

## Worker Misclassification: The Next Big Legal Concern?

Thomas R. Bundy, III

*Executives frequently ask their counsel: What is the next legal issue that should concern me because of its effect on the way my company conducts business? As the author explains, worker misclassification is an answer to that question, and it could soon become a very big issue.<sup>1</sup>*

On June 9, 2007, in an article by Steven Greenhouse published in *The New York Times*, New York Governor Eliot Spitzer announced his intention to “step up enforcement against companies that illegally misclassify workers as independent contractors” rather than employees. Then, in September 2007, Governor Spitzer created a multi-agency task force to concentrate on misclassification of employees as independent contractors by employers. The focus on this issue is not new. Rather, Governor Spitzer is joining what appears to be a growing “worker misclassification” movement.

New York is joining states such as New Jersey, Maine, California, Massachusetts, Missouri, Kansas, and South Carolina, which have increased their focus on worker misclassification during the past two years. These states’ collective efforts include:

1. Commissioning or considering detailed studies that analyze the economic cost that misclassification has had on their revenue streams;
2. Increasing enforcement efforts through audits to recapture lost revenue due to erroneous worker classification;
3. Enacting new legislation that narrows the definition of an independent contractor or raises a presumption of employment;
4. Enacting new legislation, or debating proposed legislation, that provides criminal sanctions for companies who misclassify workers; and
5. Providing a convenient method for workers to notify state agencies about potential worker misclassification through the creation of internet sites.

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States are not alone in their increased scrutiny of worker misclassification, however. Federal agencies have intensified their focus on worker misclassification through audits, examinations and/or litigation against companies—across a variety of industries—that claim their classification of workers as independent contractors is appropriate. In fact, the Department of Labor (DOL) is under tremendous pressure to increase its scrutiny of worker misclassification after the Government Accountability Office (GAO) issued a recent report noting DOL's failure to track the instances in which it refers worker classification cases to other agencies.<sup>2</sup> The GAO report concluded that DOL is missing significant opportunities to address instances of potential misclassification by failing to pay enough attention to the issue. In light of this report, as recently as July 24, 2007, private interest groups backed by Unions, like *Change to Win*, have issued press releases challenging DOL to focus on worker misclassification, and claiming that far too many workers are being cheated out of the American Dream by being denied benefits when misclassified as an independent contractor rather than an employee.

The attention on misclassification, however, does not stop with the GAO. The focus on worker classification has even reached congressional levels.

On May, 8, 2007, the House Committee on Ways and Means held a hearing on the effects of misclassifying workers as independent contractors. This hearing not only focused on the GAO report detailing DOL's failures to monitor worker misclassification, but also focused on finding solutions—such as intensifying oversight—to the misclassification problem.

Similarly, on May 15, 2007, the United States Senate's Appropriations Committee voted to urge the Internal Revenue Service (IRS) to increase its enforcement efforts on worker classification in industries in which misclassification is widespread. As a result, the IRS will likely enter data-sharing accords with state and federal agencies to conduct target examinations of companies for which worker misclassification is suspected.

Also, on July 24, 2007, the House Committee on Education and Labor held a hearing entitled, "The Misclassification of Workers as Independent Contractors." Representative Lynn Woosley (D-Cal.), who chairs the Subcommittee on Workforce Protections, said in an opening statement that the hearing is about the countless number of workers who are really employees but have been deliberately misclassified by employers. The hearing focused on the effect that misclassification has on the worker.

Finally, on September 13, 2007, Senators Obama, Durbin, Kennedy, and Murray, proposed the "Independent Contractor Proper Classification Act of 2007." This proposed legislation is designed, among other things, to close a loophole in worker classification that allows employers to avoid FICA and FUTA taxes by modifying existing and creating new procedures for proper classification of employees and independent contractors. This bill also proposes to "award of expenses, including expert

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witness fees and reasonable attorneys' fees for the individual against the taxpayer in any case in which the individual achieves reclassification."

The increased focus on misclassification by state and federal agencies and Congress should be a concern for any company that uses independent contractors as part of its workforce. As this article will discuss, the contractor relationship is under attack. Companies have substantial exposure if their worker classification is erroneous. Attacks on the contractor model may continue to gain traction with some business sectors being particularly vulnerable to attack. Companies should not wait for challenges to occur before taking action. Rather, remedial steps should be implemented now to mitigate the potential for significant damages arising from worker misclassification.

