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Employers Face Crackdown On Misclassification

By **Christine Caulfield**

Law360, New York (August 13, 2009) -- Employers looking to save money and avoid layoffs by classifying workers as independent contractors are facing heightened scrutiny by federal and state work force agencies, whose own coffers are shrinking with the rise of the U.S. jobless rate and the consequent decline in payroll taxes.

The use of independent contractors by small businesses reached a record high in 2009, according to the SurePayroll Contractor Index in March, which attributed the trend to the bleak economy and the decline in bargaining power by desperate job hunters.

But lawyers warn that companies adopting this quick-fix strategy may be abusing classification rules, whether they know it or not, and are catching the attention of the Internal Revenue Service, the U.S. Equal Employment Opportunity Commission, state agencies and lawmakers.

"The economy is tight and tax revenues are tight; and while employee taxes are paid every week and with certainty, the independent contractor, if they file at all, files once a quarter," said Steve Palazzolo, senior counsel at Warner Norcross & Judd LLP. "And, frankly, every government in the country needs the tax revenue right now, and a steady stream of it. "

Cozen O'Connor labor and employment attorney Michael Schmidt said state labor departments were cracking down on potential abuses, increasing their audits of companies and looking specifically at whether employers were misclassifying workers.

Many states have increased resources at their disposal now, too, Schmidt said, with many of them entering into data-sharing agreements with the IRS in 2007 under the agency's worker misclassification program.

New York has a similar data-sharing agreement with its various state agencies, as well.

Schmidt, who is handling an increasing number of misclassification claims for companies, said state legislators were also ramping up efforts to combat abuses, with lawmakers in Colorado, Delaware and

Maryland enacting laws to address the issue.

Congress, too, is considering legislation to clarify the rules, with Rep. James McDermott, D-Wash., introducing a bill in the House of Representatives on July 30, H.R. 3408, that would amend the Internal Revenue Code of 1986 "to modify the rules relating to the treatment of individuals as independent contractors or employees."

State law enforcers continue to scrutinize companies, Schmidt added, with eight attorneys general sending a letter to FedEx Corp. in June expressing concern about the company's practice of classifying drivers as independent contractors.

This follows the 2008 misclassification ruling by the California Supreme Court that cost the company $26.8 million.

The Montana Supreme Court also recently ruled against a company for misclassifying its staff of exotic dancers. The court held in Smith v. TCAD Inc. in May that the dancers were employees and were entitled to wages for all hours worked, plus overtime.

And a panel of the U.S. Court of Appeals for the Second Circuit, which included Supreme Court Justice Sonia Sotomayor, weighed in on the issue in 2008, ruling in Salamon v. Our Lady of Victory Hospital that the doctor plaintiff in the case had presented a genuine issue of material fact as to her employment status.

The appeals court vacated summary judgment in favor of the hospital, which had argued that the doctor was an independent contractor, not an employee, and could not therefore make a claim for sex discrimination under Title VII.

All this scrutiny by the courts, legislators and administrative agencies means it's more important than ever for employers to ensure that they are properly classifying their workers, lawyers said.

But determining whether an individual is an independent contractor is not an exact science, they added.

"It's not cut and dry," said Dave Dick, a partner at Steptoe & Johnson LLP. "Attorneys can point to the extremes and be pretty confident, but there are a lot of gray areas, and employers need to be mindful that there are consequences if they guess wrong."

The IRS has abandoned its old 20-point test for a more streamlined list of three factors an employer should consider when deciding on the status of a worker or a group or workers, but the federal agency acknowledges that there is no "magic" formula that makes the worker an employee or independent contractor, and no one factor can stand alone.

The key, it says, is to "look at the entire relationship" and to document each of the factors used in making the determination.

The factors are:

— Behavioral: Does the company control or have the right to control how the worker does his or her job.

— Financial: Are the business aspects of the worker's job, including expenses and tools or supplies, controlled by the company.

— Type of Relationship: Is the work performed a key aspect of the business, will the relationship continue, are there written contracts or employee-type benefits?

Jonathan Stoler of Sheppard Mullin Richter & Hampton LLP said he generally advised employers who were unsure of the proper classification to focus their assessment on the degree of control exerted on the worker.

"If an employer's main goal is for the tasks to be completed at a certain time, but the employer doesn't care how the job is accomplished between point A and point B — that's a good indicator that the worker is an independent contractor," Stoler said. "The more factors, such as those, we can show, the better."

How the parties themselves view the business relationship can also be a factor, he said, but not the determining one.

"For years employers tried to argue that, simply because they had identified the worker as an independent contractor, that this, in and of itself, was sufficient, but the courts and the work force agencies have rejected that argument. Just because you call it a duck doesn't make it a duck," Stoler said.

Employers who misclassify workers as independent contractors face huge liabilities, including unpaid federal, state and local income tax withholdings; unpaid Medicare and Social Security contributions, workers' compensation and unemployment premiums; back wages for unpaid overtime; and, in some cases, pension payments, medical benefits and stock options.

"You can see why employers would want to classify workers as independent contractors but, if they're wrong, all the expenses they were trying to avoid they will be on the hook for," Stoler said. "If you gamble and are wrong, the stakes are very high."

The dangers of misclassifying workers have been underscored by several court cases, notably the FedEx ruling in 2008 and the 2000 class action against Microsoft Corp., which followed an audit by the IRS. The

software giant faced claims for various benefits by thousands of freelance workers and forked out almost $100 million to settle the suit.

Schmidt said the case highlighted the need for companies to conduct their own internal audits before being targeted by the IRS.

Businesses also need to ensure they maintain well-documented files on workers, detailing the reasons for their classification, he said.

Companies should be mindful, as well, that while independent contractors targeted for reductions in force do not have the same legal rights to challenge their termination as employees do, they are increasingly looking to the courts for recourse, Greg Mersol of Baker & Hostetler LLP said.

Mersol said he had recently seen an increase in lawsuits by laid-off independent contractors challenging their status.

"I've seen some cases with long-term independent contractors saying, now that I'm being let go, I should have been a beneficiary of the company's pension plan," he said. "I think people convince themselves that since they were with the company a long time, they should have got the benefits of being an employee."

One alternative to recruiting contractors and risking such claims is to turn to temporary job agencies to supply staff, where the workers are deemed employees of that third party, Schmidt said.

"This way the workers can continue to provide services to the company, while at the same time it will be much clearer that they are not employees of the company, minimizing costs and potential exposure," he said.