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Worker Misclassification

The Labor Department has made working with other agencies to crack down on worker misclassification a top goal, Chamberlain Hrdlicka management attorneys Annette A. Idalski and Drew V. Greene warn in this BNA Insights article. They describe the various competing tests for determining whether an individual is an employee or an independent contractor—including the different tests used in two pieces of legislation that would amend labor law and the tax code with the aim of reducing misclassification. They also discuss the consequences for employers that misclassify workers, the recent increase in misclassification-related litigation, and steps employers should take to protect themselves.

Employee Versus Independent Contractor: Classification Dilemma

BY ANNETTE A. IDALSKI AND DREW V. GREENE

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Employers beware—the United States Department of Labor has employee misclassification squarely in its sights, devoting $12 million of its budget to enforcement actions in fiscal year 2011.[1] DOL recently released its Strategic Plan for FY 2011-2016 emphasizing the interagency crackdown on misclassification and noting that the Wage and Hour Division ''will be a key partner in a joint Department of Treasury-[DOL] initiative to detect and deter the misclassification of employees as independent contractors and to strengthen and

[1] U.S. DEP'T OF LABOR, FY 2011 BUDGET IN BRIEF 5 (2010).

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coordinate federal and state efforts to enforce labor law violations arising from misclassification.''[2] Independent contractor misclassification is slated as ''Strategic Goal No. 1.'' DOL, via the Obama administration, is not the only one putting pressure on businesses—Congress and several states are also cracking down on misclassification of employees as independent contractors.

In the eyes of DOL, economic instability and marketplace fluctuations over the past few years have caused employers to become overly eager in ridding themselves of the burden of paying employment taxes, overtime compensation and benefits. Employers caught in this trap will pay a high price. In certain circumstances, however, individuals are truly independent contractors and should be treated as such without fear of reprisal. In making this determination, it is critical that employers seek the advice of an employment lawyer so that the proper analysis can be conducted to what is most often a complicated legal issue.

Proposed Legislation: Clarification or Confusion? Further confusing the classification landscape are two recently introduced bills: a tax bill, the Playing Field Act of 2010 and a labor bill, the Employee Misclassification Prevention Act (EMPA). Both bills purport to have the objective of curtailing misclassification of employees as independent contractors, but may have a frustrating impact on the independent contractor versus an employee determination because of their reliance on different tests.

Introduced in September 2010 by Rep. Jim McDermott (D-Wash.) and Sen. John Kerry (D-Mass.), the Fair Playing Field Act would repeal Section 530 of the Revenue Act of 1978. The Fair Playing Field Act (H.R. 6128, S. 3786) seeks to close the ''loophole,'' otherwise known as the ''safe harbor'' provision, that for 32 years has allowed businesses to classify workers as independent contractors, regardless of the Internal Revenue Service test, as long as there is a ''reasonable basis'' for the classification and the business has consistently treated such employees as independent contractors by reporting their compensation on a 1099.

Importantly, the bill notes that ''the term 'employment status' means the status of an individual under the usual common law rules applicable in determining the employer-employee relationship, as an employee or as an independent contractor . . . .'' While IRS and courts have used the ''common law'' test in the past for determining independent contractor status as it relates to the tax code, the labor bill discussed below refers to a different test for determining who is an employee, which could be applied should the law come into effect.

Introduced on April 20, 2010, by Rep. Lynn Woolsey (D-Calif.) and Sen. Sherrod Brown (D-Ohio), EMPA (H.R. 5107, S. 3254) targets abuses of improper worker classification by establishing anti-retaliation protections for workers and incentives for people to complain about misclassification, as well as increasing the civil penalties for misclassification. EMPA promotes information dissemination and cooperation among federal and state agencies, including authorizing DOL and IRS to report reciprocally incidents of misclassification to the other. EMPA also makes reference to the definition of ''employee'' as it applies to the Fair Labor Standards Act. Traditionally, courts and DOL have applied the ''economic realities'' test to interpret the term ''employee'' under the FLSA, as opposed to the common law test applied by the IRS. Therein lies the frustration in this already murky employee versus independent contractor classification conundrum.

Should these bills become law without clarification as to the definition of ''employee,'' a business that properly classifies workers as independent contractors under the common law test used by the IRS may still come under fire for misclassification based on the ''economic realities'' approach applied by DOL. These discrepancies must be addressed to help businesses that are making legitimate efforts to classify workers appropriately and avoid liability.

