Morrison & Foerster Monthly News Volume 22, No. 3 March 2010

Employment Law Commentary

"Two-Part Series on Independent Contractors"

In this, the first part of a two-part series, we address how to determine independent contractor versus employee status, and the key factors considered by regulatory agencies in determining proper classification. Next month, part two will address the tax implications employers must consider and how to address and resolve tax enforcement efforts by state and federal agencies.

Employee or Independent Contractor: It's Time to Assess

By Daniel J. Aguilar

> There have been many attempts to define precisely what is meant by the term "independent contractor;" but the variations in the wording of these attempts have resulted only in establishing the proposition that it is not possible within the limitations of language to lay down a concise definition that will furnish any universal formula, covering all cases. At last, and in any given case, it gets back to the original proposition whether in fact the contractor was actually independent.[1]

Although the tests are fact intensive and differ among government agencies, it is critical that business owners correctly determine whether workers are employees or independent contractors. Worker misclassification exposes employers to government agency audits, enforcement actions, substantial fines and penalties, individual and class actions, and even criminal prosecution.[2]

It's Everyone's Business

Now more than ever, everyone seems to have an interest in proper worker classification. Indeed, the stakes are high for employers and workers alike, as well as regulatory bodies and labor unions.

Workers, for example, want to ensure they are paid as required by law, provided the statutorily required leave, and protected under federal and state employment laws (e.g., the Fair Labor Standards Act, the Age Discrimination in Employment Act, safeguards provided under Title VII of the 1964 Civil Rights Acts, and similar federal and state laws prohibiting harassment or discrimination in the workplace, most of which generally do not apply to independent contractors). Workers also want to ensure that their eligibility for social security and Medicare benefits is not jeopardized, their tax responsibilities are properly handled, and they are provided any additional employer-provided benefits to which they might otherwise be entitled.

Employers, on the other hand, want to ensure they are properly paying payroll taxes and the minimum wage or overtime, complying with other wage-and-hour law requirements such as providing meal periods and rest breaks, and reimbursing their workers for busi-

(Continued on page 2)

San Francisco
Lloyd W. Aubry, Jr. (Editor) (415) 268-6558 laubry@mofo.com
James E. Boddy, Jr. (415) 268-7081 jboddy@mofo.com
Karen Kubin (415) 268-6168 kkubin@mofo.com
Linda E. Shostak (415) 268-7202 lshostak@mofo.com
Eric A. Tate (415) 268-6915 etate@mofo.com

Palo Alto
Christine E. Lyon (650) 813-5770 clyon@mofo.com
Joshua Gordon (650) 813-5671 jgordon@mofo.com
David J. Murphy (650) 813-5945 dmurphy@mofo.com
Raymond L. Wheeler (650) 813-5656 rwheeler@mofo.com
Tom E. Wilson (650) 813-5604 twilson@mofo.com

Los Angeles
Timothy F. Ryan (213) 892-5388 tryan@mofo.com
Janie F. Schulman (213) 892-5393 jschulman@mofo.com

New York
Miriam H. Wugmeister (212) 506-7213 mwugmeister@mofo.com

Washington, D.C./Northern Virginia
Daniel P. Westman (703) 760-7795 dwestman@mofo.com

San Diego
Craig A. Schloss (858) 720-5134 cschloss@mofo.com

Denver
Steven M. Kaufmann (303) 592-2236 skaufmann@mofo.com

London
Ann Bevitt +44 (0)20 7920 4041 abevitt@mofo.com

Independent Contractor

(Continued from Page 1)

ness expenses incurred in performing their jobs. At the same time, employers are concerned with the risk of liability for back taxes; overtime pay and employee benefits; and any attorneys' fees, costs, and penalties associated with claims filed by employees or government regulatory agencies.

Notably, even labor unions are concerned that independent contractor relationships are being utilized as a management stratagem to evade organizing efforts. As such, labor unions are getting involved in misclassification cases to enforce applicable statutes and regulations and to recover monetary relief for such violations. In fact, at least one federal district court has held that a union had standing as an "interested party" in a misclassification case.[3]

As for federal and state governments, they are interested in recouping billions of dollars in lost tax revenues. A report prepared by the U.S. Government Accountability Office in the fall of 2009 concluded that worker misclassification is a "significant problem" with "adverse consequences" because it reduces tax revenues flowing to the government. The report estimates that the misclassification of employees as independent contractors will cost the Treasury Department more than $7 billion in lost payroll tax revenue over the next 10 years. And for every 1% of workers misclassified, it is estimated that states lose an average of $198 million each year in unemployment insurance funds.

