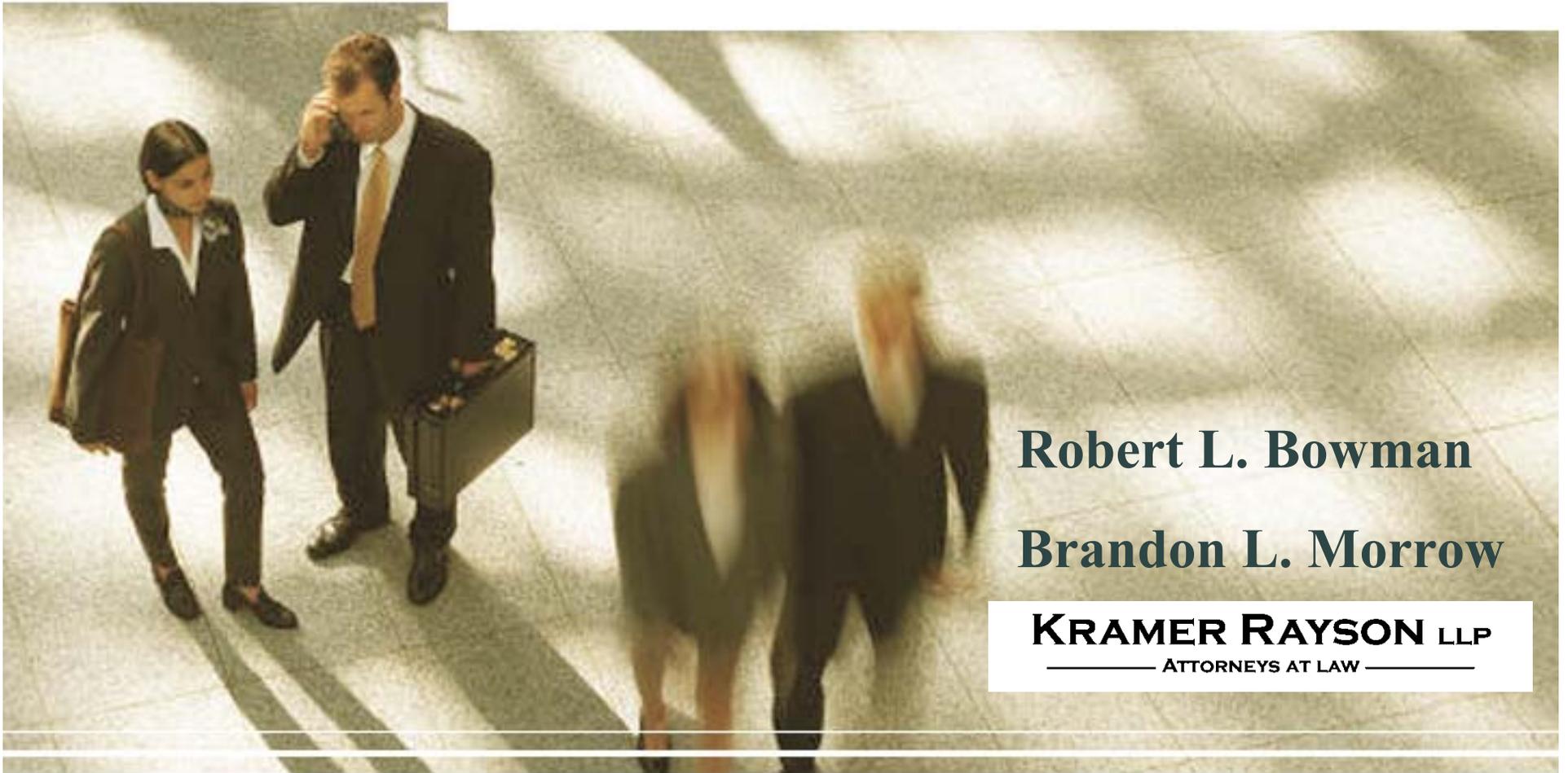


# Employee Misclassification



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# What is Misclassification?

According to the Department of Labor:

“Worker misclassification is the practice, intended or unintended, of improperly treating a worker [who is] an ‘employee’ under the applicable law as [being] in a work status other than an employee (*i.e.*, an independent contractor).”

# OVERVIEW

1. Dept. of Labor (DOL) Cracks Down on Misclassification
2. Independent Contractor (IC) vs. Employee (EE)
3. RI\$K\$ of Misclassification
4. IC Agreements
5. Practical Pointers

# DOL Cracks Down on Misclassification



- 2011 – DOL initiative on EE Misclassification
- DOL hired 350+ investigators in the Wage & Hour Division
- DOL has a Memorandum of Understanding with IRS → the agencies will share info about misclassified EEs
- Same joint effort with several states as well
- As of now, TN has not entered into an agreement w/ DOL

# It's hitting close to home...

## Knoxville Security Company Owes \$62,000

- January 2012
- 34 security guards were misclassified as independent contractors
- Company on the hook for \$62K in back wages
- DOL: “The Wage & Hour Division is **vigorously** pursuing corrective action in these situations...”

## Smyrna Auto Plant Owes \$787,000

- November 2012
- 124 auto workers were misclassified as independent contractors
- Company on the hook for \$787K in back wages
- DOL: Employers like this are “scofflaws who gain an advantage by underpaying their workers.”

In light of this DOL initiative, employers have to remain vigilant when it comes to classifying workers . . . .

