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Independent Contractor Classifications Hold Many Risks

By Randall D. Avram and Michael T. Rosenberg

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Among the handful of employment law issues currently targeted by plaintiffs' lawyers and government agencies, only independent contractor misclassifications are under attack from so many angles.

An employer's decision to classify a worker as an independent contractor can be challenged as a result of any number of triggers, such as a federal or state tax audit, a benefits dispute, a workers' compensation claim, an unemployment claim, a wage and hour lawsuit, a federal Department of Labor audit (or its state equivalent), merger/acquisition due diligence, or a discrimination lawsuit. Although each of these liability sources carries its own threat of significant penalties and costs, a misclassification challenge on any one of these fronts threatens to trigger attacks from all sides.

Potential penalties and civil damage or settlement awards represent powerful incentives for government agencies, as well as plaintiffs' lawyers, to identify misclassified workers and make employers pay. Federal and state agencies have begun treating misclassification enforcement not just as a way to protect workers but also as an important revenue source in a time of dire budget gaps. As made clear by recent legislative and administrative initiatives across all levels of government, the assault on independent contractor classifications continues to escalate.

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Allure of Independent Contractors

Employers have many good reasons for treating workers as contractors. For example, independent contractors are responsible for their own taxes. They can be paid on a Form 1099 basis without FICA or employee tax withholdings.

Also, most employment laws simply do not apply to independent contractors. Companies need not pay into the unemployment system or for workers' compensation insurance for contractors. Independent contractors also are ineligible for workers' compensation benefits (though this means they can bring civil lawsuits for workplace injuries without regard to the workers' compensation bar); are not covered by company health insurance, retirement plans or other employee benefits; are not subject to wage and hour laws, including overtime requirements; and generally cannot sue for employment discrimination under Title VII.

In addition, many businesses operate under the mistaken belief that they can safely treat a worker as an independent contractor as long as the worker agrees to be so classified. For all these reasons, many companies overuse independent contractor classifications. This trend has not gone unnoticed by government agencies.

A 2009 federal audit report estimated that independent contractor misclassification results in a $54 million underreporting of employment taxes. The prevalence of contractor misclassification makes it a prime revenue source for both plaintiffs' lawyers and governmental bodies alike, all at the expense of the employer.

Many Costs of Misclassification

The advantages mentioned above of treating a worker as an independent contractor arise because the single decision to classify a worker as an independent contractor implicates so many aspects of the company-worker relationship. However, each of these benefits of classifying a worker as an independent contractor brings a corresponding source of potential liability for misclassifying that worker.

On the tax front, the Internal Revenue Service (IRS) has implemented a three-year initiative targeting 6,000 randomly selected employers to focus on independent contractor misclassifications. Federal legislation has also been introduced to close the so-called loophole created by the safe harbor provision of Section 530 of the Revenue Act of 1978.

Section 530 protects the treatment of a worker as an independent contractor for tax purposes if, among other factors, the taxpayer has a reasonable basis for treating the worker as an independent contractor, such as reliance on judicial precedent, industry practice or the results of a prior tax audit of the company. The proposed Fair Playing Field Act of 2012 (S. 2145, H.R. 4123) would seek to limit the protection of Section 530 by requiring the IRS to issue prospective guidance on independent contractor classifications and to require that employers comply with that guidance. Significantly, the bill would also require workers classified as independent contractors to be provided a written notice of the significance of that classification and their right to seek a status determination from the IRS.

Misclassifying employees as independent contractors can also lead to significant overtime liability under the Fair Labor Standards Act (FLSA), whether triggered by a lawsuit or by a Department of Labor audit. FLSA liability can be compounded by the fact that companies often fail to keep FLSA-compliant time records for workers mistakenly believed to be independent contractors.

Inadequate time records subject employers to recordkeeping penalties and diminish their abilities to defend civil lawsuits—as courts generally accept employees' own calculations of their hours worked absent specific evidence to the contrary.

In the event of a misclassification, companies are also unlikely to have adequately focused on preserving exemptions under the seemingly inapplicable FLSA. An otherwise-exempt employee, such as a highly compensated professional, will be entitled to overtime for all hours worked over 40 each workweek if, due to a classification error, the employee was paid by the job or the hour rather than on a salary basis.

Employers are often surprised and troubled both by the magnitude of FLSA liability as well as by the realization that it could have been avoided. Had a company known a worker was not properly considered an independent contractor, it might well have structured the employee's wages so as to net the worker the same amount—such as by maintaining an FLSA exemption, by setting an hourly wage with the overtime multiplier in mind or by scheduling workweeks to avoid overtime altogether.

