

NEW AGE SCRUTINY OF EMPLOYEE VS. CONTRACTOR LIABILITIES

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From an employer's perspective, hiring employees involves both benefits and burdens. A fundamental benefit is that you can control employees, making them do what you want to further your business goals. But, you must pay their wages, withhold taxes, give them employee benefits, be liable for any acts of negligence during their employment, and face the scrutiny of state and federal law when it comes to nondiscrimination, discipline, and termination.

Independent contractors, on the other hand, are classically one-time workers who do a job for a fixed price and who generally work for multiple companies. Axiomatically, with independent contractors, you can't control them with detailed direction, and they bring no tort, contract, or tax liabilities to the employer's doorstep. That may make the dichotomy between employee and contractor seem obvious and one that could cause no controversy. Yet, nothing could be further from the truth. In fact, there are many subtle (and not so subtle) blendings of characteristics that make the spectrum of workers far more homogeneous than you might suspect, such that it is often not easy to say in which category a particular worker or class of workers belong.

In part, this is due to the obvious incentives companies have to hire independent contractors rather than employees. That has led to an epidemic of arguably bogus independent contractors who do not necessarily function the way they are supposed to. That, in turn, produces controversy about what is and is not possible with independent contractors, undermining to some extent the circumstances in which companies lawfully and legitimately use independent contractors rather than employees. This article discusses the typical types of controversies that can arise in connection with characterizing a worker as an employee versus an independent contractor.

Types of Controversies

A. Taxing and Regulatory Matters

One expects worker status controversies to occur with government taxing or regulatory agencies. The taxes, administrative burdens, and federal and state employment law liabilities for employees are much greater than for independent contractors. As a result, there is a natural (and eminently understandable) tendency for businesses to treat workers as independent contractors. Much of the lawyer or regulator's task, therefore, is in assessing what is legitimate and what is not.

With an independent contractor, of course, the employer pays gross pay with no withholding. With an employee, the employer must withhold federal, state, and sometimes even local taxes and must remit those taxes to the proper authorities. That tax axiom is perhaps the best known consequence of the employee versus contractor distinction, but it is certainly not the only one. There are workers' compensation implications, labor law issues, pension and employee benefit considerations, and a host of other issues that can ultimately hinge on this pivotal employee versus contractor divide.

Given all this, it is no wonder that disputes arise over fundamental characterization questions. Is the worker really an employee or a contractor? Such matters come up in very different contexts, including:

- Audits from federal or state taxing agencies;
- Third party lawsuits where the worker's actions (and liabilities) are sought to be attributed to the putative employer;
- Actions from labor organizations seeking to enforce worker protection measures provided to employees but not to independent contractors; and
- Audits from pension authorities seeking to determine compliance with nondiscrimination, coverage, and other rules governing pension and employee benefits.

It is inappropriate to dismiss any of these as unimportant. Worker status disputes can be protracted and expensive, and they can involve bet-the-company stakes. However, in my experience, companies are more apt to understand audits from (and disputes with) taxing agencies. To perhaps a lesser extent, this is even true with labor and employment agency audits. These disputes are about money, but they are also about the state's (or the federal government's) interest in ensuring that workers are being protected and treated fairly.

The State of New York has established a joint task force to address the problem of worker misclassification.¹ Led by the New York Department of Labor, the Joint Enforcement Task Force comprises representatives from the Workers' Compensation Board, the Workers' Compensation



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tion Inspector General, the Department of Taxation and Finance, the Attorney General's Office, and the New York City Comptroller's office. It is hoped that coordination amongst these agencies will increase efficiency and strengthen enforcement of independent contractor characterization in the state. One can only hope other states will follow suit.

More recently, Senators Barack Obama, Dick Durbin, Edward Kennedy, and Patty Murray have launched a bill to crack down on worker misclassification at the national level.² The bill, dubbed the Independent Contractor Proper Classification Act of 2007 (the "Act"), would revise procedures for worker classification, primarily focusing on section 530 of the Revenue Act of 1978.³ Section 530 relieves an employer of employment tax liabilities stemming from a failure to treat an individual as an employee if the employer meets three requirements: reasonable basis, substantive consistency, and reporting consistency.

An employer can meet the reasonable basis requirement if judicial precedent, IRS rulings, a past IRS audit, or industry practice supports the classification of a worker as an independent contractor.⁴ An employer meets the substantive consistency requirement if it consistently treated the workers in question as independent contractors,⁵ and the reporting consistency requirement is met if the employer has not classified the workers as employees on any federal tax returns (including information returns).⁶

The Act would no longer allow employers to use industry practice as a reasonable basis for not treating a worker as an employee, and it would prohibit employers from receiving employment tax relief for any worker whom the IRS has determined should have been classified as an employee. Under the bill, a worker would be allowed to petition for a determination of his status for employment tax purposes. In a kind of *Miranda* rights procedure, it would require employers pre-hiring to notify individuals classified as independent contractors of: (1) their rights to seek a status determination from the IRS; (2) their federal tax obligations as an independent contractor; and (3) the labor and employment law protections that would not apply to them.

