THINK BEFORE YOU HIRE: PERILS OF WORKER CLASSIFICATION

Federal government tightens standards

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In the government's eyes, there are three kinds of workers: non-exempt employees, exempt employees, and independent contractors. Putting an individual in the wrong box can have serious consequences with the U.S. Department of Labor (DOL), the IRS, and various state agencies. In addition, miscategorizing employees exposes a bank to the risk of civil lawsuits when a disgruntled worker decides they were misclassified.

Understanding the classifications

Taking the broadest view, it's all about how the worker is paid:

• A non-exempt employee is paid an hourly rate for 40 hours a week, and a premium rate (time and a half) for hours beyond 40. This means that rigorous time records must be maintained to keep track of hours worked and whether overtime pay is owed.

• An exempt employee is paid a fixed salary every week, two weeks, or monthly. The salary doesn't vary with the number of hours worked per week, so there's no need to keep time records.

• An independent contractor is paid for a specific task or project. Compensation may be based on an hourly rate, or paid in a lump sum. The key distinction here is that no income or payroll tax withholdings are made by the bank: the independent contractor is responsible for his or her own taxes. Also, independent contractors aren't eligible to participate in benefit plans.

Put this way, you can see the obvious advantages to the bank of classifying an employee as exempt (avoiding overtime pay and the burden of time records) or as an independent contractor (avoiding tax withholdings and the provision of benefits.)

The government sees it differently. Its default position is that workers are non-exempt employees, with the employer carrying the burden of proof that a specific exemption applies, or that the worker is an independent contractor.

Exemptions made for another era

The Fair Labor Standards Act (FLSA), which requires the payment of overtime for hours worked in excess of 40 a week, was passed in 1938. It was a different world.

The Act contains some narrow exemptions to the overtime rule which may have made some sense back then, but which hardly carry over to today's workplace, dominated by service jobs and featuring a high degree of automation. Over the years, efforts have been made-for example, by adding a "computer professional" exemption-to update the Act. In 2004, the Labor Department issued new rules attempting to clarify the administrative, executive, and professional exemptions-to little avail.

Chaos was kept at bay by DOL Opinion Letters, which applied particular exemptions to specific jobs. Although the letters always came with the disclaimer that they only responded to the individual jobs described by the employer requesting the opinion, they provided a rough guide for banks to rely on in determining which positions were exempt.

A new interpretation

The Obama Administration has taken a new approach. In March 2010, the Labor Department issued an Interpretation on whether mortgage lenders were exempt. (See my article "Overtime Pay For Mortgage Lenders" in the online ABA Banking Journal in April 2010.) This was not in response to a request for an Opinion on a particular job description. Instead, it listed "typical" mortgage lender tasks and stated that, as long as mortgage lenders were serving individuals (as opposed to commercial entities), the administrative exemption previously relied on does not apply.

Understandably, this has caused considerable consternation at banks, who are now also coping with the Secure and Fair Enforcement Act (SAFE Act) and restrictions on mortgage loan originator compensation.

But the fallout is still to be fully realized.

The Interpretation's rationale, which lists job duties in a generic way and distinguishes bank positions by whether the customer is an individual or a business, applies to a number of other bank positions, such as consumer lenders and personal bankers.

I explain in my earlier article some possible alternatives to re-classifying employees as non-exempt, and you can obtain detailed guidance on how to conduct a Wage & Hour self-audit from ELC at www.employlawcompliance.com.

The other shoe drops

Along with stepped-up enforcement of the FLSA, the Labor Department has declared war on businesses that evade employer obligations by classifying a worker as a non-employee, that is, an independent contractor. Here the department has a powerful ally in the IRS ,which already scrutinizes independent contractor relationships to ensure that they are not being used to evade taxes.

With the advent of telecommuting and flextime, the entry into the workforce of a generation of workers with a more freewheeling attitude to the job, and the growing use of contingent workers, even banks have succumbed to the attractions of independent contractor arrangements. If you have independent contractors, or are thinking of entering into any such relationship, review the arrangement carefully to determine whether it will pass the legal tests.

