



Tougher Sanctions Ahead for Worker Misclassification

What Bank HR Managers Should Know

A new Maryland state law may be a harbinger of a general toughening of the unemployment, workers' compensation, and wage and hour laws throughout the country. The Workplace Fraud Act of 2009 cracks down on employers that misclassify their employees as independent contractors, clarifies the definition of an independent contractor, and significantly increases the penalties for employers that knowingly misclassify workers to save on unemployment and workers' compensation costs. The law took effect on October 1, 2009.

The brunt of the law's enforcement authority is aimed at the construction and landscaping businesses where the problem of worker misclassification is most widespread. These businesses frequently hire workers on a short-term basis and may not classify them as employees, depriving them of access to unemployment insurance, workers' compensation, and other workplace protections.

The law has implications for other types of business too, says Fred Sommer, Chairman of the Employment and Labor Law

Group of Shulman, Rogers, Gandal, Pordy, & Ecker in Potomac, Maryland. Sommer has 30 years of experience representing financial institutions and other types of employers in all aspects of employment and labor relations law.

"All employers in Maryland are covered by the new law with respect to its increased penalties for misclassification," says Sommer.

Riskier Proposition

Compliance with the worker classification laws has recently become a riskier proposition for two reasons, notes Sommer. First, more businesses are using independent contractors or freelancers because of the economy.

By classifying an individual as an independent contractor, the business avoids paying unemployment contributions and workers' compensation premiums, as well as Social Security and Medicare taxes. In addition, the business does not have to provide the individual with benefits offered to employees, such as health insurance, retirement contributions, and paid vacation. Furthermore, an independent contractor will

not be subject to the many laws providing protections and other rights to employees, such as discrimination, overtime, and family and medical leave laws.

"A financial institution might change an employee's classification after his or her employment status changes in some way," says Sommer. For example, an institution may cut back a full-time employee's hours as a cost containment measure or may retain an individual as a less costly consultant following a workforce reduction. In such cases, employees may want to be classified as independent contractors rather than be let go. But if workers who are reclassified do not meet the definition of independent contractor, under the Maryland Workplace Fraud Act the employer is subject to a civil penalty of \$5,000 per employee plus back contributions for unemployment and workers' compensation. If the employer is found to have knowingly misclassified employees, the rate for back contributions rises 2 percentage points.

In the aforesaid situations, misclassification happens on the back-end — that is, when an existing employee's status changes. Misclassification also frequently happens on the front-end when an employment relationship is established, says Sommer. A company might bring someone onboard for a trial period and treat him or her as an independent contractor, not an employee. The arrangement may be mutually agreeable, and a person may stay on for years in that capacity. However, if the person fits the definition of an employee, the company may be found to have misclassified

the worker, with all the attendant penalties.

The second reason that misclassification has become a riskier compliance problem is that the federal and state governments are more frequently challenging worker classifications, again at least partly because of the economy. "State and federal revenues are constrained at the same time that more unemployment benefits have to be paid out," says Sommer. "As a result, the states are much more aggressively enforcing existing laws and, in the case of Maryland and some other states, are enacting new laws."

The risk goes beyond enforcement. At the federal level, Sommer reports, several bills have been introduced in Congress that would, like the new Maryland law, make it more difficult to classify someone as an independent contractor and also significantly increase the penalties for misclassification. "Under the new law in Maryland," Sommer explains, "the presumption is that a worker is an employee, and the employer has the burden of proving that the individual is properly classified as an independent contractor."

Federal enforcement has been beefed up as well. For example, the Internal Revenue Service recently announced that it will focus its employer audits on worker classification issues and presumably challenge classifications that appear to be incorrect. Sommer predicts that the federal Department of Labor will put greater emphasis on worker classification issues in the context of overtime and minimum wage claims, and a government-wide

initiative, not limited to the tax arena, is likely.

"This is a nationwide issue," notes Sommer. "If you are a business in Maryland, you are probably getting more attention than businesses in other jurisdictions, at least for now. But employers everywhere need to know that the stakes have gotten a whole lot higher."

Individual Claims Rising

Another arena where the employment classification laws may be more vigorously enforced is in the courts. "More and more cases are being brought by people who have been classified as independent contractors but who claim they are actually employees entitled to certain benefits and protections of the law," Sommer says.

