CLIENT ALERT: Misclassification of Employees Targeted by Federal Government in Budget Proposal

The federal budget for 2011, released in early February 2010, includes provisions that seek to target and prevent the misclassification of employees as independent contractors. Specifically, the budget includes the appropriation of $25 million for a joint Labor and Treasury Department initiative which bolsters these agencies' ability to penalize employers who misclassify, as well as restore protections denied to employees because of their improper classification. The budget further targets misclassification by funding competitive grants to boost States' incentives to address this problem.

The interest shown by the Federal government in this issue is a valuable reminder of the risks associated with misclassifying employees as independent contractors. In Massachusetts, as in other states, the misclassification of an employee as an independent contractor exposes the misclassifying employer to potential civil and criminal liability. Indeed, in Massachusetts, the potential costs of misclassification are particularly high, and liability highly likely, given that the law presumes that an individual is an employee and it is the employer's burden to prove otherwise.

Specifically, M.G.L. c. 149 § 148B provides that an individual will be considered an employee unless an employer can prove that: (1) the individual is free from control and direction in connection with the performance of service, both under his contract for the performance of service and in fact; (2) the service is performed outside the usual course of the business of the employer; and (3) the individual is customarily engaged in an independently established trade, occupation, profession or business of the same nature as that involved in the service performed.

The inability of the employer to prove any one of the above is sufficient for a finding that the individual in question is an employee, and that the employer is thus in violation of the law. If liability is found, the damages an employer may have to pay are significant, and include treble damages and

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attorneys' fees. Even where an employer can show it paid a misclassified independent contractor more than the company would have paid this individual as an employee, the Massachusetts' highest state court has found that the employee may still be assessed damages under the law. In a case decided last summer by the Massachusetts Supreme Judicial Court, Somers v. Converged Access, Inc., the court held that a misclassified employee is entitled to "damages incurred" as referenced in the Wage Act, M.G.L. c. 149, § 150, which includes any wages and benefits plaintiff proves he or she would have received as an employee, including holiday pay, vacation pay, and any other employee benefits. Moreover, the court added that if the employer could not prove the plaintiff was an exempt employee under the overtime act, M.G.L. c. 151, § 1A, the plaintiff would be entitled to the amount he proves he should have received for overtime based on the hourly wage he received by the employer when he was improperly classified as an independent contractor, *even if this wage was higher than the employee would have received had he been paid as an employee*. The court also iterated that an employer's intent is irrelevant to a determination of whether it violated the independent contractor law, expounding that "[g]ood faith or bad, if an employer misclassifies an employee as an independent contractor, the employer must suffer the consequences."

Many states have codified their own independent contractor tests for use in determining the lawful classification of workers. In addition, because a business's tax burdens are significantly lessened when it uses independent contractors, the IRS has its own contractor test that it applies to determine whether a business has properly classified its workers. The IRS test is broken down into three categories: (1) behavioral control, (2) financial control, and (3) type of relationship. Behavioral control speaks to whether the business has the right to direct and control how the work is done – if a business has retained the right to control the details of a worker's performance, the worker is more likely to be an employee than an independent contractor. Financial control is based on whether the employer retains the right to control the financial and business aspects of the work – for example, the business may require the worker to charge a set price to something the worker produces and sells to clients. The type of relationship refers to facts that reflect the relationship between the employer and worker, such as whether the business provides the worker with employee-type benefits such as health insurance, the permanency of the relationship (a finite period is more indicative of work performed by an independent contractor) and the extent to which the services performed by the worker are

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a key aspect of the regular business of the company. As with the Massachusetts' law described above, the IRS test is complex, difficult to apply, and fact specific. If a business has any questions about their application, consulting with legal counsel is advisable.

Growing governmental attention to the issue of misclassification, as well as court decisions such as the Somers case, ensures that misclassification cases will increasingly be litigated, and that employers should prepare for challenges to their classification. Employers who utilize independent contractors are encouraged to review the decision to classify these workers as independent contractors.

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