Even when a technical violation seems like a no-harm, no-foul situation, the FLSA holds the employer accountable for overtime payments it would never have agreed to pay in the first instance and then magnifies liability to up to six times the yearly overtime amount, plus interest and attorneys' fees. If an employer is found to have violated the FLSA, it will be required to pay back wages for the preceding two years—three years for a willful violation—to each employee. The amount will be

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doubled by a liquidated damages award unless the employer makes the difficult showing that it acted in good faith. This formula can produce staggering liability figures, especially when an entire class of employees is potentially misclassified.

Each of these various sources of liability stemming from a single classification decision has the potential to spark a chain reaction of liability. A government tax audit, or even a workers' compensation or unemployment claim by a single employee, can trigger a Department of Labor audit or a companywide class or collective action lawsuit seeking overtime pay and employee benefits.

For example, after a client recently lost an unemployment claim filed by a single worker classified as an independent contractor, it faced a companywide investigation by the state unemployment agency into whether other workers were similarly misclassified. Had we not persuaded the state that no other contractors were similarly situated to the misclassified worker, the company would have faced significant unemployment penalties, which would have threatened to spark civil liability as well.

The plaintiffs' bar monitors government enforcement efforts intently, waiting to swoop in and file wage and hour or employee benefits lawsuits on behalf of any employees who may have been misclassified. Over the last decade, while the number of cases filed each year in federal court has remained relatively constant, the number of FLSA lawsuits has nearly quadrupled and now accounts for more than 2 percent of all federal litigation.

A number of recent legislative steps seek to further connect the web of potential categories of liability stemming from a classification decision. The recently proposed Payroll Fraud Prevention Act would amend the FLSA to prohibit wrongful misclassification of employees as independent contractors. It would also require businesses to notify workers of whether they are classified as employees or "nonemployees" and subject them to fines of $5,000 per violation.

A number of state laws already prohibit the very act of misclassifying employees. New Jersey, for example, makes the knowing misclassification of an employee as an independent contractor a criminal offense punishable by 18 months in prison, thousands of dollars in fines, and a stop-work order requiring the cessation of all operations at the site of the misclassification until the employer has paid all fines and come into compliance.

In weighing the hefty costs of misclassifying employees as independent contractors against the considerable benefits achieved by classifying workers as contractors where appropriate, the obvious goal for employers should be to get classification decisions right the first time—a goal easier stated than achieved.

Paradigmatic Independent Contractor

Neither paying a worker on a 1099 basis nor having a written agreement about the worker's contractor status will justify treating an employee as an independent contractor. In the event of a lawsuit or audit, courts and government agencies will analyze whether the worker's relationship with the company more closely resembles that of the paradigmatic employee or the paradigmatic contractor.

Meet Ed. Ed is a maintenance worker in a large textile mill. He works as part of a 10-person maintenance department and reports directly to a maintenance supervisor. Ed is paid by the hour and regularly works 9-to-5 shifts Monday through Friday.

Each workday, Ed is expected to progress through a series of maintenance-related tasks such as cleaning and inspecting machine parts, checking fluid levels, and making basic repairs. Ed has been trained on how to do each task and is counseled by his direct supervisor when he deviates from his training.

Carl is a licensed plumber. He owns Carl's Plumbing LLC and markets his services primarily to industrial facilities. When he gets a call from a new customer, Carl inspects the job and gives the company a quote. Regardless of how long it

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takes Carl to complete the job, he gets paid the quoted amount. In some months, Carl's income is extremely high, but he makes almost no money in other months.

Even if Ed and Carl were to perform the same service for the textile mill, such as fixing a leaky faucet, the law appropriately recognizes the fundamentally different relationships these workers have with the mill. Since the mill does not tell Carl when to work, it is not responsible for paying him overtime. Since the mill does not tell Carl how to fix the faucet, it would not be automatically liable for workplace injuries. Since Carl is in business for himself, he bears his own risk of being out of a job. While the list goes on, the point is that at the extremes, it makes perfect sense that the very real differences between an employee and an independent contractor would have material consequences on a host of employment law issues.

Gray Area

Many workers, however, fall somewhere in the middle of the employee-contractor spectrum.

If Carl's Plumbing LLC worked exclusively for a single textile mill, Carl would look a little more like a mill employee. If the mill started telling Carl when to do his work, started paying him by the hour or started requesting that he do his plumbing work in a particular way, Carl would look more like an employee.

Quite often, certain aspects of the worker's relationship with the company resemble the employment paradigm while other aspects resemble an independent contractor arrangement. The difficulty arises because the law tries to jam each worker into one mold or the other, even if neither really fits.

