationship between the parties."[12]

Subcontracting and the Workforce: A Refrain

Subcontractors like PWV receive payment on the basis of truckloads completed (or on a similar basis for other output-based metrics). But labor subcontractors must pay their workforce for achieving those output goals. Prior to 2006, subcontractors at the Mira Loma facility paid workers on an hourly basis. Beginning in 2006, however, a new pay system and related policies were created at PWV and Impact that compensated workers on a piece rate, based on the number of trucks loaded or unloaded by the workforce.[13] The formula for loading was a complicated one that allegedly adjusted for both individual and group effort. Like the method Schneider used to compensate its subcontractors, the piece-rate system did not pay for hours worked, but for work completed. A change in scheduling policy coincided with the shift in pay policy, adjusting hours from a standard eight-hour, five-day weekly schedule to four ten-hour-per-day shifts.[14] Separate policies required workers to be present at the distribution center several hours before work commenced (without compensation) in order to reduce potential interruptions from not having enough people ready to load or unload trucks. The new policies also made it difficult for workers to take legally mandated breaks.

In October 2011 the Mira Loma facilities were inspected by the California Labor Department. The company's murky and opaque payroll records and pay stubs associated with the compensation system and the inability of PWV and Impact to produce records verifying hours for workers violated state record-keeping standards. As a consequence, the state levied substantial penalties on Impact ($499,000 for failure to provide itemized wage statements for record-keeping violations) and PWV ($616,250 for similar and related record-keeping violations).[15] At the same time, a group of workers filed a class action suit against Schneider and the three subcontractors for back wages.

However, the worker complaints leading to the October 2011 investigation and penalties did not end the saga. Four days after the investigation, workers who met with investigators and subsequently filed a complaint for lost wages were told not to come to work (despite the fact that the investigation occurred in October, during the peak season for the facility).[16] This led to a series of court rulings that directly addressed the question of the respective roles of Schneider and its subcontractors at the facility. I return to the rulings in this case in Chapter 8.

The number of workers in the logistics industry rose from 474,200 in 1998 to 672,800 in 2008 and is projected to reach 775,700 by 2018, an annual growth rate 2.5 times faster than the overall growth rate in employment for the economy as a whole.[17] The practice of retailers hiring third-party managers to operate distribution facilities who in turn draw on temporary agencies for staffing has spread quickly since 2008 and has been reported across the country.[18]

Implausible Deniability?

Walmart has responded to inquiries about the violations in Mira Loma and other facilities handling the company's local distribution center needs by pointing out that none of the workers involved were employees of the company.[19] With respect to health and safety standards, it cites its codes of conduct for suppliers that, if violated, would lead to repercussions for those contractors.[20] Before the most recent injunctions filed against Schneider Logistics, in 2012, that company similarly cited the fact that labor contractors working within its facilities were "separate corporate entities. The only legal avenue which Schneider has to enforce their compliance would be to terminate the contract with these vendors. We have no plans to terminate the contracts with our vendors; our expectation is that they will comply with all applicable statutes, regulations and orders."[21]

As with the subcontracting cases discussed in Chapter 5, ceding authority to multiple organizations creates complexity, so that enforcement of important workplace policies falls through the cracks—notably safety practices in the case of AT&T and other cell phone carriers, immigration policies for Hershey, and basic labor standards in the Walmart/Schneider case. It also illustrates how these changes alter the wage-setting environment, shifting it ever outward and into increasingly competitive environments, often into labor markets characterized by workers with limited opportunities, fear of job loss, and sometimes precarious immigration status.

Supply Chains, Outsourcing, and Offshoring

Supply chain strategy and management became a major topic in business schools in the 1990s. And for good reason: more and more industries reassessed how products could be made as a result of new information technologies, the falling cost of computers, adoption of common communication standards, improvements in international logistics, and new sources of global manufacturing. Underlying supply chain strategies is the decision whether to build things inside or outside corporate boundaries.

Outsourcing goods—deciding to purchase parts or subassemblies from other companies rather than producing them internally—was the first step in the process. Manufacturing industries core to the U.S. economy—notably automobiles—moved aggressively in this direction, first outsourcing a growing percentage of parts and later entire subassemblies to other companies. The growth of global manufacturing capacity in many industries and the ever-falling cost of transportation transformed outsourcing to offshoring—seeking suppliers for parts and assemblies that had been outsourced to non-U.S. producers. The same technologic and information systems that made outsourcing possible, combined with the reduction of many international trade restrictions, such as quotas and tariffs, enabled offshoring to expand rapidly as a source of intermediate products for manufacturers or as a source for more and more final products for retailers.[22] In more recent years, digital technologies and the growth of higher-level skills in India, China, and elsewhere led to similar offshoring in service industries—in areas ranging from call centers to software engineering.

