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Independent Contractors:

A Thing of the Past, or Just a More Cautious Future?

Introduction

In recent years, businesses have become increasingly reliant on independent contractors (commonly referred to as 1099s), as opposed to hiring employees. Independent contractors tend to cost employers less to retain than employees, and the independent contractor classification avoids many regulatory burdens associated with employees. That classification allows employers to avoid benefits costs, and unemployment and workers' compensation contributions as well as payment of employment taxes, minimum wage, and overtime. Because the National Labor Relations Act, the Fair Labor Standards Act, the Civil Rights Act of 1964, the Employee Retirement Income Security Act, the Americans with Disabilities Act, the Age Discrimination in Employment Act, and the Family Medical Leave Act apply only to employees, the use of independent contractors creates a significant reduction in regulatory burdens for companies.

The need for the labor savings created by independent contractors has become more critical to businesses in recent years. As many business owners and industries experience declining profit margins, they also face an unprecedented number of class actions and government audits for minimum wage and overtime pay. This is especially true in industries employing individuals in positions where commission - as opposed to a set wage - is the more significant component of total compensation. At the same time, benefits costs have spiked and employers' exposure to government penalties for immigration violations has expanded. This places an increased emphasis on, and interest in, utilizing contractors as opposed to hiring employees.

While the use of contractors proliferated, federal and state governments did little to provide proper guidance to employers. This silence led to routine use and widespread acceptance of practices that were not necessarily compliant with ambiguous legal standards. As a result, the use of contractors became the norm in entire industries, which unwittingly adopted classification practices that may not be consistent with applicable legal standards.

Now, a perfect storm of political change, increased union pressure, and aggressive government enforcement has developed. Premised on flawed assumptions that businesses force the contractor classification onto

workers to pay lower wages, avoid benefits, and hire undocumented workers, a sustained "grass-roots" movement opposing business' use of contractors is dictating federal and state policies.

State legislatures in New York, Illinois, Texas, Oklahoma, New Jersey, Connecticut, Massachusetts, California, Michigan, Georgia, and other states have passed tougher standards for evaluating the independent contractor classification, and/or developed coordinated inter-governmental enforcement task forces. Numerous jurisdictions have initiated crackdowns against certain industries and passed or proposed legislation holding businesses and owners civilly and *criminally* responsible for misclassifying workers. Recent studies by the United States Government Accountability Office showing that that millions of dollars in tax payments to state and local governments are being lost annually as a result of misclassification will only further fuel this trend.

On the federal level, there is similarly a focus on misclassified workers. Congressional leaders are now demanding that the Department of Labor focus on investigating and punishing employers misclassifying workers and that DOL coordinate these efforts with the Internal Revenue Service. The IRS and the Department of Justice have actually initiated criminal investigations accusing business owners of using independent contractors to evade taxes intentionally and to launder money. As set forth below, lawmakers are proposing sweeping federal legislation that would impose great risks on the business community.

To make matters worse, courts are increasingly hostile to employers' use of the independent contractor designation, a development not overlooked by the plaintiffs' class-action bar. Plaintiffs' attorneys have joined the attack in earnest, focusing on, for example, companies that engage delivery drivers, home healthcare workers, software and other technology salespersons, and mortgage and stock advisors; as well as upon advertising companies and hospitality-oriented enterprises, to seek out potential claimants to initiate multi-million dollar class actions claiming misclassification or non-payment of overtime and minimum wage - some of the many retroactive liabilities incurred when employees are found to have been misclassified as contractors.

A front-running presidential candidate, Senator Barack Obama (D-IL), has proposed new federal legislation: The Independent Contractor Proper Classification Act of 2007. If passed, this law could severely confine the ability of businesses to retain contractors.

Proposed Legislation

On September 12, 2007, Obama and Senators Dick Durbin (D-IL), Edward Kennedy (D-MA), and Patty Murray (D-WA) introduced SR 2044, The Independent Contractor Proper Classification Act of 2007, promoting the legislation as protecting government revenue and the American worker from unscrupulous employers who evade important laws that are in place to protect the public. Indeed, proponents of that bill claim that, by misclassifying

employees as contractors, employers are enabling illegal immigration and denying workers deserved benefits, wages, and overtime.