Accordingly, a number of balancing tests have evolved to determine which classification is most appropriate.

The IRS test, for example, focuses on the company's right to control or direct the worker's work (such as the degree of training and performance evaluation), the company's right to control the economic aspects of the job (such as the worker's opportunity for profit or loss and whether the worker has incurred significant investment expenses), and other factors tending to show the relationship to be more like one paradigm or the other (such as whether the parties' relationship has an indefinite duration and whether the worker's duties are central to the company's business).

The difficulty in classifying a workforce is exacerbated by the recent proliferation of legislation in this area, which is only increasing the number of different tests with which a company must potentially comply.

Don't Wait

While predicting the side of the employee-contractor spectrum that a court or government agency will come down on is both highly fact-specific and extremely difficult, the costs of getting it wrong are simply too high not to fully analyze classification decisions on the front end. Companies that already use independent contractors should have their past classification decisions audited by a lawyer to identify potential liability under the protection of the attorney-client privilege and attempt to remedy any liability before a classification challenge arises. Otherwise, a single workplace injury, unemployment claim or government audit, or one worker's chat with a plaintiffs' lawyer, can trigger a host of liability for misclassifying employees as independent contractors.

Randall D. Avram and **Michael T. Rosenberg** are attorneys at Kilpatrick Townsend in Raleigh, N.C. Avram is chair of the firm's Labor & Employment Team.

New York City Human Rights Law Has Changed Disability Law Landscape

By Neal I. Korval and Mark S. Goldstein

In a recent lawsuit that we defended, the plaintiff's attorney asserted a novel legal theory under the New York City Human Rights Law (NYCHRL).

In this case, the plaintiff suffered from a short-term pregnancy-related illness, which ceased upon delivery of her child. Her employer provided her with the requisite 12 weeks of Family and Medical Leave Act (FMLA) leave, but, upon return from leave, the plaintiff requested a part-time or work-from-home schedule. Despite the company's best efforts to reach a mutually acceptable accommodation, the requested work schedule did not coincide with the company's legitimate business needs, and the plaintiff's employment ended.

In the ensuing lawsuit, the plaintiff's attorney claimed that the plaintiff's pregnancy-related illness, although ceased by the time she sought the accommodation, constituted a record of impairment–and thus a "disability" within the meaning of the NYCHRL–that required her employer both to engage in the interactive process with the plaintiff and to provide her with the requested accommodation under the NYCHRL.

Although the notion that an employee's now-concluded temporary disability could require an accommodation is bewildering (how do you even accommodate such a record of impairment?), this would have been the first time that a court was presented with this issue. The case would have been analyzed under the explicit liberal intent of the NYCHRL, would have placed the burden of establishing "undue hardship" on the employer, could have exposed the company to uncapped punitive damages, and would have been expensive to litigate since summary judgment was unlikely due to factual issues surrounding the reasonableness of the requested accommodation. After weighing the facts and the stated liberal intent of the NYCHRL, the client chose to settle the case. But New York City employers should be on notice that the city's Human Rights Law is unique in many respects when it comes to disabilities.

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Big Apple's Own Disability Discrimination Law

As a center of global commerce, New York City is where many companies maintain headquarters, offices or some form of operations. While city employers generally are aware that their disability and leave of absence policies must comply with the federal Americans with Disabilities Act (ADA) and FMLA requirements, many are unaware that the NYCHRL imposes a greater burden on employers with respect to disability and leave practices.

The New York City Council enacted the NYCHRL to maximize protection from all discriminatory conduct for the millions of employees who work in New York City, but its impact on the field of disability law is particularly staggering. Among other things, the NYCHRL imposes responsibility on employers to accommodate and treat fairly those employees who are deemed "disabled," a principle consistent with the corresponding federal disability laws. In 2005, however, the NYCHRL was amended to ensure that courts and administrative agencies interpret the law more liberally than any of its federal and state counterparts. Thus, the groundwork was laid for an expansive disability discrimination law unlike any other.

Accordingly, HR professionals in New York City must:

- Understand the disability and leave of absence provisions of the NYCHRL.
- Appreciate the differences between the NYCHRL and other disability laws.
- Draft and implement policies in accordance with the liberal intent of the NYCHRL.
- Recognize the risks of noncompliance, including assertion of new legal theories under the NYCHRL by the plaintiffs' bar.

The NYCHRL is not the only disability discrimination law in effect, although it is the one toward which New York-area plaintiffs' attorneys appear to have gravitated in the past few years. In fact, it is rare to find a discrimination-based complaint against a New York City employer that does not contain an NYCHRL cause of action. Nevertheless, a brief review of the other relevant laws is necessary to appreciate the NYCHRL's expansive nature.