The Feds Are Coming!

President Obama's proposed federal budget for the 2011 fiscal year includes $117 billion for the U.S. Department of Labor ("the DOL"), which includes $25 million specifically designated for a "Misclassification Initiative" intended to target employers who misclassify workers. With its new budget, the DOL plans to hire more than 350 new employees, including 177 investigators and other enforcement staff, and will introduce competitive grants to boost individual states' incentives and capacities to address misclassification. But the DOL is not alone.

Starting this month, the IRS is launching its National Research Project ("NRP"), which requires the audit of approximately 6,000 employers over the next three years. While the goal of the NRP is ostensibly to examine and compile trending information in five categories (worker classification, fringe benefits, payroll taxes, expense reimbursements, and other related payroll issues), the project will require comprehensive audits, and any employment tax issue that presents itself will be addressed as the IRS works to close an employment tax gap estimated at $15 billion.

State agencies are not far behind either. Several states have commissioned studies on worker misclassification, and others have passed legislation narrowing the definition of "independent contractor." New York, for example, created the Joint Enforcement Task Force on Worker Misclassification to audit employers and investigate worker misclassification. States like New Jersey, Massachusetts, and New Mexico enacted legislation that establishes a rebuttable presumption in favor of an employer-employee relationship and places on the employer the burden of proving otherwise. And states like Delaware and Maryland passed workplace fraud statutes creating new sanctions for employers who knowingly misclassify workers.

Combined, the work of the DOL, IRS, and state agencies represents a joint effort to eliminate incentives for employers who misclassify their workers, penalize those employers who do, and replenish state and federal coffers in the process.

Assessing Classifications

Whether intentional or accidental, misclassifying workers as independent contractors has always been a risky proposition for employers. Proper classification is further complicated by the fact that most federal and state agencies consider different criteria and often apply different weight to each factor. The following is a review of the key factors considered by governmental entities. As a preliminary matter, employers need to determine which test applies to the situation at hand. For the most part, the tests are likely to yield the same results, but some tests rely more heavily on certain factors. Thus, in any given situation, the results may vary.

Common-Law Rules

Historically, at the heart of the classification decision is the issue of who has the "right of control" over the means of production. If the employer controls the details of how the work is accomplished, the worker generally is considered an employee. On the other hand, if the employer simply specifies the end product, and the worker controls how the work is performed, the worker may be considered an independent contractor. To resolve the "right of control" issue in a given situation, the government entities charged with applying the laws have developed their own factors and tests that they use as analytical aids.

According to the IRS, the question of whether an individual is an independent contractor or an employee under the common law is to be determined upon consideration of the facts and application of the law and regulations in a particular case. Guides for determining the existence of that status are found in three substantially similar sections of the Employment Tax Regulations: namely, section 31.3121(d)-1, 31.3306(i)-1, and 31.3401(c)-1, relating to the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and federal income tax withholding on wages at source, respectively.[4]

In interpreting the code sections identified above, courts have considered many factors in deciding whether a worker is an independent contractor or employee. Previously, IRS Revenue Ruling 87-41, more commonly known as the IRS Twenty Factor Test, was most often used to determine what type of relationship existed. Although this ruling remains valid, the IRS

Independent Contractor

(Continued from Page 2)

has grouped the more relevant factors into three main categories: behavioral control, financial control, and relationship of parties.

Behavioral Control: These factors show whether there is a right to direct or control how the worker does the work. The behavioral control factors fall into four subcategories:

- Type of instruction given
- Degree of instruction
- Training
- Evaluation system

Type of Instruction Given. An employer-employee relationship exists when the employer has the right to control and direct the worker not only as to the results to be accomplished by the work but also as to the details and means by which the result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but also as to how it shall be done. Types of instructions that should be considered include things like:

- When and where to do the work
- What tools or equipment to use
- What workers to hire or to assist with the work
- Where to purchase supplies and services
- What work must be performed by a specified individual
- What order or sequence to follow when performing the work

In this connection, it is not necessary that the employer actually direct or control the manner in which services are performed; it will suffice if the employer has the right to do so. In general, if an individual is subject to the control or direction of another merely as to the result to be accomplished and not as to the means and methods for accomplishing the result, the individual is an independent contractor.

Degree of Instruction. Detailed instructions indicate that the employer exercises more control over the worker. Less-detailed instructions, on the other hand, indicate that the worker is more likely an independent contractor. Because the level of instruction required varies by job, the key consideration is whether the employer has relinquished the right to control the worker's performance, or has retained it to direct and control the worker.