Despite this frontal attack, the business community has been largely silent, ceding the court of public opinion to their opponents. With increasing numbers of people buying into these negative portrayals, the stage is set for a public outcry and sweeping reforms. In such a charged environment, it is not surprising that the Independent Contractor Proper Classification Act contains provisions radically altering how the propriety of a classification is determined and imposing serious repercussions for employers:

- The Treasury Department would determine the criteria for proper classification, in effect defining who may be considered an independent contractor.
- Workers would have the right to challenge an employer's classification by petitioning the IRS, regardless of whether an agreement existed with the employer. In the event of a challenge, determinations would be made within 90 days, and employers would have to pay the costs of a contractor's successful challenge of his/her classification.
- The IRS would adjudicate worker disputes as to whether a contractor was misclassified.
- The DOL would conduct industry-targeted investigations of employers for the collection of minimum wage and overtime pay. DOL would also share its findings with the IRS and vice versa.
- The IRS would be mandated to perform an overall audit of the employer and to notify the DOL upon finding a single instance of improper classification.
- The safe-harbor provision for reliance on industry standards would be eliminated.
- The law would impose anti-retaliation provisions, such that individuals raising even unfounded complaints of misclassification would be protected from retaliation.

Analysis of Legislation

There are several problems with the proposed legislation, summarized as follows:

Enforcement mechanisms concentrated solely on employers. The proposed legislation gives no consideration to the fact that employers cannot compel individuals to work as employees. In many cases, employers have little option but to hire contractors. In industries where contractors require

minimal initial investment and have high earning capacities, there may be many qualified and gifted contractors who do not wish to be hired as employees. This is especially true in industries where, as a result of years of government inaction, the use of contractors has become the norm. Most experienced workers in these industries expect to be hired as contractors, and typically only inexperienced workers are willing to work as employees. Since the proposed legislation does little to encourage contractors' compliance, many persons will insist on being hired as contractors. Hence, employers may be placed in the unenviable position of choosing whether to risk a finding of misclassification or having to forego hiring the most qualified, experienced and valuable workers. Employers thus face a Hobson's choice between potential competitive disadvantage and accepting substantial and potentially crippling legal liabilities. Were the legislation to impose equivalent burdens and responsibility on contractors and employers, the opportunity and temptation of non-compliance as well as the perceived economic disadvantage of following the law, would be minimized. This would lead to more uniform acceptance and application of the controlling legal standards.

Curing Period. The legislation is flawed in that it fails to recognize that certain misclassifications are, in many respects, the result of a lack of government oversight and instruction. In an area of the law fraught with inconsistency and great confusion, the government continually failed to take action as potentially improper industry standards developed. In fact, it provided legislative safe harbors to employers taking improper actions based on industry standards. The proposed legislation pulls the rug from under employers by imposing retroactive liability for actions many employers believed were fully consistent with applicable legal principles. As such, any proposed legislation should provide employers an opportunity to become compliant before damages may be imposed.

Negative Economic Impact. The proposed legislation fails to account for the dramatic negative economic impact associated with increasing labor costs resulting from changes in contractor classification guidelines. It is a fundamentally incorrect assumption that employers would engage in a one-to-one substitution of employees for contractors. In reality, many employers would scale back their labor forces, hiring no one, instead of hiring employees. Of course, this would reduce profits, eliminate compensable positions, and reduce taxable earnings, and consumer spending. Those employers hiring employees would, as expected, pass on their increased labor and production costs by raising prices to consumers.

Invitation for Frivolous Claims. As it stands, the proposed legislation does not represent a fair balance of power. Employees may effectively insist on being hired as contractors with little consequence, but an employer can be held liable for the misclassification simply for succumbing to a worker's demands. Any legislation that would permit a worker to demand to be hired as a contractor, and then allow that same person to complain about the classification, exposing an employer to company-wide audits by multiple governmental agencies, cannot be considered balanced or fair legislation. One can see where persons with less than honorable intentions could misuse the statute, causing an employer to hire them improperly in order to render the employer vulnerable to demands for monetary consideration. Similarly,

workers could enter into more favorable terms as contractors, and thereafter demand to re-designate their classification. In all cases, the potential ramifications to employers are too harsh, and most employers will be forced to settle even the most baseless of claims. As drafted, the proposed legislation gives workers too much power, too little responsibility, and invites manipulative and baseless claims against the business community.

Lack of Continuity/Consistency. The Independent Contractor Proper Classification Act provides no new guidance – just more penalties for employers. In an area where employers require consistency and predictability in order to structure labor relationships, the legislation provides no guidance or stability whatsoever. Instead, it exacerbates the consequences without providing a consistent set of rules to follow. Any proposed legislation should make it easier – not more difficult – for the business community to ensure compliance.

The legislation does not provide a reasoned or balanced approach to the challenges of proper classification. Instead, it unfairly presumes to punish employers without considering the practical obstacles to compliance. It fails to account for the economic challenges faced by the business community. Accordingly, the legislation, as proposed, is neither fair nor likely to be productive.