Outsourcing and offshoring have also been a growing topic of popular debate in the past decade and featured prominently in the presidential campaign of 2012. Offshoring has drawn particular attention because of its perceived impacts on wages and employment of U.S. workers directly affected by it. A *New York Times* report in 2012 found that 86% of those surveyed said buying products in the United States was "very or somewhat important to them," and that 58% believed that "a lot" of unemployment is caused by products sold by U.S. companies being manufactured abroad.[23]

Outsourcing and offshoring share a fundamental characteristic with other organizational forms that create fissured workplaces: they entail a lead company focusing on a core area of competency and shedding activities (manufacturing and assembly) to other businesses, all the while ensuring that technical, quality, and delivery standards are rigorously adhered to by those subordinate suppliers. Successful global manufacturers accomplish this through supply chain management, which comprises the planning, coordination, and control of the activities of that network of suppliers through the creation and implementation of standards.

Offshoring, Trade, and the Impact on Workers

The economic literature on the consequences of trade between nations goes back to David Ricardo's work on comparative advantage in the early 1800s. The focus of discussion has been trade in final goods.[24] But offshoring typically involves the use of outside suppliers to provide intermediate products—

arising from what trade economist Rob Feenstra calls the "disintegration of production." The changing nature of trade—as well as the growing importance of trade in intermediate goods—is illustrated by looking at U.S. imports and exports with respect to their end use over time. Table 7.1 charts the share of U.S. exports and imports by end use from 1925 to 2010.[25]

The destination of U.S. imports and exports in terms of end use has changed dramatically since 1925. Whereas the vast majority of imported goods were in either agriculture or raw materials in the early part of the twentieth century (over 90% in 1925), in the past few decades they have become far more dominated by capital goods (those used in the production of other manufactured products) or consumer goods. The share of imports of consumer goods rose rapidly from the 1960s to the 1980s and doubled from 16% of imports in 1965 to 32% by 2010. But the share of capital goods increased even more rapidly, from 7% to 30% over the same period.[26]

Modern supply chains and the offshoring practices related to them play out on an international stage. The question about who gains and who loses from supply chains therefore begs the more fundamental question of the gains from trade. To the extent that offshoring is simply a specific case of trade between two nations, X and Y, with different comparative advantages, traditional economics argues that both nations benefit from it. If country X can produce a good (or subassembly) at lower cost than country Y, the national economy of Y benefits from letting that work go to country X, thereby freeing country Y's resources for more productive uses.[27]

Many questions arise, however, in the trade literature on the gains from trade where there are other imperfections in product or capital markets. In addition, Ricardo's ideas on gains from trade were built around natural endowments (climate, access to raw materials) conveying comparative advantages to different nations. Two countries producing products where they could translate those endowments into lower costs would benefit from exchanges between them. The situation becomes more complicated if each party can create an advantage through volitional policy (for example, educating its workforce; investing in research and development; devoting significant national resources to developing comparative advantage in an industry), although the overall benefits from trade between those with higher and lower productivity arising from those policies still hold.

Several articles by eminent economists rekindled the debate on the gains from trade. In 2004 the Nobel laureate Paul Samuelson examined in an essay

Table 7.1 Share of U.S. imports and exports by end use categories (percentage)

	1925	1950	1965	1980	1990	2000	2007	2010
Imports								
Foods, feeds, beverages	21.9	30.0	19.1	11.3	5.0	4.4	5.3	6.1
Industrial supplies and materials[a]	68.2	62.4	53.3	31.3	18.2	16.1	17.7	16.6
Capital goods (except autos)	0.4	1.3	7.1	19.0	33.6	33.4	29.0	30.0
Consumer goods (except autos)	9.4	6.1	16.0	21.5	24.3	27.1	31.0	32.3
Automotive vehicles, parts, and engines	0.02	0.3	4.5	16.9	18.8	18.9	16.9	15.0
Exports								
Foods, feeds, beverages	18.7	15.5	19.2	16.9	9.2	6.5	7.8	9.4
Industrial supplies and materials[a]	59.8	45.5	34.8	32.2	25.6	21.8	25.6	27.5
Capital goods (except autos)	8.7	22.4	31.4	35.0	42.4	48.6	41.7	38.9
Consumer goods (except autos)	6.0	8.9	7.0	7.8	11.7	12.3	13.6	14.4
Automotive vehicles, parts, and engines	6.8	7.8	7.5	8.1	11.2	10.9	11.3	9.8