Training. Training workers on their job duties tends to indicate that the employer wants the job done a particular way, which is a sign of an employer-employee relationship. In this respect, periodic or ongoing training is an even stronger indicator of such a relationship.

Evaluation System. An evaluation system that simply appraises the end result can be used to show that the worker is an independent contractor. On the other hand, an employer-employee relationship is likelier the case if the appraisal system details how the work is executed at various points throughout the job.

Financial Control: These factors show whether there is a right to direct or control the business part of the work. The three indicators of financial control include financial investment of the contractor, opportunity for profit or loss, and method of payment.

Financial Investment. Generally, an independent contractor has a significant investment in the equipment he or she uses in working for someone else. Note, however, that a significant investment does not necessarily indicate independent contractor status since some employers exercise a great deal of control over workers despite the individual's large expenditures.

Opportunity for Profit or Loss. If the worker can realize his or her own profit or loss in addition to what an employee normally would experience, the indi-

Morrison & Foerster's Independent Contractor Working Group

To help our clients meet the challenges presented by the independent contractor issue, Morrison & Foerster has assembled a group of its employment law, federal tax, and state and local tax ("SALT") attorneys. Our team will work together to address the panoply of issues that can arise in the event the IRS or a private party contends that a business has misclassified its workers. Our employment lawyers have substantial experience defending companies in court and advising companies on best practices regarding classification issues. Our federal tax and SALT attorneys have significant experience defending businesses in the audit and litigation phases of enforcement actions and on related employment tax issues, such as 409A, executive compensation, and reporting issues. It is our general experience that tax agencies are overly aggressive in classifying workers as employees, and we have been very successful in representing businesses on these matters.

Our team attorneys are: Employment Law: Daniel J. Aguilar, Lloyd W. Aubry, Jr., James E. Boddy, Jr., Marc G. Fernandez, Anna Ferrari, Karen J. Kubin, Timothy F. Ryan, Janie F. Schulman, and Daniel P. Westman; SALT: Eric J. Coffill, Hollis L. Hyans, and Andres Vallejo; Federal Tax: Linda A. Arnsbarger, Robert A. N. Cudd, Stephen L. Feldman, Joseph K. Fletcher, III, Edward L. Froelich, Yana S. Johnson, and James E. Merritt.

If you are currently undergoing an employment tax audit at the federal or state level, or receive a letter from the IRS in connection with the NRP audit program, feel free to call any of our team members. We would be happy to assist you.

Independent Contractor

(Continued from Page 3)

vidual is more likely to be considered an independent contractor. The more the individual realizes a profit or loss based on the results of the individual's work, the less the fee looks like wages paid to an employee. Along these lines, the payment of business expenses by the worker throughout the course of the job and the existence of unreimbursed expenses can both be used in assessing this criterion since both are indicia of independent contractor status.

Method of Payment. An independent contractor is generally paid a flat fee for the job. An employee, on the other hand, is generally guaranteed a regular wage amount for an hourly, weekly, or other period of time.

Relationship of the Parties: These factors illustrate how the business and the worker perceive their relationship. The factors generally fall into the subcategories of:

- Written contracts
- Employee benefits
- Permanency of the relationship
- Services provided as key activity of the business

Written Contracts. The designation of a worker as an employee or an independent contractor in a contract while certainly relevant is not sufficient to determine the worker's proper classification. Thus, if the relationship is actually that of an employer-employee, the designation or description of the parties will not control.

Employee Benefits. Employers tend to not provide employee benefits such as insurance, pension plans, paid vacation, sick days, and disability insurance to independent contractors. An independent contractor will generally finance his or her own benefits out of the overall profits of the enterprise.

Permanency of the Relationship. An employer-employee relationship is generally found if the employer engages a worker with the expectation that the relationship will continue indefinitely. Independent contractors, on the other hand, are typically hired for discrete projects of reasonably established duration. Here, the more open-ended a project, the likelier the individual will be considered an employee instead of an independent contractor.

THE MORE THE INDIVIDUAL REALIZES A PROFIT OR LOSS BASED ON THE RESULTS OF THE INDIVIDUAL'S WORK, THE LESS THE FEE LOOKS LIKE WAGES PAID TO AN EMPLOYEE.

Services Provided as Key Activity of the Business. The IRS considers how critical or essential the work is to the employer's business. If the work is part of the main operation of the business, the IRS presumes that the employer necessarily must exercise significant control over the work and will thus find that an employer-employee relationship exists.