Individual, collective, and class actions by workers against putative employers in the gray area of misclassification have skyrocketed in recent years, increasing costs to companies in defending these claims. Given the crackdown by DOL and IRS, not to mention the legislative initiatives looming on the horizon, employers should take steps now to ensure that workers who are classified as independent contractors are indeed independent contractors and not employees.

The Tests: Independent Contractor or Employee? While no universally accepted definition of an independent contractor exists, there are attributes that help differentiate between an independent contractor and an employee. DOL uses the ''economic realities'' test for determining a worker's status as an independent contractor or employee for purposes of the FLSA. These factors include: (1) the degree to which the worker is independent or is controlled by the business with respect to the way the work is done and the nature of that control; (2) the individual's opportunities for profit or loss; (3) the individual's investment in the facilities and equipment of the business; (4) the permanency and length of the relationship between the business and the individual; (5) the degree of skill needed to do the person's work; and (6) if, and how much, the work performed by the individual is an integral part of the business.

No one factor is determinative of the worker's status as an independent contractor or an employee. Even if a written agreement exists with the worker, the language used by the parties to describe their relationship is not determinative of the worker's status as an independent contractor. Courts will analyze these factors based on the ''totality of circumstances.''

The U.S. Court of Appeals for the Eleventh Circuit continues to apply the ''economic realities'' test to determine whether an individual is an employee or an independent contractor under the FLSA (*Freund v. Hi-Tech Satellite, Inc.*, 185 Fed. Appx. 782, 11 WH Cases2d 917 (11th Cir. 2006)). In *Freund*, the installer of home satellite and entertainment systems brought suit for overtime pay. Hi-Tech Satellite defended against the lawsuit and argued that the installer was an independent contractor, not an employee, and thus was not entitled to overtime under the FLSA. The appeals court agreed with Hi-Tech Satellite and found that the installer was an independent contractor and not an employee.

Several factors persuaded the court that the installer was not an employee. For example, Hi-Tech Satellite scheduled installation appointments, but the installer could reschedule the appointments. Details of how the

[2] U.S. Dep't of Labor, Strategic Plan, Fiscal Years 2011-2016 (2010).

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installer carried out his duties were generally left up to the installer. However, the installer (1) was not permitted to perform additional services that were not paid for by the customer, (2) was required to wear a Hi-Tech shirt during appointments, (3) was required to follow minimum specifications during an installation, and (4) had to call Hi-Tech to confirm the completion of an installation and report any problems. The installer was compensated mainly by the job and not by the hour; had special skills; provided his own equipment, drove his own vehicle, and provided his own tools and supplies for each installation. Although the installer did not hire any workers to assist him with installations, other Hi-Tech installers did hire workers to assist. The installer could accept jobs from other companies and could accept as many or as few jobs from Hi-Tech as he desired, thus providing the installer with the opportunity for profit or loss.

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IRS has adopted a common law test, known as the ''right-to-control'' test, with 20 factors that can be summarized as follows: (1) is the worker required to follow instructions about when, where, or how the work is done; (2) must the worker be trained to perform services in a particular method or manner; (3) is the work an integral part of the company's business; (4) does the worker render services personally; (5) is the worker able to hire, supervise, and pay assistants; (6) is the nature of the work temporary, permanent, continuous, or intermittent; (7) does the worker or the company choose/control the hours of work; (8) must the worker devote substantially full time to the business, or is the worker free to work when and for whom he or she chooses; (9) is the work performed on the premises of the company; (10) must services be performed in a certain order or sequence determined by the company; (11) is the worker required to submit regular or written reports; (12) is payment by the hour, week, or month or by job or commission; (13) does the company pay the worker's business and/or travelling expenses; (14) does the worker bring his or her own tools to the job; (15) has the worker made a significant investment in the facilities used to perform the work; (16) can the worker realize a profit or suffer loss as a results of the worker's services; (17) is the worker able to work for more than one firm at a time; (18) does the worker make his or her services available to the general public; (19) does the company have the right to discharge the worker; and (20) does the worker have the right to end his or her relationship with the company without incurring liability.[3]

[3] *See* Rev. Rul. 87-41, 1987-1 C.B. 296.

What Are the Consequences of Misclassification? If a business improperly classifies an employee as an independent contractor, the employee may recover back pay, liquidated damages, and attorneys' fees. Back pay is equal to the difference between the amount the employee was paid and the amount he or she should have been paid by the employer. This amount includes the minimum hourly wage as well as overtime.

