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Tough new government measures to uncover the misclassification of independent contractors and to impose heavier penalties upon transgressors are on the way, attorneys John E. Thompson and Deepa M. Subramanian of Fisher & Phillips in Atlanta warn in this BNA Insights article. The authors describe Labor Department, Internal Revenue Service, and state initiatives targeting employers using independent contractors and provide guidance on structuring independent contractor relationships in this new era of government scrutiny.

Misclassification in the Cross Hairs: Independent Contractors Under Fire

BY JOHN E. THOMPSON AND DEEPA N. SUBRAMANIAN

Some businesses and other organizations have long conducted at least a part of their activities through workers they have not treated as employees. The labels for these individuals are seemingly endless, but among them are such monikers as ''contract labor,'' the oxymoronic ''contract employees,'' ''freelancers,'' and the one we use here, ''independent contractors.'' Convergent trends are drawing unprecedented attention to whether, whatever such workers are called, they are employees within the definitions of the myriad laws to which that status is relevant.

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Those trends include both the still-growing wave of wage-hour claims and the perception in government that the independent contractor concept is curtailing tax revenues and other required payments tied to employment status. Workers question why they are not paid overtime only to be told that they are not ''employees'' and thus are not covered by overtime laws. Organizations classifying workers as independent contractors might neither withhold taxes from those individuals' compensation nor remit the payroll taxes and other required employment-related sums.

Whether independent contractorship is invoked more broadly or more frequently now than in the past probably is hard to know with any reasonable confidence. However, it *is* certain that enforcement officials and individual workers are increasingly likely to contend that the classification is incorrect.

Misclassification can lead to a variety of serious legal consequences. An illustrative few include the potential for such things as liability for failing to withhold and to pay the employer's share of payroll taxes; exposure for failing to include the individuals in employee benefits

plans; the tax disqualification of retirement plans; and back wages, add-on damages, and penalties for failing to comply with wage-hour requirements. Moreover, tough proposals are in the works that are designed both to uncover misclassification and to impose even heavier penalties upon transgressors.

The Federal Misclassification Initiative. The Department of Labor (''DOL'') seeks stepped-up enforcement in this area. Its 2011 Budget Report says:

> ''Individuals wrongly classified as independent contractors are denied access to critical benefits and protections to which they may be entitled as regular employees. Worker misclassification also generates substantial losses to the Treasury and the Social Security, Medicare and Unemployment Insurance Trust Funds. To address this problem, the FY 2011 Budget includes a joint Labor-Treasury initiative to strengthen and coordinate Federal and State efforts to enforce statutory prohibitions, identify, and deter misclassification of employees as independent contractors.''

DOL would devote $12 million and 90 employees to targeted investigations by its Wage and Hour Division. It proposes to allocate over $11 million to competitive grants to encourage states to focus upon misclassification, and it would ''reward'' states showing the most success. The solicitor of labor would receive resources aimed at both increased litigation and additional efforts coordinated with those of the states.

These measures would include mutually supportive state and federal audits of ''problem industries,'' litigation against ''major employers that cross state lines,'' and increased cooperation among and training of enforcement agents. Industries that should expect particular attention include business services, construction, childcare, grocery stores, home healthcare, janitorial services, landscaping, and poultry and meat processing.

It is probably no coincidence that, for a three-year period beginning in 2010, the Internal Revenue Service reportedly will conduct detailed examinations of more than 6,000 businesses using independent contractors. Estimates are that the revenue flowing from these audits will be around $7 billion.

Federal Legislation. The ''Employee Misclassification Prevention Act'' (H.R. 5107 and S. 3254), was referred to appropriate House and Senate committees on April 22, 2010. The bill would amend the Fair Labor Standards Act (''FLSA'') to require organizations to keep certain records on and to provide various notices to employees and putative nonemployees who perform labor or services for remuneration. It also provides for targeted audits of ''certain industries with frequent incidence of misclassifying employees as non-employees, as determined by the Secretary of Labor.'' The bill further prohibits ''fail[ing] to accurately classify an individual as an employee''; authorizes penalties of up to $1,100 for each individual who was the subject of violation; and authorizes per-person penalties of up to $5,000 for repeated or willful violations.

State Activity. State governments are also ratcheting up enforcement. Colorado, Illinois, Maryland, Massachusetts, New Jersey, and New Mexico have passed laws targeting the construction industry.