In determining whether an individual is an employee or an independent contractor under the common law, all evidence of control and autonomy must be considered. The facts of each situation illustrate whether there is a right to direct or control how the worker performs the specific tasks for which he or she is hired, whether there is a right to direct or control how the aspects of the worker's activities are conducted, and how the parties perceive their relationship. These factors provide evidence of the degree of control and autonomy.

Additional Factors Considered in Other Tests

California has developed its own common-law factors. The Employment Development Department has essentially added three more factors to the IRS Twenty Factor Test to include custom and usage in the industry, skill required, and whether the parties believe they are creating an independent contractor relationship. In 1989, the California Supreme Court created the "*Borello* test" in *S. G. Borello & Sons, Inc. v. Dept. of Industrial Relations*, 48 Cal. 3d 341 (1989). While paying lip service to the common-law right of control test, the court created a more nuanced approach that looks to the purpose of the social legislation and the totality of the circumstances of the particular workers at issue. In the context of workers' compensation, the court found that "share farmers" growing pickles for a national pickle company were exactly the type of workers that workers' compensation was intended to cover. Some commentators have likened this approach to the so-called "economic realities" test under the Fair Labor Standards Act, but the court denied it was adopting this approach. Subsequent attempts to limit *Borello* to workers' compensation cases have not been successful.[5]

As with cases before federal agencies or courts, there is no set definition of the term "independent contractor" in California. As such, one must look to the interpretations of state courts and enforcement agencies to decide if in a particular situation a worker is an employee or independent contractor. Since different laws may be involved in a particular situation, it is possible that the same individual may be considered an employee for purposes of one law and an independent contractor under another law.

FedEx Home Delivery: A Change of Focus?

Whether federal or state, the common-law principles outlined above are intended as an initial guide for the determination of the relationship. Yet the opinions that define and, ideally, clarify their application continue to evolve and shift emphasis.

Independent Contractor

(Continued from Page 4)

FedEx Home Delivery v. NLRB illustrates this complexity.[6] In 2009, the United States Court of Appeals for the District of Columbia shifted the focus from the common-law "right to control" to that of examining "entrepreneurial opportunity." In a 2-1 decision, Judges Janice Rogers Brown and Stephen F. Williams concluded that the non-exhaustive test "is not especially amenable to any sort of bright-line rule" and noted with frustration that the legal distinction between employees and independent contractors "is permeated at the fringes by conclusions drawn from the factual setting of the particular industrial dispute." The court then held that focusing on the individual's entrepreneurial opportunity "better captures the distinction between an employee and an independent contractor" than focusing on who controls the means and manner of work.

In determining whether the FedEx drivers retained sufficient "entrepreneurial potential" to warrant independent contractor status, the court observed that the drivers signed independent contractor agreements, were not subject to reprimands or other discipline, provided their own vehicles "although the vehicles [were required to] be compliant with government regulations and other safety requirements," and were responsible for all costs associated with operating and maintaining their vehicles. They were also allowed to use their vehicles for non-related commercial or personal purposes, could hire drivers as temporary replacements for their routes, and could assign their contractual rights to their routes to others without FedEx's permission. In comparison, the court downplayed the NLRB's argument that the drivers should be classified as employees because, among other things, FedEx required them to wear a recognizable uniform and conform to grooming standards; paint their vehicles a particular color and stay within a particular vehicle size range; display FedEx's logo on their vehicles in a larger format than required by Department of Transportation regulations; complete a driving course or equivalent and be insured; and undergo two customer service rides per year to audit performance. According to the court, such facts "reflect differences in the type of service the [drivers] are providing rather than differences in the employment relationship." Thus, after considering all of the facts before it, the court held that the FedEx drivers were independent contractors, not employees.

This new focus, which differs markedly from rules established by other courts, may spawn considerable confusion among employers seeking guidance regarding how to classify their workers.

Tips for Drafting Independent Contractor Agreements

A written independent contractor agreement, as well as the terms in that agreement, can affect several of the factors discussed above and can aid a company in establishing that a worker is an independent contractor and not an employee. In addition, the agreement can affect other important rights and obligations for the independent contractor. Here are some of the issues that companies should be aware of as they prepare independent contractor agreements:

1. Should you have a written agreement with your independent contractors?

The answer to this question is almost always "yes." Although a written agreement cannot transform an employment relationship into an independent contractor relationship that satisfies the tests discussed above, the existence of a written agreement (or the lack of a written agreement) is considered an important factor under some of these tests. Also, the written agreement can establish a framework for the working relationship that, if followed, would constitute a valid independent contractor relationship. Finally, a written agreement can clarify other important rights – for example, intellectual property rights.