Sources: Estimates for 1925–1990 from Feenstra (1998, table 3, p. 37). Estimates for 2000, 2007, and 2010 based on data from U.S. Census Bureau, *US International Trade in Goods and Services, Annual Revisions,* table 6, "Exports of Goods by End-Use Category and Commodity"; and table 7, "Imports of Goods by End-Use Category and Commodity"(2000, 2007, and 2010).

a. Following Feenstra, the following petroleum categories are excluded from import and export totals for "Industrial supplies and materials": crude oil; petroleum products other; gas—natural; fuel oil; natural gas liquids (export); liquified petroleum gases (import).

late in his life situations where an increase in the productivity of a trading partner reduces its partner's gains from trade relative to the status quo. Samuelson modeled a situation where one country (for example, China) rapidly creates new comparative advantage in a good that its trading partner (for example, the United States) historically had specialized in producing. The ability of the first country to rapidly expand supply of the product results in falling export prices for the second country, thereby worsening the latter's terms of trade. The gains from trade between the two countries are still positive for the second country, but diminished from the period prior to the first country "catching up" to the second.[28]

Studies of the impact of offshoring on manufacturing jobs a decade ago found evidence of positive associations between rising import shares and decreasing employment, but that overall effect was relatively small. Skill-biased technologic change, where new technologies lead to displacement of low-skilled jobs by those demanding higher skills, represented a far larger factor in explaining employment declines.[29] Estimates of service offshoring similarly indicate that the effects have so far been small when compared to the overall size of the labor market. But for those service activities that are vulnerable to outsourcing because they require provision of what the economist Alan Blinder calls "impersonally delivered services," the opportunities for future movement are significant, spanning skill levels from low-skill work like scanning books and newspapers to high-skill work such as architecture and financial analysis, and sectors from parts of health care to financial services.[30]

Even fervent adherents of the classic gains from trade view accept that there may be deleterious distributional impacts from offshoring: the economy can benefit overall, even though certain groups are adversely affected (sometimes severely) by it in the form of lost jobs and earnings. Offshoring also prompts questions about the capacity of the economy to move people from those jobs most affected by it into more productive, higher-skilled jobs so that the gains from trade can hopefully help in part those most likely to be hurt by offshoring.[31]

Apple, Foxconn, and the Global Electronics Supply Chain

Another way to look at the effects of offshoring on the workplace is to focus on the decisions underlying globalization of supply chains. The decisions leading to the offshoring of parts of production arise from balancing the benefits and costs of doing work inside versus outside firm boundaries, similar to other organizational design choices that result in fissuring.[32] Offshored activities are those where the benefits of finding outside suppliers capable of providing subassemblies at lower cost outweigh the benefits of keeping those activities inside the organization in order to preserve competitive advantage or areas of core competency (for example, product design) or the difficulties of coordinating production through arm's-length relationships.

In some instances, this balancing act means that components produced abroad by other companies are brought to the United States to be assembled closer to the final market, a practice that characterizes automobile production.[33] Alternatively, balancing the benefits and costs of offshoring may compel companies to shed virtually the entire production process to other businesses, with the United States serving as the anchor of product development, research, marketing, and retail distribution, as has become the rule in the apparel and electronics industries.

The balancing of inside versus outside work has also moved into nonmanufacturing sectors. This is reflected in the decision by financial services companies, airlines, and other businesses with significant customer service needs to offshore these "impersonally delivered services" to other countries, as has famously happened with call center work.[34] But nothing better portrays the tensions inherent in outsourcing strategies than the global electronics industry and its most famous (and valuable) company.

On February 24, 2012, Apple became the world's largest publicly held company when its stock price hit $526.29, giving it a market capitalization of $487.1 billion.[35] Its role in the U.S. economy was compared to that of General Motors in the mid-1950s when its market share stood at 54% percent and it produced its 50 millionth car. At that time, Charles Erwin Wilson, the former CEO of GM, famously answered a question about personal conflicts of interest during his confirmation hearings to become President Eisenhower's secretary of defense by saying that "for years I thought what was good for the country was good for General Motors and vice versa."[36]

Despite their common achievements, the GM of the 1950s and the Apple of 2012 were fundamentally different kinds of organizations. Design, engineering, marketing, manufacturing, and assembly were intrinsic to what General Motors did throughout its heyday in the post–World War II period. The breadth of its operational scope was reflected in the number of people it directly employed. At its manufacturing peak in 1979, General Motors directly employed 618,365 workers in the United States alone, making it the largest private employer at that time.[37]