## **ATTACKS ON THE CONTRACTOR MODEL**

Worker misclassification occurs when an employer improperly classifies a worker as an independent contractor rather than classifying that worker as an employee. Employers hire independent contractors for a variety of reasons including, for example, to accommodate fluctuating work conditions, to test workers for permanent positions, and to control employee benefit costs. Often, it is the employer, and not the worker, who determines the classification status of the worker at the time he or she is hired.

There is no uniform test under state law, however, that determines whether a worker is properly classified as an employee or an independent contractor. The worker classification tests that exist differ from jurisdiction to jurisdiction with each test in each jurisdiction being equally complex and subjective in nature. Even classification challenges under federal statutes, like the National Labor Relations Act, the Civil Rights Act, the Fair Labor Standards Act, the Employee Retirement Income Security Act and Internal Revenue Code, rely on varying application of the common law test of employment and apply different definitions of employee when determining whether a worker is properly classified as an independent contractor.<sup>3</sup> The lack of uniformity results in a slippery application of the test and leaves employers with uncertainty as to the outcome or steps to take to bring its contractor model in line with the law—particularly when the company has a national practice.

Broadly stated, nevertheless, courts analyzing whether a contractual or employment relationship exists under these statutes or at common law rely on several criteria. These criteria have been codified generally into three tests: an economic reality test, a common law test and a combination of the two tests often called the hybrid test.<sup>4</sup> The primary element underlying each of these classification tests is the element of control. Thus, attacks on the contractor model (*i.e.*, the reliance on an independent workforce to conduct business) focus on indicia of control over the manner and means of a contractor's performance of his or her services.

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Independent contractors are supposed to be skilled individuals who perform services for companies without being subject to control over the manner and means in which their services are performed. Employees, on the other hand, often lack unique or highly technical skills and are told specifically how their work is to be performed (including the hours, pace, place, and nature of their work). Problems arise when the lines distinguishing “control” over desired results, which is generally acceptable in a contractual relationship, and “control” over the manner and means of performance, which is generally not permitted in an independent contractor arrangement, become blurred. When companies blur the lines of control, those companies’ contractual relationships become susceptible to attack.

In recent years, the contractor model has been attacked by:

- The National Labor Relations Board;
- State agencies that administer workers compensation or unemployment compensation;
- The IRS;
- Disgruntled contractors;
- Plaintiffs’ lawyers; and
- Labor unions.

These agencies, groups and individuals are attacking the contractual relationship and seeking reclassification of contractors as employees based on allegations that companies are exerting control over:

- Contractors’ time and schedule (*i.e.*, the time contractors start their work day, finish their work day, take their lunch, and even take their breaks);
- The person(s) or client(s) with whom contractors will be working or are allowed to use to assist the contractors in the completion of their work; and
- Contractors’ methods for performing their work (*i.e.*, how the contractor will service a client or complete a task).

Companies often believe that they can defeat an attack on their contractor model by carefully crafting an agreement that memorializes the contractual relationship and ceding control over the manner and means of performance to the contractor. However, it is the actual performance of the written agreement rather than the agreement itself that is most indicative of a contractual relationship. Consequently, attacks on the contractor model, in addition to identifying issues of control over the manner and

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mean of performance, focus on whether contractors: are provided training (or familiarization), work solely for one company, have incorporated their businesses, supply their own tools or equipment, wear uniforms, are given paid leave, have a limited term relationship or can be terminated at will, and/or have an opportunity to increase their profits or incur losses. Depending on the answers to these issues, it is possible that a regulatory agency or a court may conclude that an employer-employee rather than an independent contractor relationship exists notwithstanding the existence of an agreement stating that the worker is an independent contractor.

### **COMPANIES' INCREASED EXPOSURE**

Misclassifying workers leaves companies exposed to increased government scrutiny, significant liability, and a reduction in productivity. Federal and state agencies' and private litigants' attacks on the contractor model increase companies' exposure by making them susceptible to:

- Claims for back taxes such as federal payroll taxes (*i.e.*, Social Security and Medicare) and state taxes;
- Claims for back benefits (like health insurance), which the previously classified contractor may have paid himself or herself;
- Claims for pension accruals or profit sharing or matching contributions, which the previously classified contractor would not have received;
- Potentially large fines from federal and state agencies;
- Increased tort liability under the theory of *respondeat superior* (a legal doctrine holding employers responsible for the actions of their employees), which typically does not apply to independent contractors;
- Increased liability arising from suits alleging intentional misclassification and seeking punitive or treble damages;
- Increased or new organizational efforts from unions; and
- Potential criminal sanctions (including imprisonment).