Immediate and Interim Business Considerations

Given that 2008 is an election year, such sweeping legislation is unlikely to pass during this congressional term. However, it will undoubtedly be a topic that comes up during the election, and will only continue to gain support as long as a one-sided debate is permitted. On the state level, the trend of anti-contractor legislation and enforcement will continue. In the next Congress, some form of federal legislation is likely, and the extent and scope of that legislation will be affected by business' ability to respond and eventually to control the debate that has already begun. The sooner the business community forms effective coalitions to address the proposed legislation, the better its chances of summarily defeating such legislation at its early stages and/or proposing alternative legislation that could advance the business community's interests. Given the seriousness and potential impact of this debate, the business community should develop coalitions aimed at ensuring a fair and reasoned discussion.

In the meantime, employers must contend with the immediate challenges posed by state governments, federal agencies, inconsistent judges, and class action lawyers. Businesses already face substantial challenges and risks in connection with the classification of workers. Recognizing the "red flags" that can lead to legal challenges, and knowing how to defuse these issues, is the best starting point. Auditors and lawyers often look for the following factors to find instances of misclassification:

- Core functions of the business are performed by contractors.
- Contractors make up a large percentage of the workforce.

- Contractors and employees perform similar jobs, under similar terms and conditions.
- Employers who provide contractors with benefits.
- Reimbursing contractors for expenses.
- Providing contractors with the place and instrumentalities to perform the work.
- Providing anything more than minimal supervision and oversight.
- Evaluating performance based upon the manner or means of performing the work.
- A single worker being considered or paid as both a contractor and an employee.
- Restrictions on working for competitors or simultaneously performing other work.
- Contractors supervising a business' employees.
- The lack of a formal contractor agreement and/or reliance on verbal arrangements.
- Contractors' lack of risk, lack of potential for loss, and/or lack of investment.
- The use of shell companies to shield or legitimize otherwise improper classifications.
- Over-reliance on titles or labels to identify the relationship.

Fortunately, businesses can address many of these concerns through proper agreements that can effectively serve as not only a contract, but also evidence of the propriety of the relationship. Courts and government agencies often focus more upon form than substance. Because of this, changes to the legal rights of the parties - as opposed to the actual practices of the parties - may, when properly constructed, render an otherwise improper classification valid. For example, a business that maintains a sales force consisting of similarly situated commissioned sales employees and contractors would likely be considered to have misclassified the contractors. However, the parties could: (1) enter into contractual arrangements giving contractors and employees wholly different rights and responsibilities; (2) establish rights for the contractors consistent with those accompanying a valid business-to-business transaction; (3) change the form of contractors' compensation so it is vastly different from employees' compensation (which need not necessarily result in a material modification to the contractors' actual

compensation); and (4) establish minimum fees, bonds or investments for the contractor, indicative of risk and investment (such terms need not be prohibitive or a deterrent in actual practice). These actions could provide numerous indicia of contractor status and differentiate the terms associated with employment, while minimizing actual changes to the relationship. While oversimplified and general, this example is demonstrative of the ability to create across the board distinctions and supportive criteria through properly and creatively drafted agreements. Although not applicable in all situations, appropriate agreements can render valid what was otherwise an improper classification.

Considerations for Employers With Established Contractor Relationships

Even employers with clearly established contractor relationships must remain vigilant. New legislation on the federal and state levels could impose liabilities on employers for the actions of their properly classified contractors. In other words, an employer could face liability due to its contractors' violation of immigration laws or failure to pay proper wages. Employers can similarly face liability under "negligent retention" theories for torts committed by their contractors' employees. Confounding matters, the more an employer does to regulate its contractors, the greater the risk of the propriety of its contractor classification being called into question. This risks the company becoming a "joint employer" and having a direct liability to its subcontractors' workers for wages, overtime, and harassment, among other things.

Conclusion

With employers facing increasingly stringent regulation, maintaining the independent contractor designation in a manner consistent with sound business practice and applicable laws and regulations, is becoming a high-wire act on an increasingly thin wire. While it can still be safely done, the maintenance of the independent contractor relationship is no longer an afterthought or quick-fix solution to problems. Instead, it must be a carefully developed and implemented business decision, which if properly used and documented can accomplish an employers' goals.

The immediate needs of businesses are to understand clearly the issues surrounding the classification and use of contractors as well as to be aware of particular vulnerabilities and potential liabilities associated with the use of contractors. Developing auditing practices and implementing proper contractor agreements are of critical importance.

In the longer term, businesses must consider how to respond, as a community, to the debate surrounding independent contractors and the misperceptions being created about businesses' role in hiring them. In addition to blocking imprudent legislation, the business community should seize the opportunity afforded by the Obama-backed legislation to introduce pro-business legislation designed to counter the difficulties posed by regulators, legislators, and enforcement mechanisms that vary from state to state, agency to agency, and court to court. Further, industries could seek exclusions for certain positions, and even preemption of certain state laws.

By effectively and promptly responding to the introduction of the Independent Contractor Classification Act of 2007, the business community can position itself to defeat this or other anti-contractor legislation and counter balanced legislation that benefits businesses that use independent contractors.

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