Under the FLSA, employees must be paid at least the minimum wage ($7.25) for each hour worked. Unless the employee falls within an exemption, federal law requires that hourly employees who work more than 40 hours in a workweek must be paid overtime, at a minimum of one and a half times the regular pay rate. Employees have up to *two years* to seek recovery of back pay. However, if the employee can show that the employer willfully violated the FLSA, he or she can seek recovery for up to *three years* of back pay after the alleged violation. Employees also may recover liquidated damages in an amount equal to the back pay award *unless* the company can establish that it had a good faith belief that its pay practices complied with the FLSA. Employees who prevail will recover attorneys' fees in collective actions.

Further, failure to properly classify workers as employees can expose an employer to liabilities including assessment of penalties, income tax withholding, Federal Insurance Contributions Act (social security), and Federal Unemployment Tax Act taxes that were never withheld or paid. The statute of limitations for assessing additional tax penalties is three years from the time the employment tax returns specific to the misclassification periods were filed.

Government agencies soon will be sharing information for the first time ever. Therefore, an audit by one agency could lead to additional government audits. State government agencies that enforce unemployment compensation and workers' compensation laws also may conduct an audit to determine whether a company has properly classified its workers. In addition to audits by DOL and IRS, companies also face action by the Equal Employment Opportunity Commission, the Occupational Safety and Health Administration, the National Labor Relations Board, and other federal agencies that enforce employment laws. These audits can lead to additional liability (for example, for violation of federal anti-discrimination laws and work safety standards).

Recent Litigation. The number of DOL lawsuits initiated nationwide against employers for independent contractor misclassification is expected to increase with the infusion of monies and new investigators now devoted specifically to this issue, including those initiated by DOL and other agencies. Between 2007 and 2009 alone, the filing of FLSA actions rose by 21 percent.[4] By 2011, the number of FLSA claims nationwide is projected to jump by 41 percent.[5]

With DOL homing in, recent high-dollar settlements in other circuits highlight the critical nature of appropriately classifying workers as independent contractors. For example, in October 2010, district court judges in Oregon and Washington preliminarily approved a

[4] Public Access to Court Electronic Records (PACER) Database, *available at* www.pacer.gov.

[5] *Aggressive Plaintiff's Bar, Labor Secretary Spotlighting FLSA Compliance, Speaker Says* (127 DLR C-1, 7/7/09).

settlement pay out of $2.25 million for alleged independent contractor misclassification (*Phelps v. 3P Delivery, Inc.*, D. Or., No. 3:08-cv-00387, and *Frey v. 3PD, Inc.*, W.D. Wash., No. 2:08-cv-00630). 3P Delivery Inc. is a truck delivery firm for major retailers that had historically classified its drivers as independent contractors. The allegations in favor of employee status included the following: requiring drivers to fill out an application; requesting past and present employment history, driver's licenses, and accident history; requiring drivers to undergo a physical examination and random drug and alcohol testing; furnishing the drivers with a vehicle, equipment necessary for work, a fuel card, and uniforms that they were required to wear at all times when working; paying drivers a fixed amount weekly or by commission; using direct deposit; and requiring the drivers to strictly conform to standards outlined in a ''Contract Driver Guide Book.''

What Are the Most important Actions Employers Should Take Now?

Review and update independent contractor agreements and follow them. Companies should execute independent contractor agreements with all independent contractors. Although independent contractor agreements do not conclusively establish independent contractor status, they are a factor to consider in making this determination. Independent contractor agreements should set forth, among other things: (1) the lack of control by business over means by which worker performs his or her duties; (2) the term of the agreement is on a project basis; (3) the intent of both parties that the worker is an independent contractor; (4) the worker uses his or her own equipment and tools; (5) the worker may perform services for other businesses; (6) the worker may assign tasks to others; (7) the worker provides his or her own liability insurance and benefits; (8) the worker is ineligible for employee benefits; (9) the worker has its own business and tax identification number; and (10) the opportunity for bonuses or charge backs. A new agreement should be entered into for each project assigned.

Perform a classification audit with your employment counsel. The benefits of performing an FLSA classification audit include: identification of potential FLSA compliance problems before a DOL audit and mitigation of the risk of an IRS, DOL, or other federal or state agency initiated audit. The audit may also create a good faith defense to a liquidated damages claim for businesses that believe that their pay practices comply with the FLSA.

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