The result of this increased exposure is a loss of the competitive advantage gained from using an independent workforce if contractors are reclassified as employees (meaning a company will have higher fixed costs which translate into lower profits). The increased exposure and potential reclassification also would cause a diversion of resources (monetary and human capital) to address problems associated with the misclassification rather than growing the business.

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## **ATTACKS ON CONTRACTOR MODEL HAVE STAYING POWER**

The misclassification issue is here to stay, and attacks on the contractor model will likely continue to increase for one reason: money. The desire to raise revenue or obtain damage awards attracts those who attack the contractor model, including government agencies, disgruntled contractors, plaintiffs attorneys, and unions. Yet, they are attracted for different reasons.

First, as *The New York Times* article notes, federal and state governments are attracted to this issue because they claim that they are losing hundreds of millions, if not billions, of dollars in tax revenue as a result of the erroneous classification of workers. Federal and state governments' tax, treasury, and labor departments are deploying significant resources to develop audit plans and enforcement strategies to collect the taxes to which they believe they would have been entitled but for the misclassification.

Second, disgruntled contractors are looking to profit from classification challenges. These contractors, if reclassified as employees, may stand to gain from judgments or settlements for lost overtime pay, the expenses of providing their own benefits (like insurance), and even retirement contributions or lost stock options which might have been provided to the contractor's employee counterpart. Throw punitive damages into the mix and the contractor has significant reasons to challenge the model.

Third, the plaintiffs' lawyer also sees worker classification as a potential source for a pay day. Because the contractor model is generally applied to all workers in an enterprise who perform the same function, challenges to classification usually involve a group of workers who were similarly classified. The plaintiffs' lawyer typically challenges the contractor model by class action, hoping to recover substantial attorneys' fees.

Finally, labor unions also see an opportunity in the classification issue to organize and obtain new members. Increased membership translates into increased dues for unions. In fact, unions sometimes work hand-in-hand with the plaintiffs' lawyer to find the best client(s) to challenge the models. Unions are even using Web sites to solicit potential plaintiffs to challenge companies' models.

In light of the significant opportunity for monetary gains for federal and state governments, employees, plaintiffs attorneys, and unions, it is likely that scrutiny of worker classification will continue to increase.

## **VULNERABLE BUSINESS SECTORS**

Many industries are potential targets for claims of worker misclassification. As the *Times* article noted, Governor Spitzer previously targeted gro-

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cery companies, and the article also noted that construction and package delivery companies are susceptible to classification challenges based on those industries' heavy reliance on independent contractors. Even Microsoft was involved in a high-profile challenge to its worker classification. Defense companies could face similar challenges because of their utilization of contractors for projects; home service industries could face challenges given their reliance on contractors to conduct product installation or repairs; multi-level marketing agencies could face similar challenges based on their utilization of contractors to sell products; and the list goes on.

While worker misclassification cuts across virtually any industry using a contractor workforce, the industry perhaps most vulnerable at first glance to the misclassification challenge (albeit often erroneously) is the financial services industry. Financial services companies are likely targets because they have regulatory responsibilities that require control, either as a broker-dealer themselves or over the broker-dealers or registered representatives that the companies utilize. As the Ninth Circuit noted in *Hollinger v. Titan Capital Corp.*,<sup>5</sup> "Congress adopted § 20(a) [of the Securities and Exchange Act of 1934 ('34 Act)] in an attempt to protect the investing public from representatives who were inadequately supervised or controlled."<sup>6</sup> The *Hollinger* court sided with the Securities and Exchange Commission (SEC) which, in an *amicus curiae* role, noted that "the representative - broker-dealer relationship is necessarily one of controlled and controlling person because the broker-dealer is required to supervise its representatives. This requirement arises from § 15 of the '34 Act, which the SEC has interpreted as authority to impose sanctions on broker-dealers who have failed to provide adequate supervision of their registered representatives."<sup>7</sup> On this basis, the *Hollinger* court held that "[a] broker-dealer has control person liability under the Securities Act with respect to its registered representatives, even when the representatives are independent contractors."<sup>8</sup>