ADA

The ADA is the federal statute that prohibits discrimination based on an employee's actual or perceived disability. Although the ADA's definition of disability was recently expanded by the ADA Amendments Act, disabilities still must be permanent or long-term in nature to be covered by the ADA.

In addition to barring discrimination, the ADA requires an employer to provide a reasonable accommodation to enable the employee with a disability to perform the essential functions of his or her job. The burden is on the employee, however, to demonstrate that the employer wrongfully denied him or her a requested accommodation that would have allowed the individual to perform such functions.

FMLA

The FMLA is a related federal statute that requires employers to provide up to 12 weeks of unpaid leave within a 12-month period to those employees with a serious medical condition or other qualifying event. The leave provisions of the FMLA cover essentially all ADA disabilities as well as pregnancy-related medical conditions. With rare exception, the FMLA-protected employee is guaranteed job security and the continuation of benefits upon return from leave.

PDA

The Pregnancy Discrimination Act (PDA) requires that employers treat pregnant employees no less favorably than they treat employees with other disabilities or employees seeking nonmedical leaves of absence.

NYSHRL

Just as New York City maintains its own protective discrimination laws, New York state maintains the New York State Human Rights Law (NYSHRL). Although the NYSHRL broadens the ADA definition of "disability," it does not include short-term impairments in its definition of the term and is not nearly as expansive as the NYCHRL.

Broad Scope of the NYCHRL

While the above-referenced laws provide significant disability and leave of absence protection to employees, the NYCHRL goes much further to protect and potentially expand the rights of employees working in New York City. When the New York City Council passed the Restoration Act in 2005 to ensure and preserve the NYCHRL's broad scope and liberal interpretation, the management bar anticipated that plaintiffs' lawyers would assert significantly more claims under the NYCHRL in the following years. What has ensued, however, has shocked both

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the senses and the wallets of New York City employers. In the aftermath of the Restoration Act, state and federal courts have given a broad reading to the council's already liberal legislative intent, and have thus given rise to an extremely powerful pro-employee law.

The courts have liberally interpreted the NYCHRL with respect to employment issues. For example, the New York State Court of Appeals recently held that the *Faragher/Ellerth* sexual harassment defense is not a permissible affirmative defense to a claim asserted under the NYCHRL (*Zakrzewska v. New Sch.*, 14 N.Y.3d 469 (2010)). Further, in recent years the New York City Council has considered (although not yet adopted) legislation that would provide employees with paid FMLA leave.

Broad Definitions

Among the principal reasons why the NYCHRL is considered so expansive are the broad definitions included in the law.

Similar to the ADA, the NYCHRL requires both non-discrimination and reasonable accommodations for employees with disabilities, but the city law defines "disability" much more broadly than its federal counterpart. In fact, by defining the term "disability" as "any physical, medical or psychological impairment, or a history or record of such impairment," it has become clear that the NYCHRL was intended to protect even those employees with short-term disabilities (arguably even those with a record of a temporary impairment). As bizarre as it may seem, until a court rules otherwise, it would be safest to conclude that the common cold or a sprained ankle are covered disabilities under the NYCHRL and that histories of such impairments are statutorily protected.

Further, the NYCHRL defines reasonable accommodation not only as those accommodations that would allow an employee to satisfy the essential requisites of the job, but also those accommodations that would allow the employee to enjoy a right that nondisabled employees enjoy as long as the disability is known or should have been known based on the specific circumstances. Relying on this broad definition, a New York state appellate court in 2009 issued a decision opining that essentially no requested accommodation should be deemed per se unreasonable according to the language of the NYCHRL (*Phillips v. City of N.Y.*, 66 A.D.3d 170, 884 N.Y.S.2d 369 (1st Dep't 2009)). According to that court, even a one-year leave of absence request (following the completion of FMLA leave) might constitute a reasonable accommodation that the employer could have a duty to provide to the employee with a disability.

Limited Defenses

In further contrast to its federal and state counterparts, the NYCHRL places the burden of refuting the reasonableness of a requested accommodation on the employer. Although two affirmative defenses are available to employers, their standards exemplify how burdensome this statute can be.

First, the employer may contend that the employee with a disability could not, even with the provision of a reasonable accommodation, satisfy the essential requisites of the job. This is in direct contrast to the ADA, under which the employee has the burden of proving that the employer wrongfully denied him or her a requested accommodation that would have allowed the employee to perform such functions.

The second affirmative defense to an employee's claim that he or she was denied a reasonable accommodation is that such accommodation would cause an "undue hardship" on the conduct of the business. The employer's burden of proving an undue hardship, however, is a difficult one to meet and will be analyzed under factors (e.g., size, financial resources, etc.)