2. How should you define the services in the independent contractor agreement?

The definition of the services to be performed by the independent contractor is important. The services must be defined clearly and specifically so the company knows when it must pay the contractor and when the services have been completed. Projects change over time, however, and you do not want to define the services so narrowly that you have no flexibility to change the project without renegotiating the contract. In addition, the definition of the services affects many of the factors discussed above – for example, factors considering the degree of instruction provided to the contractor and how critical or essential the work is to the employer's business.

3. What terms affect the validity of the independent contractor relationship?

Agencies and courts that scrutinize independent contractor relationships often focus on a few key terms. The compensation terms are important because they affect the payment and realization of profit or loss factors. Also, the provisions discussing the manner in which the independent contractors will perform the services must be carefully drafted to balance the company's legitimate security and other needs with the important "right of control" factors.

4. How should I handle intellectual property, trade secrets, and competition rights?

In many independent contractor agreements, the ownership of intellectual property, the rights to proprietary information used during the project, and the protection against unfair competition are some of the most important provisions. A company obviously wants the fruits of the independent contractor's services (which often include intellectual property), but by overreaching (e.g., by using a typical "work for hire" provision), the company may be creating an employment relationship. Similarly, the company and often the contractor want to protect their proprietary information, but some protective clauses may affect some

Independent Contractor

(Continued from Page 5)

of the factors discussed above, and others may be unenforceable (e.g., non-competition clauses).

5. How should I handle the contractor's authority and the parties' indemnity, insurance, and tax obligations?

Terms defining the contractor's authority and the indemnity, insurance, and tax obligations of the parties should be included in independent contractor agreements. In independent contractor relationships, these obligations are not as clearly defined by law as they are in employment relationships.

What Companies Should Do

Given the increased scrutiny by federal and state agencies, now is a good time for companies to review their worker classifications. With the coming DOL Misclassification Initiative and IRS National Research Project, as well as the various state programs along these lines, companies need to ask hard questions and not simply rely on common industry-wide practices. Thus, for starters, companies should initiate an internal review of employment tax compliance. Such an audit should include a factual and legal analysis of any risks and potential financial exposure. In addition, companies should review compliance with Section 530 of the Revenue Act of 1978, a safe-harbor provision that prevents the IRS from retroactively reclassifying a company's classification of workers where the employer meets certain prerequisites and has a reasonable basis for its position.

Going forward, companies should consider carefully the reasons for wanting to use independent contractor classifications and how the relationship between the parties will be viewed in light of the tests described above. However, once a company decides to proceed with such status, the company should be proactive in protecting itself by requiring all independent contractors to enter into written agreements that are drafted with consideration of the various independent contractor tests.

Companies should not underestimate the difficulty of applying these standards to specific individuals performing services. In doubtful cases, always consult a knowledgeable labor and employment law attorney. ■

---

1 *Kisner v. Jackson*, 159 Miss. 424, 427-28 (1931).

2 *In Crabbe v. United States*, No. 08-1393, 2010 U.S. App. LEXIS 1931 (10th Cir. Jan. 28, 2010), the Tenth Circuit U.S. Court of Appeals recently affirmed the conviction and 37-month sentence of a business owner who willfully failed to pay the IRS payroll taxes withheld from his employees. In doing so, the court rejected, among other things, defendant's claim that his workers were independent contractors and not employees. *See also, United States v. Easterday*, 539 F.3d 1176 (9th Cir. 2008) (upholding the conviction and 30-month sentence of a business owner).

3 *See Chi. Reg'l Council of Carpenters v. Joseph J. Sciamanna, Inc.,* 2009 U.S. Dist. LEXIS 46380 (N.D. Ill. June 3, 2009).

4 *See* Department of Treasury regulations, 26 CFR 31.3121(d)-1, 31.3306(i)-1, and 31.3401(c)-1.

5 *See, e.g., Air Couriers Int'l v. Employment Development Dep't,* 150 Cal. App. 4th 923 (2007); *Estrada v. FedEx Ground Package System, Inc.,* 154 Cal. App. 4th 1 (2007).

6 *FedEx Home Delivery v. NLRB*, 563 F.3d 492 (D.C. Cir. 2009).

Daniel J. Aguilar is an associate in our San Francisco office and can be reached at (415) 268-6314 or daguilar@mofo.com.