

# “What keeps you up at night?”

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## Independent contractor misclassification creates serious employer liabilities

By Emily H. Bensinger, Edward R. Levin, Robert C. Nagle and Catherine E. Walters

During the extended period of economic distress, there has been a sharp increase in the use of outside contractors, so-called “independent contractors,” to perform traditional staff functions as businesses attempt to run leaner workforces. This is because such “nonemployees” generally do not qualify for employee benefits and employers can avoid numerous other expenses, including Federal Insurance Contributions Act (FICA) contributions, Federal Unemployment Tax Act (FUTA) contributions, state unemployment fund contributions, workers’ compensation premiums, and overtime. Further, independent contractors typically are not considered employees for the majority of other protective employment laws. The danger with this practice is that many employees are misclassified as “independent contractors” and do not meet legal tests to qualify as nonemployees. While this practice has gone on for many years, only a few high-profile cases have focused attention on misclassification and its consequences; however, governments hungry for revenue and creative attorneys who recognize the considerable potential of such claims are actively targeting employers who classify workers as independent contractors.

The risks and costs to a business of “getting it wrong” are quite high. For any business that classifies workers or service providers as independent contractors, a careful case-by-case review should be a priority.

### WHAT HAPPENED?

Recently, President Obama announced a proposed 2011 budget that includes a \$25 million allocation for a Department of Labor “Misclassification Initiative” targeting employers who misclassify workers as “independent contractors” rather than employees. The Initiative includes the Department of Labor’s hiring of 100 additional enforcement personnel and introduction of competitive grants to boost individual states’ incentives and capacities to address misclassification. The Initiative follows a joint proposal by the Department of Labor and the Department of the Treasury to enhance both agencies’ abilities to penalize employers who misclassify employees as independent contractors and eliminate incentives to continue to do so.

## “What keeps you up at night?”

The proposal follows Senator John Kerry's December 2009 introduction of the Taxpayer Responsibility, Accountability, and Consistency Act of 2009, intended to increase penalties for filing incorrect information on tax returns regarding employment taxes owed.

Similar legislation is becoming increasingly common on the state level as well. In 2009, both Delaware and Maryland passed new workplace fraud acts imposing new penalties on employers who knowingly misclassify workers as independent contractors. For example, Maryland's Workplace Fraud Act provides that “knowing” misclassification includes misclassification as a result of actual knowledge, deliberate ignorance, or reckless disregard for the truth. Similar legislation has been introduced in Pennsylvania related to misclassification of construction workers.

State enforcement actions are also on the rise. For example, at least eight states have challenged Federal Express' classification of certain delivery drivers as independent contractors, arguing that the misclassification allows the company to avoid paying taxes and denies workers full protection of employment laws such as anti-discrimination laws and wage and hour laws. In another example, the state of New York's unemployment insurance office has sent questionnaires to employers asking a series of detailed questions about independent contractor arrangements including requests for copies of the contract and evidence that the contractor operates an independent business offering its services to other purchasers.

### A COMPLEX ANALYSIS

Lawmakers and government agencies on both the federal and state level see the “correction” of misclassified workers as a way to raise revenue by recouping lost tax revenues and collecting fees and penalties associated with misclassification. Coupled with this is a concern that workers are being deprived of the protections of various employment laws, including protections under the Fair Labor Standards Act, discrimination laws, and availability of unemployment compensation for displaced workers.

The fact that state and federal courts use different tests to determine employment status complicates the analysis for employers. Moreover, a state can even use different tests for different purposes. For example, in Pennsylvania, for worker's

compensation purposes, whether a worker is an independent contractor requires analysis of the following factors: (1) control of the manner in which the work is to be done, (2) responsibility for result only, (3) terms of agreement between the parties, (4) the nature of the work or occupation, (5) skill required for performance, (6) whether one is engaged in a distinct occupation or business, (7) which party supplied the tools, (8) whether payment is by the time or by the job, (9) whether work is part of the regular business of the employer, and (10) the right to terminate the employment at any time. *Universal Am-Can, Ltd. v. Workers' Comp. Appeal Bd.*, 762 A.2d 328, 490 (Pa. 2000). In contrast, in determining whether someone is an employee or contractor for purposes of eligibility for unemployment compensation, Pennsylvania courts use a simpler test, i.e., a person is an independent contractor if he or she is free from control and direction in the performance of the work and if the business is one which is customarily engaged in as an independent trade or business. *Danielle Viktor, Ltd. v. Dep't of Labor & Industry*, 892 A.2d 781, 792 (Pa. 2006) (citing Pennsylvania Unemployment Compensation Law, 43 P.S. § 753(l)(2)(B)).

In New Jersey, where there has been an increase in the number of audits and enforcement actions by the state Department of Labor, employers must comply with the “ABC test” prescribed by state statute to classify an individual as a contractor. Specifically, under New Jersey law, services performed by an individual for remuneration are deemed “employment” unless the employer can prove: (1) the individual has been and will continue to be free from control or direction over the performance of his services, both under the terms of his contract and in fact; (2) the service provided is either outside the usual course of the business for which such service is performed, or is performed outside all the places of business of the enterprise for which the service is performed; and (3) the individual is customarily engaged in an independently established trade, occupation, profession or business.

A slightly different formulation of the “independent contractor” test applies to workers who allege discrimination in violation of Title VII of the Civil Rights Act of 1964. Courts employing that test consider the following factors: (1) the skill required, (2) the source of the instrumentalities and tools, (3) the location of the work, (4) the duration of the relationship between the parties, (5) whether the hiring party has the right to assign additional projects to the hired party, (6) the extent of the hired party's discretion over when and how long to work, (7) the method of payment, (8) the hired

## “What keeps you up at night?”

party's role in hiring and paying assistants, (9) whether the work is part of the regular business of the hiring party, (10) whether the hiring party is in business, (11) the provision of employee benefits, and (12) and the tax treatment of the hired party. *Brown v. J. Kaz, Inc.*, 581 F.3d 175, 180 (3d Cir. 2009).

The discernable emerging theme in new legislation and regulatory enforcement seems to focus on two primary issues. One is whether the service provider is engaged in a truly independent business which is offered regularly and available to other customers, or is merely performing a normal function of the customer's own business. The second is the contractor can exercise entrepreneurial control in order to earn a profit or suffer a loss in the operation of the independent business.

### WHAT IS AN EMPLOYER TO DO?

Employers who misclassify workers as independent contractors face numerous types of actions, including federal and state agency audits and enforcement actions, individual employee actions, and possible class actions. One of the risks of a finding of misclassification is, of course, the imposition of income taxes that have not been paid by the contractor. However, the worst case scenario may be a claim that the contractor was, in fact, an employee and entitled to premium overtime pay for all hours worked over forty in any workweek. In the construction industry, for example, it has been common for workers to be on the job six or seven days a week and to be paid a fixed hourly rate of compensation or on a piece rate. Employers found to have misclassified workers also face potential liability for:

- Minimum wage and overtime premiums
- Unpaid Medicare and Social Security contributions
- Unpaid workers' compensation premiums
- Unpaid unemployment compensation contributions
- Pension payments or 401(k) plan contributions
- Medical benefits
- Stock options
- Related penalties and interest

With increased scrutiny of independent contractor classifications and the current economic climate, now is a good time for employers to review their worker classifications. Performing such a review now could reduce the risk of a full-blown audit and costly penalties for employers found to have misclassified their employees as independent contractors.

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