Apple's core competency rests on product development and design of an ever-changing array of digital products. It is also a marketing and retail juggernaut. Apple directly employs designers, engineers, and marketing professionals central to its product development strategy. It is not, however, a manufacturer. When Apple achieved its market capitalization peak, it directly employed 43,000 workers in the United States (30,000 of them retail workers employed in Apple Stores) and an additional 20,000 worldwide. This represents a very small number given its market value (by comparison, Walmart employed about 2.2 million people worldwide in the same year). But the scale of direct employment masks how many people are globally engaged in the production of Apple products: in 2012, the company depended on 730,000 workers in global supply chains to manufacture its wide variety of digital gadgets.[38]

In the 1970s and 1980s, U.S. companies in the global electronics sector (IBM, Hewlett Packard) and Japanese producers (Sharp, Hitachi, Sony) were vertically integrated manufacturers, capitalizing on their competencies in research and development, product introduction, and scale economies. But in the 1990s, scale economies became less central as design innovation and technological innovations allowed the modularization of the components making up electronic products like personal computers. A global base of suppliers emerged, facilitated by national development strategies in countries like Singapore, Taiwan, and the People's Republic of China. Falling costs of transportation and coordination further facilitated the disintegration of vertically integrated manufacturers.[39]

Apple's reliance on an international supply chain is therefore not unique to the industry. Hewlett Packard (HP) sold over 64 million personal computers in 2011, all of them produced by an international supply chain of companies. It directly employed a far larger number of people than Apple—some 325,000 worldwide. But it also relied on an international network of 1,000 suppliers located in 1,200 locations. The major subset of suppliers of this group, representing about 90 companies, employed over 260,000 workers.[40] Other major electronics companies, including IBM, Dell, Cisco, and chipmakers like Intel, similarly draw upon a broad and dispersed supply base.[41]

The lead companies in the global electronics business now rely on a small number of major suppliers to act as the spine of their supplier networks. They do so for good reason given the scale of production and assembly that must flow through the system. One of the largest suppliers is Foxconn, a Taiwanese-based electronics manufacturer that employs a staggering 1.2 million Chinese workers in its plants and assembles an estimated 40% of smartphones, computers, and other electronic devices sold in the world.[42] In addition to Foxconn, contract companies like Flextronics, Jabil Circuit, Celestica, and Sanmina-SCI have grown in scale and scope and represent manufacturing powerhouses on their own (albeit unknown to most computer purchasers). Negotiations between these contract manufacturers and leading companies like Apple and HP are not the same as the arm's-length, commoditized relationships that characterize dealings with smaller suppliers.

Even so, profitability remains at the forefront of the supply chain: according to Locke et al., the five most profitable electronics firms (HP, IBM, Apple, Dell, and Cisco) took in cumulative revenues of $350 billion in 2009, earning $122 billion in gross profits from them (or about 35% profits as a percentage of revenue). The top five contract manufacturers in terms of total profitability (listed above) received about $116 billion in revenues and earned gross profits of about $4.4 billion over the same period (or about 3.8%).[43] As happens in multitiered organizational forms documented throughout Part II, as businesses compete in tiers further and further away from the lead companies, margins become thinner as products become more standardized and competition becomes more intense.

Consequences and Having It Both Ways

Despite its size and scope of production, Foxconn has placed unrelenting pressure on lowering its labor costs. The company became notorious for the consequences of its human resource practices, in particular the long work hours it required, the relentless pace of work, serious health and safety problems, and its low wages and lack of overtime pay despite the formal requirements of Chinese labor law. In 2010 stories of numerous worker suicides at Foxconn plants became widely reported. Advocacy organizations undertaking monitoring inside China, such as China Labor Watch and SACOM, documented the pressures and poor conditions facing employees at the company in a series of reports.[44]

In 2012, following a yearlong investigation, *New York Times* reporters David Barboza, Keith Bradsher, and Charles Duhigg published several articles detailing the problems facing workers at Foxconn facilities. The stories, part of a larger series of articles by the three on Apple Computer, documented accidents and serious safety problems. These included two explosions at factories producing iPads that killed four people and injured seventy-seven as well as serious chemical exposures of workers to solvents used to clean iPhone screens. In addition, they documented routine use of excessive overtime and the employment of underage workers, in both cases violating Chinese labor laws and standards (as well as codes of conduct promulgated by Apple for its suppliers).[45]

The mounting public pressure led Apple to join the Fair Labor Association, one of the largest nonprofit labor monitoring groups in the world. The Fair Labor Association conducted audits of Foxconn facilities and issued a report in February 2012. The report confirmed the continuing existence of problems documented by worker advocates and the *New York Times* reporters, including student interns working night shifts and ongoing safety problems that "exposed potentially hundreds of thousands of workers to at least 43 violations of Chinese law and regulation."