"A situation that comes up with increasing frequency involves individuals who are treated as independent contractors but bring a lawsuit claiming they are employees entitled to overtime or other benefits such as health insurance, pensions, or paid vacation," Sommer points out.

Courts reach their determinations of whether someone is an employee or an independent contractor by weighing the specific factors in each case, and the outcome is not always easy to predict. "It is rare when all the factors point in one direction. The worker classification laws and definitions are not cut-and-dried," Sommer notes.

Compliance Complications

In conjunction with Maryland's Workplace Fraud Act, Governor O'Malley issued an executive order creating a Joint

Enforcement Task Force on Workplace Fraud, comprised of representatives from the state Department of Labor, Licensing, and Regulation, state Attorney General's office, state Comptroller's office, and Worker's Compensation Commission. The task force is responsible for coordinating investigations and facilitating the sharing of information with other authorities and the filing of complaints against violators. The result is likely to be more consistent and increased enforcement.

In addition, because of the number of agencies that have an interest in worker classifications, compliance is becoming more complicated. One such complication, according to Sommer, is that a correct classification in one instance may not hold true in other instances. "Under Maryland law, even if a worker is correctly classified as an independent contractor for federal Internal Revenue Service purposes — and therefore the employer does not have to pay Social Security or Medicare or withhold income taxes — the worker may still be an 'employee' for purposes of Maryland unemployment and workers' compensation," says Sommer. "A much stricter test for classification as an independent contractor is provided under the Maryland law."

As a result, inadvertent violations become more likely. "Many of our clients have not had a problem with their independent contractor classifications and even passed an IRS audit, but they nonetheless were deemed liable for unemployment contributions for those individuals," Sommer points out.



What To Do

"Misclassification issues come up in our practice in many different contexts," says Sommer. "They arise as a result of federal and state audits and enforcement actions, and also through claims by individuals alleging that they have been misclassified and therefore deprived of employment law benefits and protections."

To avoid compliance or legal complications, HR managers in financial institutions and other businesses should, as a preliminary matter, identify individuals with whom the institution is contracting, as opposed to treating as employees, and determine whether the classifications are correct.

"Given the complexity of the law and the fact that the classification rules are sometimes different for different purposes, the safest and best thing to do is ask a lawyer who is well versed in employment law and up-to-speed on changes to review the company's independent contractor classifications," Sommer advises.

Consultation is recommended even if a company has what it believes to be airtight agreements with independent contractors. According to Sommer, "A common mistake that can lead to penalties is the belief that a contract that labels someone an independent contractor is all that a business needs to prove the correctness of the classification. An agreement can help you, but it can certainly hurt you as well. You might have the lengthiest and most formal agreement with an independent contractor that has all the bells and whistles, but it won't mean much if the actual relationship

in fact does not meet the legal test of being a contractor."

Sommer also suggests centralizing worker classification matters within the HR function. "HR managers should not relinquish to individual managers the ability to classify someone as a contractor. HR managers generally understand the risks and requirements, but decisions to bring someone onboard on a contract basis are too often made by managers who do not have the same familiarity with the legal and regulatory issues. Indeed, they may not think they even have to involve HR if they are not treating the person as an employee.

And that's how things can get out of control and your institution can have significant exposure," Sommer cautions.

The main take-away for bank HR managers — particularly in Maryland but in other states as well — is that "they should get with a qualified attorney to make sure all independent contractor classifications are in compliance with the law," advises Sommer. "The consequences of misclassifying individuals can be rather significant and far outweigh whatever benefits an employer might gain by treating workers as contractors and not employees." ■■



Certain Reductions to Salaried Exempt Pay and Work Schedules Approved

by John Skousen

Whether an employer may temporarily reduce the work schedules and, correspondingly, the salaries of exempt employees in order to avoid job layoffs during difficult economic conditions was recently the subject of an opinion letter by the

California Labor Commissioner. The opinion letter, dated August 19, 2009, announced that the Commissioner would reconsider a prior opinion prohibiting reduction of a salaried exempt employee's salary in connection with a reduced work schedule. The interpretation brings California's enforcement position in line with federal law interpret-