**Independent Contractor**



**Or Employee**

# Misclassification: IC vs. EE

- For ICs, ERs are not required to:
  - Withhold income taxes
  - Pay FICA taxes (Social Security/Medicare)
  - Pay FUTA (federal unemployment) taxes
  - Contribute to unemployment insurance and workers' compensation funds

# Misclassification: IC vs. EE

- ICs do not have access to certain benefits and protections
  - FMLA
  - Overtime
  - Minimum wage
  - Unemployment insurance
  - Health insurance
  - Retirement plans

# Misclassification: IC vs. EE

- So sure, there is a competitive advantage to using (or classifying workers as) ICs:
  - Reduce costs/expenses
  - Permits staffing flexibility and efficiency
  - Reduces potential ER liability under federal/state laws

# Misclassification: IC vs. EE

- But there's also the danger of misclassifying workers:
  - IRS audits
  - Individual claims
- These can morph into larger, unwieldy inter-agency investigations that consume valuable company resources

# Risks of Misclassification ...

## It can get expensive!

- FLSA minimum wage and overtime suits
  - Unpaid wages + OT wages + liquidated damages
  - Possible Collective Action, attys fees, costs
- Failure to withhold federal employment taxes
  - Pay back taxes, myriad of penalties + interest
- Failure to pay employment insurance premiums
  - Pay unpaid premiums + interest
- Failure to pay Workers' Comp premiums
  - Pay unpaid premiums + interest

# Case Study: Impact of Misclassification



## Microsoft v. Vizcaino, 173 F.3d 713 (9th Cir. 1999)

- 2 classes of workers:
  - EEs who received full benefits
  - ICs who received no benefits
- ICs did the same type work as EEs and were expected to work the same amount of hours
- Brought suit against Microsoft alleging that they were entitled to all of the same benefits as the EEs
- 9 CA held that they were EEs and eligible for all EE benefits
- Microsoft eventually settled the matter for **\$100 million**



How do we prevent  
misclassification?

First, we have to know:  
what's the difference  
between an EE and IC?

# Misclassification: IC vs. EE

- Remember: an “EE” is someone the ER “suffers or permits to work” (FLSA).
- Ideally, ICs are business entities that control their own EEs and bid for work

# Misclassification: IC vs. EE

- Traditional FLSA test: “Economic Reality Test”
- But there are lots of tests:
  - IRS old “20 factor” test now only “3 prongs”
  - ERISA “12 factor” test
  - UC “ABCs” test

# Misclassification: IC vs. EE

- Key is “control” (usually over the method and manner of work)
  - IC decides when, where and how to do the work
  - IC’s client (not ER) sets expectations for end-product
  - For ERs, the idea is to lose control

# FLSA Economic Reality Test

1. Nature/degree of company's control over the manner in which work is performed
2. Worker's opportunity for profit or loss, based on managerial skills and efficiency
3. Worker's investment in required materials or equipment and the worker's employment of others
4. Special skills required to complete the task
5. Permanency/duration of relationship
6. Extent to which worker's services are an integral part of the company's business

# Here's how to look at it . . .

Assume you are the IC:

- Companies are not your “employers” but rather your “clients” – as clients, they are not entitled to direct you in your work
- But, of course, they do have the right to set forth their expectations for what they are paying you – but only as it relates to the end product.
- It's your right to decide when, where, and how to complete the project

# If you go “IC” . . . Have an Agreement



- Don't set hours/schedule
- Limit service to specific term or project
- State IC not covered by insurance/benefits and no PTO
- Specify IC will pay employment taxes, UC and WC insurance (include indemnity provision)
- Ideally, agreement is with an “entity” not an “individual”

## It's a thin line of distinction . . .

- The facts: you're a cable splicer after major disaster/hurricane restoring phone lines
  - Work several months exclusively for company
  - No direct supervision – highly skilled work
  - Not told how to do job – no training provided
  - Had to have own truck, equipment, tools
  - Paid hourly and worked 12-hour days
  - Paid own employment taxes and vehicle insurance (but not WC and liability insurance)
- Are you an IC or EE?



. . . a very thin line of distinction.

- Actually, 2 different cases, 2 different decisions (from the same court – 5<sup>th</sup> Circuit)
- Key distinctions:
  - **Nature of relationship** – 1 was more “permanent” (11 months vs. 3 months) and other was a “temporary, project-by-project, on-again-off-again relationship”
  - **Economically dependent** – 1 was effectively (but not “really”) limited from other opportunity for profit/loss and other was in business for himself (“a sophisticated, intelligent businessman who entered into a contractual relationship to perform a specific job”)

## IC Agreements Aren't Easy

- Just because there's an IC Agreement doesn't mean the person/entity is an IC!
- Even strongly drafted agreement can be recharacterized – so be accurate and ensure your IC has freedom!
- As the contracting company . . . **LOSE CONTROL!**

## Pitfalls to Avoid – Don't do the following:

- Treat EEs and ICs the same (remember Microsoft)
- Retain former EEs as ICs
- Allow ICs to perform their core business functions
- Prevent/prohibit from working with others
- Allow ICs to have a long-term relationship
- Integrate compensation systems (*i.e.*, ICs eligible for commissions or bonuses that apply to EEs)

## Pitfalls to Avoid – Don't do the following:

- Provide ICs with the EE Handbook – only policies that relate (i.e., harassment, workplace violence), not attendance/performance
- Conduct formal/informal performance reviews
- Provide training/development opportunities
- Open participation in Company EE events (holiday party, social events, training meetings) to ICs.

## Practical Pointers

- Ideally, ICs don't require training to do the work
  - It's the IC's "job" to have that ability/training . . . that's why you engage their services in the first place!
- Ideally, ICs are free to work for others too
  - So, no non-competes
- Pay, if possible, should not be by hour, week or month by lump sum or progress payments
- Try to avoid/limit expense reimbursement
- IC should provide own tools/equipment
- IC should have risk of economic loss (due to significant investment or liability for expenses)

# Questions?