The new legislation would also impact the IRS and Department of Labor. The IRS would be allowed to issue regulations and revenue rulings on employment status. In any case in which the IRS determines workers were misclassified, the bill would also allow the IRS to perform an employment tax audit, inform the Department of Labor, notify the worker of the possibility of a self-employment tax refund, and instruct the worker to take affirmative action to abate the violation.

The Department of Labor would be required to identify and track complaints and enforcement actions involving misclassification

of workers and to investigate those industries where worker misclassification arises frequently. Much like New York's joint task force, under the Act, the Department of Labor and the IRS would be required to share and exchange information on worker misclassification cases and to provide the information to relevant state agencies.

B. Civil Litigation

Not all worker status disputes involve government agencies. Companies have a far harder time understanding these disputes in civil litigation. Worker status controversies can—and do—arise in civil litigation between private parties. For example, the status of a worker may be pivotal in assessing a company's liability for the worker's acts. If a delivery driver is your employee when he hits a pedestrian, you must pay. If the driver is a true independent contractor, the tort liability is his, not the company's.

Civil litigation involving the status of workers who are contractually labeled as "independent contractors" appears to be increasing. In many of these cases, the workers themselves sue their employers expressly seeking reclassification. The workers in such a dispute may be seeking employee benefits, protection under state or federal nondiscrimination or employment rights laws, wage and hour protections, etc. Indeed, there is significant variety in such cases.

An employer may be startled to learn that a written contract with a worker that clearly identifies the worker as an "independent contractor" may not be respected by the courts. One could argue that a worker who signs a contract labeling him as an independent contractor should be estopped from later claiming he is an employee.

This discussion serves only as a general introduction to private worker status litigation. It is not meant to provide specific aspects of state, federal, or local laws, and it is essential for litigants and lawyers to consider such specifics.

(i) Smell Test?

The true relationship and the true practice between the worker and the company will control the worker status question. The worker's true status is important. Mere words in a contract are generally not determinative.⁷ In part, this may merely reflect the fact that worker status determinations must generally take into account the totality of the situation, not merely the contract.

Indeed, the contract itself is not the be-all and end-all of the relationship. Many companies have written reasonable contracts purporting to establish independent contractor relationships only to find that their actual practice involves many actions (and many controls over the worker) that fly in the face of the contract lan-

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guage. Where this occurs, anyone attempting to characterize the relationship is likely to look beyond the language of the contract to the actual conduct of the relationship. In fact, it could not be otherwise.

Moreover, some courts have discounted written contracts even more readily when the facts suggest they were “adhesion” contracts signed by unsophisticated workers with no contractual bargaining power.⁸ Notwithstanding written contract terms that unambiguously identify a worker as an independent contractor, the courts will generally analyze the facts and circumstances surrounding the relationship. Although the language of the contract is relevant, the courts also assess the pattern of practice between worker and employer. The contract is only one piece of evidence a court will evaluate in assessing whether a worker is an employee or independent contractor.

(ii) *Vizcaino v. Microsoft*

Although it was not the first such case, the cornerstone of the modern era of worker status litigation is *Vizcaino v. Microsoft*.⁹ In that case, a group of freelance programmers sued Microsoft claiming that as common law employees, they were entitled to various savings benefits under Microsoft’s Savings Plus Plan (SPP) and stock-option benefits under Microsoft’s Employee Stock Purchase Plan (ESPP).¹⁰ The programmers were hired with the understanding that they would not be eligible for benefits given to Microsoft’s regular employees. They were paid through the accounts receivable department, not the payroll department. They were also paid at a higher hourly rate than comparable regular employees.

Although Microsoft may have assumed there was no risk of reclassification, in prior years the IRS had examined Microsoft’s employment records and had determined that Microsoft’s programmers were not independent contractors, but were actually employees for withholding and employment tax purposes.¹¹ In determining that the programmers were really employees, the IRS concluded that Microsoft either exercised or retained the right to exercise direction over the services they performed.

Employee vs. Contractor Liabilities

Learning of the IRS rulings, the programmers sought employee benefits from Microsoft. Microsoft denied their claims for benefits, taking the position that they were independent contractors who were not eligible for employee benefits. Microsoft's plan administrator also reviewed and denied the claims, determining that they had contractually waived all rights to benefits and they were not regular, full time employees.