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that will make it almost impossible for large and many mid-size employers to prevail. Thus, not only does the NYCHRL protect a wide variety of "disabilities," including those that are short-term, but it also requires that employers provide accommodations in almost all circumstances unless they can prove the unreasonableness of such accommodation by meeting a heightened legal standard.

Unlimited Damages Recoverable

The NYCHRL is unique not only in the broad protections it provides to employees but also in the damages that successful litigants may recover. In addition to compensatory damages and reinstatement, employees may recover reasonable attorneys' fees and uncapped punitive damages if they prevail under the NYCHRL. By contrast, federal discrimination laws set a statutory cap on punitive damages that varies depending on the size of the employer, and the NYSHRL does not permit successful litigants to recover either attorneys' fees or punitive damages. Thus, a jury may award considerably higher damages under the NYCHRL than under its federal and state counterparts.

The NYCHRL and You

The case that I discussed at the beginning of this article illustrates the need for companies and human resource professionals to be proactive in their approach to the NYCHRL. Understanding the law's broad protections is only the first step. Putting that knowledge to practical use, as will be demonstrated below, is the only way for companies to reduce or avoid liability under the NYCHRL.

Individualized Interactive Process

One of the easiest ways to ensure compliance with the NYCHRL is to actively address any issues as they arise and to maintain policies that assure employees that the employer will do so. When an employee who is or may be disabled (remembering the broad definition of that term) comes to you or his supervisor to request an accommodation, the company representative has an affirmative duty under the NYCHRL to "engage in the interactive process." Keep in mind that the employee does not need to explicitly request a disability-related accommodation in order for the interactive process to be initiated; the specific circumstances will dictate whether the employer knew or should have known that the employee was making a request for an accommodation.

The interactive process means working with the employee to achieve a satisfactory accommodation by considering and reviewing a variety of options. It may include a review of the employee's job functions and how the proposed accommodation(s) affects those functions, but it is important for the process to be individualized to the particular employee's situation; the goal is to "clarify the individual needs of the employee and the business." A broad, one-size-fits-all approach will not be viewed kindly by the courts. The goal is not to simply avoid a lawsuit but to make the interactive process a win-win scenario for both the employee and the company, which can often be best achieved by suggesting reasonable alternatives. In addition, it is important for the employer to document and memorialize all steps taken during the interactive process and beyond; this can be critical if an accommodation cannot be achieved and a lawsuit arises.

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Maintain Clear, Concise, Uniform Policies

Company disability and leave of absence policies should be clear and thorough. Ensure that policies cover those disabilities contemplated by the law and do not restrict rights protected by the NYCHRL. Further, such policies should provide a clear and simple mechanism by which employees may request leaves of absence (and other accommodations) and remember that the 12 weeks of FMLA leave is no longer the absolute outside boundary for disability-related leaves of absence. Clearly define how leave periods will run and the way in which the company determines the viability of accommodations. Importantly, companies must also uniformly implement their policies in order to avoid claims of discrimination.

Risks of Asserting Undue Hardship

Remember that, under the NYCHRL, it will be the employer's burden to prove that any rejected accommodation that was suggested by the employee would have imposed an "undue hardship" on the employer. Documenting your reasons for denying the accommodation and tailoring those reasons to the statutory factors for proving "undue hardship" can be invaluable.

Err on the Side of Caution

If you are unsure whether the employee is "disabled," whether an accommodation has been requested or what the appropriate accommodation is under the circumstances, it is probably safer to err on the side of caution and assume that the NYCHRL will cover the condition. Then act accordingly; it is better to be safe than sorry when it comes to the NYCHRL.

As the New York City Council and state and federal courts permit the NYCHRL to grow exponentially, it is critical to protect your company from liability. Plaintiffs' attorneys will likely continue to stretch the boundaries of the NYCHRL for the foreseeable future, so it is imperative to protect your company in advance.

Neal I. Korval is a shareholder with Vedder Price in New York and can be reached at nkorval@vedderprice.com. **Mark S. Goldstein** is an associate with Vedder Price in New York and can be reached at mgoldstein@vedderprice.com.

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Editors: Allen Smith
Joanne Deschenaux

Copy Editor: Erin Binney

Designer: John R. Anderson Jr.

+1-800-283-7476 (U.S. only)
+1-703-548-3440 (Int'l)
+1-703-548-6999 TTY/TDD
+1-703-535-6490 FAX

Internet: www.shrm.org/law
E-mail: Allen.Smith@shrm.org

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