In March 2012, Auret van Heerden, the head of the Fair Labor Standards Association, met with Terry Gou, founder and chairman of Foxconn, Jeff Williams, Apple's senior vice president of operations, and other Foxconn senior executives regarding the results of the audit. Gou reportedly turned to his top executives during the meeting and shouted, "This is a disgrace! . . . The world is watching! . . . We are going to fix this, right here!"[46] Subsequently, Foxconn agreed to wide-scale reforms of its policies, including reductions in work hours, major increases in wage rates (amounting to 50% raises for many workers), new policies on health and safety, and reform of practices and conditions on the company's vast assembly lines. Apple also agreed to major changes to its monitoring policies, including tripling the number of people in its social responsibility unit in charge of implementing its monitoring program and recruiting prominent former Apple executives to head up the renewed efforts.

Public scrutiny and the contradiction between Steve Jobs's fabled attention to minute product detail juxtaposed with wide-ranging failure to adhere to labor standards, provoked Apple to recognize that it could no longer "have it both ways" in terms of embracing its attention to design detail while claiming little knowledge of the working conditions surrounding production. Other companies in the sector—notably HP—have similarly accepted greater responsibility to ensure adherence to labor and environmental standards among their principal suppliers, with notable success.[47]

But two tragedies in Bangladesh reemphasized the fragility of such monitoring arrangements in the presence of the competitive pressures placed on extended supply chains. In late 2012, a factory fire at Tazreen Fashions, a large Bangladeshi apparel company, killed 112 workers. Conditions that resulted in the deaths had parallels with the infamous Triangle Shirtwaist fire of 1911 in New York City: locked fire exits, supervisors demanding that workers return to their stations in the face of alarms, and people jumping to their deaths from a burning building. Notably, the facility provided products for a number of major U.S. brands and retailers and had been covered by a workplace monitoring arrangement with Walmart, one of its major customers.[48]

Less than six months later, in April 2013, a multistory building in Savar, Bangladesh, collapsed, killing 1,127 people who worked in the numerous apparel manufacturing companies located in it. The Rana Plaza complex collapse was the deadliest accident in the history of the garment industry. Apparel contractors in the building produced goods destined for such global brands as Walmart, Benetton, the Children's Place, and British retailers Bonmarché and Primark.[49]

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Global supply chains give rise to benefits to the companies that draw upon them, the consumers who purchase goods produced through them, and the workers who are employed as part of them. But supply chain structures also raise the "have your cake and eat it too" conundrum swirling around the fissured workplace. Modern supply chains often represent an intermediate organizational form between arm's-length market transactions and vertical integration. Lead companies at the top of supply chains are deeply integrated with their network of orbiting companies. When Apple specifies the technical standards for Foxconn and hundreds of other core suppliers to exquisite length and operates as a supervisory agent inside the walls of its suppliers, we come back to the same question posed by the practice of franchisors prescribing minute day-to-day activities for franchisees, or AT&T demanding such strict adherence to performance standards by its subcontractors that it virtually drives their business models.

On one hand, companies at the helm of international supply chains—whether in electronics, automobiles, or traditional industries like apparel—create work for people far beyond those directly employed by them, and that is beneficial. But given their deep integration with the supply base and the essential strategic need to carefully prescribe, certify, and conduct ongoing monitoring of adherence to technical, quality, and delivery standards, it seems arbitrary to absolve those lead companies from responsibility for, at the very least, seeing that those suppliers adhere to the labor standards of their home country. The Apple/Foxconn story illustrates that lead firms can take more responsibility. The Tazreen and Rana Plaza tragedies exemplify the failure to do so.

Any effort to address wage levels, health and safety, labor standards compliance, or other aspects of work must recognize that the modern workplace, as redrawn through the organizational forms discussed in Part II, looks less and less like the one enshrined in most public policies. Improving the workplace requires changing the way laws assign responsibility. It requires a reformation in the way government agencies operate. It requires new approaches and roles for worker advocates, employer associations, and other organizations. And ultimately it requires a different relationship between lead organizations and the complicated business networks they rely upon.

How to mend the fissured workplace?