



DAILY LABOR REPORT



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INDEPENDENT CONTRACTORS

Using independent contractors is attractive to employers for a host of economic reasons; however, as government agencies, legislators, and the plaintiffs' bar intensify their focus on these issues, the current legal environment provides significant—and costly—consequences for misclassifying workers as independent contractors, Morgan Lewis & Bockius attorneys Larry L. Turner and Joy F. Grese write in this BNA Insights article. To help employers withstand the increased scrutiny, Turner and Grese offer thorough checklists of best practices for creating and maintaining independent contractor relationships.

Independent Contractor Relationships and the Perils of Misclassification: What All Employers Should Know

BY LARRY L. TURNER AND JOY F. GRESE

Many employers use independent contractors to remain competitive within the marketplace. When used correctly, independent contractors can supplement an employer's regular workforce and

provide costs savings, staffing flexibility and efficiency, and reduce potential liability under federal and state law. Unfortunately, some employers fail to appreciate the attendant risks of wrongly classifying regular employees as independent contractors, an underappreciation that could prove costly.

The misclassification of workers has become the focus of intense scrutiny by the federal and state regulatory and legislative arms of government, as well as by an active plaintiffs' bar. It has never been more important for employers to get it right when it comes to creating and maintaining legitimate independent contractor relationships. This article examines how the interest in this issue has increased, risks under the current law,

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and a few best practices to foster an independent contractor relationship.

I. Increased Scrutiny of the Independent Contractor Classification

As early as 2000, the Department of Labor (DOL) noted that 30 percent of businesses misclassify their employees as independent contractors.

Federal and state officials are directing their attention to businesses that attempt to pass off regular employees as independent contractors. Their motivation is clear—while they wish to protect workers, they also realize that the more workers classified as employees, the more tax revenues and insurance monies federal and state agencies will add to their beleaguered coffers.

It has never been more important for employers to get it right when it comes to creating and maintaining legitimate independent contractor relationships.

In September 2009, the Internal Revenue Service (IRS), which estimates that it loses billions in tax revenue each year due to misclassification of employees as independent contractors, unveiled its intention to target 6,000 companies for special audit, with the goals being to reduce the number of misclassified independent contractors and to close the associated tax gap.

Following on the heels of the IRS audit initiative, on Feb. 1, 2010, DOL released its proposed budget for fiscal year 2011, the hallmark of which is the Wage and Hour Division's (WHD) \$25 million Employee Misclassification Initiative, a joint Treasury-Labor initiative to detect and deter the inappropriate misclassification of employees as independent contractors, and to enhance and coordinate federal and state efforts to enforce labor violations arising from misclassification. The budget proposal is designed to yield collections of more than \$7 billion dollars over the next 10 years from employers that misclassify workers.

The announcement of the Employee Misclassification Initiative has increased the momentum for proposed legislation to regulate the use of independent contractor relationships, including, but not limited to, the Taxpayer Responsibility, Accountability, and Consistency Act of 2009 (H.R. 3408, S. 2882). The purpose of this proposed legislation is to make it more difficult for employers to classify workers as independent contractors for employment tax purposes, as it would revise Section 530 of the Revenue Act of 1978, commonly referred to as a "safe harbor" provision.

Under the terms of this legislation, an employer would be allowed to treat a worker as an independent contractor only if that decision was based on a written determination by the IRS addressing the employment status of the individual or another individual holding a substantially similar position with the employer, or on a concluded employment tax examination that did not find that the individual (or one holding a substantially similar position) should be considered an employee. In addition, the employer or its predecessor must not have

treated any other individual holding a "substantially similar position" as an employee for employment tax purposes for any period beginning after Dec. 31, 1977. The determination regarding whether an individual holds a substantially similar position held by another would be made in a manner consistent with the Fair Labor Standards Act.

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This legislation also would increase employer reporting requirements. Businesses that pay more than \$600 during the year to corporate providers of property and services would be required to file an information report with each provider and the IRS. In addition, the bill would allow individuals deemed independent contractors to petition the IRS for a determination of whether they are properly classified as independent contractors, and would significantly increase employer penalties in the event of misclassification.