Right of control

The problem is that there is no one national test for whether an independent contractor relationship passes muster. The Labor Department uses an "Economic Realities Test" focusing on the employer's control of the worker and worker's economic dependence on the employer. The IRS has an 11-factor test for determining whether someone is an independent contractor, organized under three substantive categories: behavioral control, financial control, and type of relationship.

• Behavioral control: For example, is the worker instructed on what equipment to use and what sequence to follow in doing the work? Does the worker receives training on the job?

• Financial control: Factors include: Is the worker reimbursed for business expenses? Does the worker provide similar services to other businesses?

• Type of relationship: Examples: Is there a written contract describing the relationship? Does the worker get benefits? How permanent is the relationship?

Another test used in many states also has three main factors:

Is the worker free from direction or control from the employing unit in the performance of the work?

Does the worker perform services outside the usual course of, or places of business of, the employing unit?

Even if performing services of the same nature as the employing unit, is the worker customarily engaged in an independently established trade, occupation, profession, or business wholly apart from the employing unit?

One common factor in all these tests is the employer's right of control over the worker. The more control, the less likely the independent contractor arrangement will stand up.

In the real world

So when and how do challenges to independent contractor arrangements crop up, and is there a way to forestall them? Here are a few scenarios that keep recurring. Perhaps they sound familiar.....

• The hiring freeze. No one wants to break the law, and the bank has spent time and effort to establish policies that should prevent it. However, in special circumstances, managers may look for ways to circumvent regular policies and procedures. Bringing on a much-needed staff person as a "consultant" during a hiring freeze may seem like a good idea from everyone's point of view at the start, but things change over time, and, as the next bullet points show, today's happy independent contractor may be tomorrow's plaintiff.

• Benefits envy. Independent contractors are not eligible to participate in your employee benefit plans. The classic case illustrating how freelancers can feel cheated is Vizcaino v. Microsoft, where Microsoft independent contractors claimed, despite a written agreement to the contrary, that they should be eligible for the company's employee stock purchase plan. Microsoft settled the claim for $96 million. More usually today, health benefits may be the motive for a disgruntled independent contractor to rethink his or her status.

• Unemployment benefits claim. After the relationship is over, the former contractor may file a claim for unemployment benefits, listing the bank as his last place of work on the application questionnaire. This will lead to the state agency to investigate. If the agency determines the contractor was really an employee, the bank will be required to pay unemployment contributions.

But the real danger lies in the way state and federal agencies now routinely share information, leading to further enquiries, fines, and penalties, embracing not only the individual that made the unemployment benefits claim, but other "suspect" classifications too.

• Workers compensation. Workers compensation protects the bank from tort claims by employees who are injured or become ill in the course of their employment. By definition, this protection does not apply to independent contractors, who may sue the bank for injuries or illnesses resulting from their work. Perhaps a more significant risk is that the bank's workers' compensation insurance carrier may dispute the bank's use of the independent contractor classification, even though the parties have agreed to it in writing. To cover potential claim exposure from an independent contractor, the carrier may increase premiums.

• After the relationship sours. The most typical scenario is when the bank decides to terminate the relationship before the independent contractor expects or wants it to end.

No matter how eagerly he or she agreed to sign away employment protections at the inception of the relationship, the disgruntled worker (have you ever met a "gruntled" worker?) is now looking for grounds to assert a claim. Was the relationship ended because of the worker's age, sex, race, or disability?

Anti-discrimination laws only cover employees. Remembering all those late nights and weekends, perhaps the worker was entitled to overtime pay? The FLSA applies to hours worked by employees, not contractors. While most cases fall in the gray area, with some indicia of employment and some indicia of an independent contract, the courts and enforcement agencies tend to favor extending the protections of employment. The consequences of an adverse ruling go beyond damages to the former contractor to liability for past tax and insurance obligations as well.

How to avoid liability

The government, be it IRS, the Labor Department, or state-level tax, unemployment, or workers compensation agencies, has a strong interest in shifting independent contractors into employment status.

The bank's best tools in avoiding misclassification problems is a clear understanding of the risks, and the adoption of policies and procedures covering the engagement of independent contractors. Those policies and procedures should take into account insurance and indemnification issues, benefit issues, liability to third parties or consumers, and so on. Misclassification, even if unintentional, can bear heavy costs.

Disclaimer: This column does not provide, nor is it intended to substitute for, professional legal advice.

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