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EMPLOYERS BEWARE: HOW DO YOU PROTECT AGAINST THE SIGNIFICANT LEGAL RISKS POSED BY THE USE OF CONTINGENT WORKERS?[1]

By Daniel N. Janich

The Wall Street Journal and other media outlets report almost on a daily basis that continued high unemployment and underemployment rates are to continue for a long time to come despite an improved economic picture. This suggests that employers will be slow to hire full time employees even when they have returned to profitability. Cautious companies will likely hire contingent workers who do not present a significant financial long - term commitment, thus allowing for maximum flexibility as economic conditions dictate. However, if companies do not structure the use of contingent workers properly from a legal viewpoint, they could face significant legal and financial risks. Perhaps chief among these risks are costly claims for benefits filed by such workers that could range from a few thousand to millions of dollars, depending on the size of the workforce.

Who is a Contingent Worker?

Individuals designated as contingent workers, include independent contractors (also known as freelancers), employees leased from a staffing agency (leased employees), seasonal and temporary workers, and part-time employees. Frequently these individuals are not readily distinguishable from the company's regular, full-time employees with one major exception; contingent workers are not eligible to participate in the company's employee benefit plans. However, this fact alone has not stopped these workers from attempting to and sometimes being successful in challenging their classification.

Companies as service recipients must structure their relationship with the contingent workforce in such a manner that when either the courts or the IRS investigates it, it is clear that these individuals by virtue of their status are not eligible to receive benefits. Courts have adopted the traditional common-law agency test to ascertain whether a worker qualifies as an "employee" for ERISA purposes. Under this test, "employee" status is examined by determining the extent to which the hiring party retains the right to control the manner and means by which the work is accomplished ("right to control test"). In addition to the right to control test, courts have adopted the use of the ***Darden*** factors, as articulated by the United States Supreme Courts in ***Nationwide Mutual Insurance Co. v. Darden*****,** where the Court first enunciated what constitutes an "employee" for plan eligibility purposes under ERISA. The following are the ***Darden*** factors which should be

[1]This article first appeared in the Winter 2009 edition of the Greensfelder, Hemker & Gale, P.C. newsletter entitled ***Employee Benefits & Executive Compensation Update*****.**

given equal analytical weight: 1) the skill required; 2) the source of the instruments 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 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) the tax treatment of the hired party.

The Court **in *Darden*** did not address how the term "employee" is defined under the Internal Revenue Code. The IRS in its investigations as to whether certain contingent workers should be re-classified as common law employees, has applied the common-law agency test as well, by applying a 20-factor test to assess worker status for purposes of benefit eligibility. The 20 factors identified by the IRS include a consideration of the manner in which the worker is paid, the right to discharge, whether services are made available to others; furnishing of tools and materials.

Given that the determination under either test entails a fact-intensive inquiry, service recipients must be prepared to answer how their contingent workers have been treated under the factors enumerated above. The courts frequently encounter situations where the job assignments of contingent workers are no different than that of full time regular employees, and the hiring company exerts or has authority to exert a great deal of supervisory control over the work of such contingent workers. In such cases, the danger of a misclassification and subsequent claim for coverage under a company's benefit plans will certainly be a very real possibility.

Vizcaino v. Microsoft Corporation: Independent Contractors

One of the most important cases in the last dozen years or so to have addressed the issue of worker eligibility for benefits arose in the Ninth Circuit Court of Appeals. In ***Vizcaino v. Microsoft Corp.,*** freelance workers brought a class action suit under ERISA against Microsoft seeking benefits under its savings and stock purchase plans. Although the workers had signed agreements when hired that described them as "independent contractors" only, their day-to-day work was indistinguishable from Microsoft's permanent full time regular workforce. As a result, the IRS subsequently classified the workers as common-law employees for tax purposes. In the litigation that followed, the Ninth Circuit found that the classification was based on "mutual mistake" thereby rendering the "independent contractor" language entirely meaningless. Notwithstanding a subsequent settlement of this claim for $96.885 million, a legion of similar claims has been asserted and continues to this very day.