Other examples include Nebraska's recently enacted penalties for misclassification in both the construction and transportation sectors and the Connecticut legislature's passing of increasingly stringent misclassification assessments. A task-force-spurred New York effort has recovered millions in back wages and unpaid taxes and resulted in an ''employment fraud hotline'' and website. Iowa established an interagency Independent Contractor Reform Task Force, adopted online reporting methods for workers who believe that they have been misclassified, and is pursuing penalties, fines, back-tax collection, and even criminal charges for intentional misclassification.

'Employee' Versus 'Independent Contractor.' Addressing these matters under every relevant law is beyond the scope of this article. We focus on independent contractorship under the FLSA, which serves as a good bellwether for circumstances revealing potential misclassification.

The FLSA's requirements include paying covered, nonexempt employees (i) not less than its minimum wage (currently $7.25 per hour) for their work time, and (ii) overtime compensation at a rate of at least 1.5 times their regular rates of pay for all hours worked over 40 in a workweek. However, as the Labor Department's Wage and Hour Division observes, ''In order for the FLSA to apply *there must be an employee-employer relationship*. This requires an 'employer' and 'employee' and the act or condition of employment.'' Section 10b00, *Field Operations Handbook* (U.S. Labor Department, October 20, 1993)(emphasis added).

The FLSA's 70-year-old definitions on this score are vague and unhelpful. It defines ''employer'' only as ''includ[ing] any person acting directly or indirectly in the interest of an employer in relation to an employee.'' 29 U.S.C. 203(d). ''Employee,'' in turn, is simply defined as ''any individual employed by an employer.'' 29 U.S.C. 203(e)(1). The U.S. Supreme Court has construed this to mean that the FLSA's reach is ''expansive'' and encompasses ''working relationships, which prior to [the FLSA] were not deemed to fall within an employer-employee category.'' *Walling v. Portland Terminal Co.,* 330 U.S. 148, 150-51 (1947).

The 'Economic Realities' Test. Courts sometimes apply different factors or weigh similar factors differently in evaluating whether an individual has been properly classified as an independent contractor. A better reference point is the set of criteria DOL uses to evaluate what courts call the ''economic realities'' analysis:

1. The degree to which the person's work is controlled by the organization;
2. The individual's investment in facilities and equipment, if any;
3. The individual's opportunities for profit or loss, if any;
4. The amount of any initiative, judgment, or foresight the person uses in open-market competition;
5. The permanency of the relationship; and
6. Whether and to what extent the individual's work is an integral part of the organization's business or activities.

No one factor is necessarily determinative. The ultimate question is whether overall they reveal that, in reality, putative independent contractors are economically dependent upon the organization for their livelihoods. It is fair to say that the typical FLSA result is a finding of dependency, that is, employment.

A 1999 opinion letter from the Wage and Hour Division's Office of Enforcement Policy illustrates how these factors are applied. It concluded that a company's

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''Bone Procurement Technicians'' who obtained organ or tissue donations from hospitals would not be independent contractors. For one thing, the technicians' services were to be part of the company's core business, and sometimes acknowledged employees would perform the same work. The division viewed the training, supervision, and other oversight to be exercised over the technicians and over the arrangements for and circumstances of their work as being no different from those present in an employment relationship. The technicians made no financial investment, and instead they used the company's equipment and worked at either the company's premises or those of its collaborating hospitals. The technicians were to be paid a per-case sum that evidently was not to be established through bidding or negotiation, and the division saw no reason to believe that they would exercise any initiative, judgment, or foresight in open-market competition. *Op. Off. of Enforcement Policy*, (DOL Wage-Hour) (July 12, 1999); *see also Op. Wage-Hour Administrator*, BNA Wage-Hour Manual 99:8331 (December 7, 2000) (''economic reality'' analysis showed courier company's pickup and delivery drivers to be employees rather than independent contractors).

It's Not All Doom and Gloom. Despite the increased attention and skepticism, the fact remains that independent contractorship can properly be asserted in the appropriate circumstances with careful evaluation, planning, and structuring. Among the important considerations are these:

■ In what ways and to what extent will the organization control the workers? Will the organization tell them what to do and how, when, and where to do it? If it will not, is this because those things are so obvious that they need not be specified? Will the organization apply the same procedures, policies, and rules to the workers that it does to employees? Will the organization approve others the workers retain to help them or cause the workers to discharge those helpers? The prospects for valid independent contractorship generally increase as the organization's degree of control over the workers' activities decreases.