The district court concluded that the programmers were not eligible for SPP benefits because the SPP restricted participation to individuals on Microsoft's payroll, and they were not paid through the payroll department. The district court also concluded that the programmers were not eligible to participate because their contract with Microsoft clearly so stated. Furthermore, the workers had no expectation they would receive benefits.

The Ninth Circuit reversed and remanded, holding that the programmers were eligible to receive benefits. The court also ruled that by incorporating Internal Revenue Code section 423 into the provisions of the ESPP, Microsoft manifested an objective intent to make all common-law employees, including these programmers, eligible to participate in the plan. It is important to note that Microsoft conceded that the programmers were common law employees, and it contested their eligibility for benefits on other grounds. The court also noted that Microsoft could have easily limited participation in the SPP by using more explicit language in the plan.

Vizcaino demonstrates that employers cannot rely entirely upon the labels placed in contracts to define a worker as an independent contractor. The denomination of a worker as an independent contractor in the contract is not sufficient to establish an independent contractor relationship.¹² The fundamental truth of the relationship will control.

(iii) Domino Effect

Vizcaino also nicely shows the nearly inevitable interaction between tax controversies and other worker status inquiries. The IRS started *Vizcaino* because the programmers made their claims on the heels of an IRS reclassification. Frequently, a later reclassification controversy emanates from a simple worker's compensation claim.

Furthermore, one tax-driven dispute over worker status often comes on the heels of another. State taxing authorities may follow federal or vice versa. A state employment development audit may be followed by an IRS or state tax audit or by a direct suit by workers seeking recognition as employees.

Virtually all types of employers may run the risk of such disputes. Even public agencies are not immune from private litigation over the classification of workers. In *Metropolitan Water District*

of Southern California v. Superior Court of Los Angeles County,¹³ the plaintiffs were workers hired through private labor suppliers to work on long-term projects for the water district. They sought relief to compel the water district to enroll the workers into the California Public Employees Retirement System (CalPERS).

The dispute arose because the workers were labeled as "consultants" or "agency temporary employees" and were thus ineligible for benefits. The California Supreme Court held that the Public Employee's Retirement Law (PERL) required the water district to enroll all common-law employees into CalPERS, with only a few statutorily defined exceptions.¹⁴

B. Class Actions by Workers Seeking Employment Status

Class actions on worker status are becoming more common. For example, in *Estrada v. FedEx Ground*,¹⁵ the plaintiffs were parcel delivery drivers denominated as independent contractors in contracts they signed with FedEx. The plaintiffs sought to be classified as employees, and the court agreed, finding that FedEx had the right to control the drivers. The court admonished that "the label placed by the parties on their relationship is not dispositive, and subterfuges are not countenanced."¹⁶

It may seem to violate principles of fundamental fairness for workers to sign a contract explicitly agreeing to treatment as an independent contractor and then to turn around and sue to be treated as an employee. On the other hand, equity also dictates finding the truth. The truth of the relationship between worker and company is often defined more by actions than by words in a contract. Indeed, the courts are inclined to see this issue through a lens of realism. In *Estrada*, the court stated:

As to whether or not the parties believed they were creating an employer-employee relationship, it would seem that the [drivers] thought they were either investing in a 'job' or believed that they would be independent contractors, only to find out by reason of the [company's] controls that they were being treated like employees.¹⁷

Thus, courts will not allow employers to call a worker an "independent contractor" while subjecting him to the control it exercises upon a normal employee.

C. Private Rights of Action

Most worker classification suits are brought as claims for employee benefits under state or federal law. Having standing to sue is usually not an issue. However, in some cases, courts have been reluctant to grant private rights of action where the statute in question does not expressly grant individuals a private right of action on a worker misclassification issue.

For example, in *McDonald v. Southern Farm Bureau Life Insurance Co.*,¹⁸ the Eleventh Circuit upheld a district court ruling that individuals have no private right of action under FICA to seek damages from their employer resulting from the employer's misclassification. This case shows the multiplicity of reasons worker status can be critical. Beginning in 1989 and ending in 1998, Craig McDonald was employed as an insurance agent by Southern Farm Bureau Life Insurance Co. ("SFB"), which, according to his federal class-action lawsuit, misclassified him as an independent contractor. This caused McDonald to be liable for applicable self-employment taxes.

McDonald alleged that notwithstanding the fact that he and SFB had a signed agreement labeling him an independent contractor, he was in fact an employee. He said that the company: (a) exercised substantial control over his daily activities, including mandating that he keep certain hours of business; (b) provided him with an office and staff; and (c) controlled the circumstances and manner in which he sold its products.