States are following suit with similar initiatives and legislation. A host of states, including Iowa, New Jersey, New York, Maine, Michigan, and Massachusetts, have created multiagency task forces to combat worker misclassification. A number of states—including Maryland and Delaware, among others—have also recognized the potential tax revenue at stake in misclassification and have moved quickly to enact laws to close existing gaps. Colorado, for example, passed a law in 2009 that included penalties of up to \$5,000 per misclassified employee for the first offense and up to \$25,000 per employee for subsequent violations. Colo. Rev. Stat. § 8-72-114.

While there are no reliable methods of tracking the number of misclassification lawsuits filed each year, there undeniably is an increased interest on the plaintiffs' side in these types of cases. These lawsuits are similar to wage and hour challenges of employers' classification of workers as exempt or nonexempt, and they are likely to be as prolific. If there was any question before, employers can now be certain that companies that utilize a large number of independent contractors in the course of business will be put under a microscope. Employers should take the time to ensure that they have appropriately classified workers.

II. The Perils of Misclassification

While government agencies, legislators, and the plaintiffs' bar intensify their focus on these issues, the current legal environment provides significant—and costly—consequences for misclassifying workers as independent contractors. Employers may be subject to significant federal, state, and local tax liabilities for monies that should have been withheld from the "wages" of the "employees," employer Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) contributions, interest, and penalties if workers are found to have been misclassified.

Employers that misclassify workers as independent contractors may face litigation for failing to provide benefits to those workers, costs associated with back contributions to benefit plans, and the loss of tax-exempt status for their benefit plans. Misclassifications may expose employers to significant retroactive liability for state unemployment insurance payments, workers' compensation insurance premiums (and potential liability for workplace injuries), and mandated disability insurance.

Moreover, because numerous federal and state statutes protect the health, safety, and employment rights of workers and they apply specifically to "employees," employers who misclassify workers as independent contractors are at risk of liability for discrimination, harassment, and wage and hour claims, as well as for outside actors' wrongful acts against the misclassified worker.

Potential damages associated with worker classification errors may include the following:

- Pay: back wages and overtime pay.
- Taxes: back payroll tax contributions, as well as local, state, and federal government's claims for back income taxes and penalties.
- Social Security: payment of 100 percent of the employee's Social Security contributions.
- Insurance premiums: retroactive premium payments for individuals who should have had coverage.
- Unemployment insurance: claims for FUTA contributions.
- Penalties: monetary punishments for failing to keep "employee" records.
- Benefits: retroactive entitlement to a number of employee benefits, including workers' disability compensation, unemployment, vacation, pension, and stock options.

Depending on the particular statute and cause of action at issue, an employer may be required to pay out benefits and wages extending as far back as six years. The potential damages are further amplified due to the likelihood of class action lawsuits in the misclassification context where damages can be exponentially greater simply by virtue of the number of workers at issue.

Finally, because "employees" (and not independent contractors) have the right to unionize under the National Labor Relations Act (NLRA), employers under the misimpression that their workers are independent contractors could face liability for unfair labor practices in the event that they hinder organizing activity. For example, Section 8(a)(1) of the NLRA restricts employers from interfering with, coercing or restraining any employees in their rights to organize a union or bargain collectively with employers.

When an employer has been found to have committed a violation in this area, the National Labor Relations Board (NLRB) will issue a cease and desist order. The NLRB also will require a notice to be posted for 60 consecutive days at the employer's premises. If the NLRB finds flagrant or egregious violations of this and other sections of the NLRA that outline unfair labor practices, it can order extraordinary remedies, which may include requiring the employer to mail the NLRB's orders directly to each employee's home or granting the union access to the employer's premises to post notices or meet with employees on nonwork time. None of these actions are normally required. The NLRB also can re-

quire the employer to pay litigation costs, attorney's fees, and union expenses.