■ Will the workers provide services that are an integral part of what the organization does? Will the organization in fact carry out its activities completely or nearly so through those workers? Will the workers do the same kinds of work that the organization's acknowledged employees do? The more dependent the organization is upon putative independent contractors to do what it exists to do, the more likely it is that those workers will instead be deemed employees.

■ Will the organization's relationship with the workers be permanent or for an indefinite duration, or will it instead be fixed or determinable (such as for the length of a specific project)? If the relationship will ostensibly be for a particular project, will there be a nonstop, continuous series of those projects into the indefinite future? Will the workers perform similar services for other, independent organizations at the same time? The more open-ended the relationship's duration, the more it looks like employment rather than independent contractorship. The same is often true of a relationship in which the workers are not permitted to, or as a practical matter are precluded from, providing their services to others.

■ Will the workers have an independent, significant financial investment in the services they perform? Will they carry out their services through their own, separate business entities? Will they have opportunities for profit and risks of loss in the sense that businesspeople do? Positive answers favor a finding of true independence.

■ Will the relationship be memorialized in a written agreement that establishes an arrangement having characteristics of arms-length dealing and autonomy? It is insufficient simply to have an individual sign something saying that he or she is an independent contractor, but the presence or absence of a written agreement can be another fact weighing for or against independent contractorship.

A line of relatively recent cable telecommunications cases demonstrates that independent contractorship still exists. A good example is *Herman v. Mid-Atlantic Installation Servs.*, 164 F. Supp. 2d 667 (D. Md. 2000), in which the court found cable installers to be true independent contractors. The parties entered into a contract detailing their arrangement, and the installers invested in their own tools, equipment, and vehicles and were paid on a piece-rate basis. Although the company assigned routes and prescribed schedules and policies, the court did not see these factors as compelling a finding of employment.

The U.S. Court of Appeals for the Fourth Circuit affirmed, further observing that the installers supplied their own equipment and insurance, set their own hours, and had ''an opportunity for profit or loss'' in the way they managed their work. That the installers were integral to the company's installation and repair business was, in the court's eyes, insufficient to create an employment relationship when balanced against the other considerations. *Chao v. Mid-Atlantic Installation Servs*, 16 Fed. Appx. 104 (4th Cir. 2001); *see also Freund v. Hi- Tech Satellite Inc.*, 185 Fed.Appx. 782 (11th Cir. 2006).

DOL's Wage and Hour Division might also approve independent contractor status if the circumstances support it. For instance, in 2002, the Division's Office of Enforcement Policy said that ''Bowl Builders'' could be independent contractors, even though in some ways the facts presented a mixed picture. *Op. Off. of Enforcement Policy,* BNA Wage-Hour Manual 99:8386 (Sept. 5, 2002).

The company's business was to design, engineer, build, manufacture, and sell ''feeder bowls'' that routed parts into assembly-line manufacturing machinery. The builders designed, engineered, and built these items, so clearly they were an integral part of that business. They worked under an independent contractor agreement that included an arbitration mechanism and liability indemnity provisions, and in which the company disclaimed all control over their efforts, and the agreement expressly permitted the builders to provide their services to other businesses. Builders worked on the company's premises during its normal times of operation, but they decided their own hours and work methods, did not report to management, and did not attend employee meetings. They supplied their own specialized tools and other items and had an investment in their endeavors worth from $5,000 to $10,000. Builders received a predetermined per-project lump-sum; were self-insured; paid their own taxes; hired and fired helpers as they saw fit and without any company involve-

ment; and paid those helpers' workers' compensation coverage and other taxes. Builders could incur a financial loss on untimely projects, and they performed their work without company training or oversight. With the caveat that what happened in actual practice was the key, the Division said that builders were ''likely'' to be independent contractors.

There's No Easy Checklist. The governing principles in this area are inherently ambiguous and unclear. To some extent, whether a worker is or is not an independent contractor rests in the eye of the beholder. Some beholders have the power to impose substantial liability and penalties and are seeking the authority to do more.

One might view the question as a continuum running from clear independence at one end to obvious employment status at the other. Most real-world situations are at neither end but are instead somewhere in between.

Organizations evaluating independent contractor arrangements should first think candidly about whether the circumstances lend themselves to such an arrangement *at all* when the need for control and other, broader operational and managerial concerns are taken into account. Sometimes, the answer will be ''no.'' Even if the answer is ''yes,'' often it is impossible to predict with certainty that workers will be found to be independent contractors no matter who is asking the question or under what law the issue arises. Consequently, an organization will want to do everything it reasonably can to move things as far toward the independence side of the spectrum as possible.

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