Two-Pronged Eligibility Test for Leased Employees

Companies often use the services of leased employees pursuant to agreements with staff leasing agencies. Unless these arrangements strictly comply with the requirements of IRS Code §414(n) (2), there remains a significant risk that the IRS could reclassify such workers as common law employees of the service recipient. Code §414(n) (2) allows for companies to use contingent workers notwithstanding the fact that the service recipient has the right to control and supervise the manner in which the work is to be performed. Section 414(n) (2) describes a narrower class of leased workers as any person who is not an employee of the recipient and who provides services to the recipient where: 1) such services are provided pursuant to an agreement between the recipient and the leasing organization; 2) such person has performed services for the recipient on a substantially full-time basis for a period of at least 1 year; and 3) such services are performed under the primary direction or control of the recipient.

Over time the courts developed a two-pronged analysis of eligibility when addressing whether workers initially classified as "leased employees" were, in fact, entitled to maintain their benefits claim. The first prong is a threshold requirement whereby courts determine whether the claimant is indeed a common law employee or as asserted by the service recipient, a leased employee. Then, if the court determines that the individual is a common law employee, the second prong requires an analysis of the benefit plan's language to ascertain whether the plan expressly excludes the claimant's worker classification. In response to the ***Vizcaino*** case, employers increasingly began to adopt plan provisions that rendered reclassified contractors ineligible for plan benefits.

Temporary or Seasonal Workers and Part-Timers

Temporary or seasonal workers are, by definition, hired for a limited duration. Such workers may be common law employees hired by the company, or independent contractors or leased employees. The temporary status of such workers generally precludes plan eligibility because they may not satisfy the minimum service requirements of the company plans. If such a worker, however, satisfies the plan's eligibility requirements—as is often the case with part-timers—such worker will be entitled to participate in the plan and thereafter receive plan benefits.

Recommendations on How You Can Minimize Potential Liability Exposure

It should be readily apparent by now that the short term financial benefits of using contingent workers can be easily wiped out by the long-term consequences of doing so. Therefore, what can a company do to minimize its liability exposure in such cases? How can it best defend itself when its worker classification is challenged by those it had considered to be either leased employees or independent contractors? Although such

inquiries are almost always fact intensive ones, companies should consider adopting the following defensive measures when using a contingent workforce:

- ❑ The company must have written agreements with the independent contractors containing clear language designating their status as contractors, not employees, and describing the consequences of such status: i.e., no eligibility for plan benefits. To ensure that such agreements are to be deemed enforceable knowing waivers of benefits, such workers must be required to sign off on them through written acknowledgements.

- ❑ Leased employee arrangements should fall within the requirements of Internal Revenue Code §414(n) to ensure that such workers will not be reclassified as common law employees of the service recipient.

- ❑ The specific language of your benefit plans should be reviewed to confirm that it clearly excludes independent contractors and leased employees, including workers who may later be reclassified by any governmental agency as common law employees of the plan sponsor.

- ❑ The plan administrator must ensure that any exclusion of season, temporary or part-time workers from plan eligibility complies with the service requirements of the plan. If such workers are likely to satisfy the plan's service eligibility requirements, you must assess whether such workers may be reasonably excluded from eligibility (on some other basis without referenced to the number of hours they typically perform service) as a class without violating the plan's minimum coverage requirements.

- ❑ Exercise great care when reclassifying a portion of your regular full time employees as non-employees, whether as independent contractors or leased employees, to ensure consistent with the factors discussed above that they are thereafter treated for all purposes as non-employees, and do not continue performing the same services in the same fashion as they did prior to the reclassification.

- ❑ Implement and follow a program that clearly documents and distinguishes the company's regular full time employees from its independent contractors and leased employees with respect to the type of work being performed, how it is performed, what support is provided for performing the work, and how the worker is supervised. Incorporating the factors enumerated above should develop this program.

You will find a more detailed legal analysis of this topic in the chapter I authored entitled "Contingent Workers and Employee Benefits" which appears in the legal treatise, ***ERISA Litigation***, published and updated by the Bureau of National Affairs (BNA).

A copy of this chapter is available for download at
http://www.greensfelder.com/publicDocs/DNJ.Chapter.38.pdf

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