III. Best Practices for Creating the Independent Contractor Relationship

Many employers succeed in creating legitimate independent contractor relationships. There are a number of steps that employers can take to ensure that they have properly classified their workers as independent contractors, which also will help them avoid or substantially reduce their potential exposure to litigation and government inquiries:

1. Enter into written agreements with independent contractors before work begins. These written agreements should:

- provide a complete list of tasks to be performed.
- specify the results to be obtained.
- identify the individual consistently as an independent contractor.
- limit the service to a specific term or project that cannot automatically roll over.
- avoid requiring daily or weekly reports, or specifying working hours or work schedules. Milestones (i.e., dates/production), however, are acceptable.
- allow the independent contractor to determine how the work will be accomplished.
- allow the independent contractor to provide the same or similar services to other companies while the agreement is in effect. Companies concerned about disclosure of their trade secrets should note that requiring their independent contractors to execute a noncompete agreement may threaten the worker's status as an independent contractor. That being said, businesses concerned about trade secrets should at least include confidentiality and nondisclosure provisions in their independent contractor agreements.

■ specify that the independent contractor is not covered by the employer's liability, health, or workers' compensation insurance. Employers should note, however, that if they otherwise misclassify their workers as independent contractors, and those workers are subsequently reclassified as employees, this contract language will not be dispositive, and the associated benefit costs can be astronomical. Consequently, companies should amend plans to add language that provides that even if the worker is subsequently reclassified as a "common law" employee, such reclassification will not apply on a retroactive basis.

■ Include an indemnification provision requiring that the worker will indemnify the employer for tax or other liability if the worker is held to be an employee by the IRS, another government agency, or a court.

2. If the company "leases" workers from a leasing, staffing, or temporary help agency, the written agreement with the agency should:

- Specify that the individuals are employees of the agency and not employees of the company.
- Specify that the agency itself is an independent contractor; that the agency is solely responsible for paying wages, paying and withholding all applicable taxes, providing workers' compensation coverage, and providing any benefit programs.
- Specify that the agency will indemnify the company for any failure to pay wages, including overtime

wages, and/or withhold and remit applicable payroll taxes.

- Specify that the agency will indemnify and hold harmless the company for any claim brought against it as an “employer” or “joint employer.”

IV. Best Practices for Maintaining the Independent Contractor Relationship

Once the independent contractor relationship has been created, certain steps must be followed to maintain the relationship. First and foremost, it is crucial to remember that the existence of a written agreement, although important and helpful, is *not controlling in determining whether a worker is appropriately classified as an independent contractor*. What will influence a later judicial review and determination is what occurs in the relationship, not what is contained in the written agreement. Consequently, companies should:

1. *Not* treat employees and independent contractors the same.
2. *Not* overutilize independent contractors.
3. *Not retain* former employees as independent contractors.
4. Make certain that independent contractors are doing what they were retained to do.
5. *Not* allow independent contractors to perform core business functions.
6. *Not* prevent or prohibit independent contractors from simultaneously working with other entities.
7. *Not* require independent contractors to undergo extensive substantive training after they have been retained.
8. Arrange for independent contractors to use their own tools or equipment.
9. *Not* provide independent contractors with an “employee” handbook.
10. Provide contract provisions that address only those policies that relate to worker’s status as an independent contractor (e.g., harassment, workplace violence, security).
11. *Not* provide independent contractors with policies that address protections for statutory employees.

12. *Not* provide independent contractors with policies concerning attendance, performance, supervisors, and benefits.

13. Never discipline and/or terminate independent contractors except under the terms of the independent contractor agreement.

14. *Not* grant awards or bonuses to independent contractors. Any recognition of an independent contractor’s good performance should be directed to the worker’s staffing agency management (to the extent there is a staffing agency involved).

15. *Not* conduct formal or informal performance reviews of an independent contractor.

16. *Not* provide training and development opportunities (Such training and development should be provided by the staffing agency, to the extent there is one). Exceptions include training regarding nondiscrimination/harassment, the handling of confidential information, and insider trading.

17. Separate independent contractors from company staff, if feasible. Companies should utilize separate office space rather than a cubicle in an open environment.

18. Prohibit, or severely limit, independent contractors’ participation in company employee events (e.g., holiday parties, training meetings, company-sponsored social events.) If invited at all, independent contractors should receive a special invitation and not an “employee” invitation.

V. Conclusion

In light of the increasing scrutiny of independent contractor classifications, the stronger presumption of employer-employee relationships, and the heightened penalties and damages for misclassification—both at the federal and state levels—it is imperative that employers carefully examine their independent contractor relationships to ensure that their workers are properly classified. Employers should create a written document to memorialize independent contractor relationships and zealously monitor the company’s adherence to the guidelines for that relationship.