The company moved for summary judgment, asserting that no private right of action under FICA allowed McDonald's claim. Granting the motion, the court cited *Cort v. Ash*,¹⁹ which established a four-part test for "determining whether a private remedy is implicit in a statute not expressly providing one":²⁰

- Does the statute create a federal right in favor of the plaintiff?
- Is there any indication of legislative intent, explicit or implicit, either to create such a remedy or deny one?
- Is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff?
- Is the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law?²¹

D. The Road Less Traveled?

Plainly, worker status litigation will continue to evolve. If anything, the stakes seem likely to increase. Companies facing worker status issues should consider the larger ramifications since one dispute may serve as a catalyst to another. This is one area where it is not exaggeration to note the domino effect one recharacterization battle can have on others. That, in turn, raises a fundamental precept. A fight avoided is a fight won.²² Undeniably, the independent contractor versus employee line is often not crystal clear. On the other hand, it is also not always unintelligibly murky. One can—and should—evaluate what workers are and what they can reasonably be expected to be.

Some companies label workers as independent contractors who could have no reasonable chance of withstanding scrutiny as same. This can seem expedient in the short run, even savvy, yet it rarely saves money in the long run. Even companies in the infancy of drafting and implementing independent contractor relationships should have realistic expectations. They should make contract language and actual practice consistent wherever possible. Moreover, they should bear in mind the adage that only very rarely can one have one's cake and eat it too. ■

Endnotes

¹ See State of New York Executive Order No. 17, "Establishing the Joint Enforcement Task Force on Employee Misclassification," September 5, 2007; see also <http://www.ny.gov/governor/press/ExecutiveOrderNo17.pdf>.

² See Sen. No. 2044, 110th Cong., 1st Sess. 2007 ; Independent Contractor Proper Classification Act of 2007.

³ Pub. L. No. 95-600, 92 Stat. 2763, *amended* by Pub. L. No. 96-167; Pub. L. No. 96-541; Pub. L. No. 97-248; Pub. L. No. 99-514; and Pub. L. No. 104-188 (hereinafter referred to as "Section 530").

⁴ See section 530(a)(2).

⁵ See section 530(a)(3).

⁶ See Section 530(a)(1)(B).

⁷ See *Abillo v. Intermodal Container Service, Inc.* (Jan. 21, 2000) 226 Dkt. No. BC 17450 (Cal. Sup. Ct. Jan. 14, 2000), *reported in* 14 Daily Tax Rep. G-8 (the actual working relationship is more instructive than the contract language.); see also *Loomis Cabinet Co. v. OSHRC* (9th Cir. 1994) 20 F.3d 938, 942 (finding that the economic reality test emphasizes the substance over the form of the relationship between the employer and the hired party); *Valdez v. Truss Components, Inc.* (D. Or. Aug. 19, 1999) U.S. Dist. Lexis 22957 at *8 (citing *Loomis Cabinet Co.*).

⁸ See *S. G. Borello & Sons v. Dep't of Indus. Relations* (Cal. 1989) 48 Cal.3d 341, 349 (holding that cucumber farm laborers who were contractually classified as "independent contractors" were, in fact, common-law employees covered under California's Workers' Compensation Act).

⁹ *Vizcaino v. Microsoft* (9th Cir. 1996) 97 F.3d 1187, reh'g en banc granted, (9th Cir. 1997) 105 F.3d 1334, cert. denied, (1998) 522 U.S. 1098.

¹⁰ See *id.*

¹¹ Thus, Microsoft was required to pay withholding taxes and the employer's portion of Federal Insurance Contribution Act (FICA) tax.

¹² See *S. G. Borello & Sons v. Dep't of Indus. Relations*, *supra*, 48 Cal.3d 341.

¹³ *Metropolitan Water District of Southern California v. Superior Court of Los Angeles County* (2004) 32 Cal.4th 491.

¹⁴ See *id.* at p. 509.

¹⁵ Superior Court of Los Angeles County, No. BC210130, *aff'd in part, rev'd in part, and remanded with directions; Estrada v. FedEx Ground Package System, Inc.* (2007) 154 Cal.App.4th 1.

¹⁶ *Id.* at p. 22 (citing *S. G. Borello & Sons v. Dep't of Indus. Relations*, *supra*, 48 Cal.3d at p. 349).

¹⁷ See *id.* at p. 21.

¹⁸ *McDonald v. Southern Farm Bureau Life Insurance Co.* (11th Cir. 2002) 291 F.3d 718.

¹⁹ *Cort v. Ash* (1975) 422 U.S. 66.

²⁰ *McDonald v. Southern Farm Bureau Life Insurance Co.*, *supra*, 291 F.3d at p. 718 (citing *Cort v. Ash*, *supra*, 422 U.S. at p. 78).

²¹ *Id.*

²² The exact origins of this phrase are unclear, although it is often uttered by masters of martial arts. Some people attribute this axiom to Bruce Lee.