As the *Hollinger* court notes, a tension appears to exist between the '34 Act regulations (with its associated duties to supervise and control independent representatives) and the criteria on which courts rely when analyzing whether a contractor or employment relationship exists. As the argument goes, the '34 Act regulations require financial services companies to exert control over the day-to-day manner and means of the performance of their brokers or registered representatives notwithstanding their classification as independent contractors. As the Ninth Circuit and SEC reasoned in *Hollinger*:

Because a sales representative must be associated with a registered broker-dealer in order to have legal access to the trading markets, the broker-dealer always has the power to impose conditions upon that association, or to terminate it. The broker-dealer's ability to deny the representative access to the markets gives the broker-dealer effective control over the representative at the most basic level . . . [including] ongoing control over the types of transactions made by the representative and her ways of handling clients' accounts.

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Accordingly, the agencies, groups, and individuals attacking the contractor model have identified the independent broker-dealer and registered representative relationship as one steeped in fraud based on the misclassification.

Web sites have sprung up to solicit potential plaintiffs to challenge this contractor model. These same sites, which solicit workers to join the fight against financial services companies' alleged classification fraud, may lead to cases similar to *Havel v. Sun America Securities Inc.*,<sup>9</sup> in which the classification of registered representatives as independent contractors is being challenged.

Ultimately, despite the potential for sound and fury, it is important to note that any attack on the broker-dealer/registered representative relationship, as well as other similar relationships, are generally misguided. In the case of the financial services companies, the potential plaintiff often has concluded erroneously that because the broker-dealer-registered representative relationship requires some control, an employment relationship must exist. This is not true. The presence of control in some limited fashion over independent representatives does not operate to create a *per se* finding of employment. Rather, the '34 Act provides, *inter alia*, general control measures for representatives with respect to desired results, such as providing access to financial markets and identifying potential types of clients and products for which service can be provided. Control over the desired results is generally acceptable in a contractual relationship. Equally important, control—while a very important element—is not the sole determinant of a contractor relationship. Courts also rely on other indicia of independence, such as skill, corporate form, number of clientele, self-sufficiency, and the opportunity to increase profits or incur a loss, in order to determine whether a worker is an employee or independent contractor.

The determination of a registered representative's status as an independent contractor is properly based on the entire work picture, not just unspecified statutory duties of control. Regardless of the position on this issue, however, financial services companies should take remedial steps now to ensure that their independent representatives are truly acting independently.

## REMEDIAL STEPS

Worker classification is a multifaceted issue that requires a multifaceted legal response. The issue implicates tax, employment and labor law expertise as well as litigation and class action specialties. In the financial services sector, the issue also requires the necessary regulatory background. A company's legal team not only must possess the experience, specialties and background needed to address this dynamic issue, but also must monitor closely the trends in this arena and be experienced in identifying the problems associated with worker classification.

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A company should employ counsel who will work to find creative solutions to stymie attacks on that company's contractor model and take proactive remedial steps to strengthen the model to protect that company from pending, potential or future attacks. Defending the contractor model is not impossible (or even difficult for that matter), but taking action before challenges arise places companies in the best position to defend their contractor model when challenges do arise. In this area, an ounce of prevention does equate to a pound of cure.

### NOTES

1. "New York to Investigate 'Contractors,'" *Traffic World*, Sept. 14, 2007, at Air & Expedite.
2. GAO, *Employment Arrangements: Improved Outreach Could Help Ensure Proper Worker Classification*, GAO-06-656 (Washington, DC: July 11, 2006).
3. See GAO-07-859T, prepared testimony before Subcommittee on Income Security and Family Support and Subcommittee on Select Revenue Measures, Committee on Ways and Means, House of Representatives.
4. *Id.*
5. 914 F.2d 1564, 1574–1575 (9th Cir. 1990).
6. *Id.* (citing *Zweig v. Heast Corp.*, 521 F.2d 1129, 1134–1135 (9th Cir. 1975) (overruled on separate grounds)).
7. 914 F.2d at 1574–1575.
8. *Id.* (noting that "there is no support in the statutory scheme for such a restrictive definition of controlling person that would exclude independent contractors, and thus, we do not distinguish for purposes of § 20(a) between registered representatives who are employees or agents and those who might meet the definition of independent contractors").
9. 2006 WL 2917591 (N.D. Cal).