

Hot Issues Alerts – Law Firms

Curbing Misclassification Pitfalls: Challenges In Today's Economic Environment

The Editor interviews **Michael C. Schmidt**, member of Cozen O'Connor's labor & employment practice group in New York.

Editor: Please tell our readers about your labor & employment practice and your area of concentration.

Schmidt: I represent large and small employers in various types of employment matters including discrimination, retaliation, non-compete claims and harassment. I also have a considerable amount of experience in wage-and-hour-related issues under the federal Fair Labor Standards Act, as well as New York state law. This is in addition to advising on general day-to-day employment matters for our clients, and creating and reviewing employment and severance agreements, non-compete agreements and employee manuals. I also serve as an adjunct professor of law at Touro Law School in Central Islip, N.Y., where I teach an employment law course.

Editor: What are the key labor and employment risks facing companies today?

Schmidt: Companies continue to face the typical discrimination and harassment lawsuits. However, misclassification of workers is a growing problem. I am referring to misclassification of employees as exempt for overtime purposes under wage and hour laws when the claim is that they should be more properly classified as "non-exempt," as well as misclassification of workers as independent contractors when they should be classified as employees.

Editor: What factors do you attribute to this surge in misclassification litigation?

Schmidt: Not only is there an increase in litigation in this area but also an upswing in agency audits that have been separately instituted against employers on both the state and federal levels. I attribute this phenomenon to three primary factors.

First, in today's economy, companies, more than ever, are looking to reduce costs. One way they might do this is by classifying employees as exempt from overtime, which results in them not having to pay premium overtime compensation, as well as re-classifying existing workers or hiring new workers as independent contractors, and therefore avoiding certain withholding and other financial costs inherent in the normal employment relationship. I must stress that companies are not necessarily looking to violate the rules intentionally but are, in many cases, acting under mistaken beliefs about what the rules are and how they are applied.

The second factor is that agencies and governments, both on the federal and the state level, are looking to increase revenue in these economic times. Agencies such as the Department of Labor (DOL)

or taxing authorities are seeking to reclaim lost contributions and tax revenues that they believe have not been made because of some of these misclassifications.

Third, and this is primarily in the overtime misclassification area, these lawsuits tend to lead to large class actions where multiple plaintiffs are involved, oftentimes hundreds if not thousands of potential class members, as well as the prospect for large fees being awarded to plaintiffs' attorneys if successful. For these reasons, and because of the really strict requirements under the wage and hour laws, there seems to be an increase in these types of lawsuits.

Editor: On the independent contractor side, the U.S. Government Accountability Office is strongly advising the IRS and DOL to ramp up their efforts to reduce misclassification. What other measures are underway? And how is this increased crackdown going to impact the litigation landscape?

Schmidt: In addition to growing audits, we've already seen state and federal movement to curb problems, including Maryland's Workplace Fraud Act of 2009 and Colorado legislation aiming to halt contractor misclassification. The New York State legislature has been considering proposed legislation on this issue as well. It's also predicted that Rep. Rob Andrews (NJ) will reintroduce federal legislation to limit independent contractor classification, after Rep. Jim McDermott (WA) introduced legislation this past summer to further define classification rules.

Companies will likely start to look at reaching early resolutions in the initial phases of these audits, as opposed to letting them languish and grow into protracted lawsuits. With all of these agency audits in the news and an increasing focus on them being so prevalent, the hope is that companies will take steps early on to reduce their possible exposure before any significant agency audit is commenced or any subsequent lawsuit pursued.

Editor: So far, how are the courts treating employers as far as independent contractor misclassification?

Schmidt: The courts, like the agencies, will determine whether an individual is an independent contractor based on day-to-day activities and economic factors; having the title of independent contractor does not in and of itself mean that one truly will not be considered an employee. The current rules generally examine the actual behavioral control a company exercises over the manner and means that work is performed, the financial control the company has in terms of bearing all risks of loss and realizing all potential profits, and the intentions of the



Michael C. Schmidt

parties to the relationship.

For example, two plaintiffs, classified as independent contractors, recently won their appeal in a Fifth Circuit case that they were entitled to overtime for extra hours worked restoring damaged telecommunications lines along the Mississippi Gulf Coast in the wake of Hurricane Katrina. The court determined that the men were employees because they worked on a steady and reliable basis for a substantial period of time and were economically dependent on their employer and not in business for themselves.

Editor: What industries are particularly vulnerable to such claims and why?

Schmidt: Target industries are transportation as well as brokerage and those heavily involved in sales. Much has to do with the fact that those industries tend to significantly use true independent contractors, so they are looked at more closely by agencies. In addition, in those industries, there are often certain expectations that companies have, based on custom and practice, that the individuals performing services are independent contractors and should be treated as such.

Editor: On the overtime exemption side, what challenges are companies facing? Which industries are hardest hit?

Schmidt: In terms of the latter question, I think many of these cases involve companies in the financial services and retail industries. Again, this is due to expectations and traditional assumptions about how employees have historically been treated for exemption purposes under the wage and hour laws. Based on the strict tests and regulations issued by the DOL, employers are faced with the challenge of understanding and correctly applying particular exemption tests to the day-to-day job activities of particular employees.

Editor: In both of these situations, what are the common company pitfalls that are leading to misclassification?

Schmidt: I think the primary pitfall is when companies make certain assumptions and then classify based on those assumptions. For example, in the overtime setting, businesses often mistakenly believe that simply because an employee is paid a salary (and often, a high salary), that means the employee is automatically exempt from overtime. Another common assumption is that because overtime may not have been authorized the company is not required to pay the overtime compensation. Again, this is not necessarily the case.

There are myths that persist in both overtime and independent contractor classification cases. For example, the fact that someone has a particular title or a written job description customarily used in the industry is sufficient to clas-

sify the worker as either exempt from overtime laws or to classify him/her as an independent contractor. That is simply not the case. What companies need to do is look at the individuals' day-to-day responsibilities and activities based on the tests, as well as the wage and hour and independent contractor guidelines, set forth by federal and state labor departments. Then, businesses must determine whether they are properly classifying workers based on these standards as opposed to assumptions and myths.

Editor: What are the steps that in-house counsel and HR can take together to curb such problems?

Schmidt: First, it's important that companies understand the basic tests for overtime exemptions and the guidelines used to evaluate independent contractor classification. Second, companies' in-house counsel, HR personnel and, where appropriate, outside counsel, should conduct internal audits to determine, as soon as possible, whether they are properly classifying employees based on day-to-day actual job activities before an agency decides to conduct an audit or before a lawsuit is commenced. Third, businesses need to have a well-documented file showing the reasons for the particular classification of the individual or the group of individuals so that they can justify classification in the event of any subsequent audit or lawsuit.

Editor: Federal Reserve Chairman Ben Bernanke has said that the country is most likely out of recession, but the road to recovery will be longer. How will current economic conditions impact the landscape for misclassification claims? And, how should this impact companies' strategies to limit their risks?

Schmidt: Even when objective data shows that we are out of the recession, the nature and duration of this current downturn will continue to take a psychological toll on both employees and companies. Companies will further look at ways of cutting costs and perhaps unintentionally make mistakes that lead to potential liability in classification lawsuits. Also, employees will pursue certain claims and try to find ways to collect money that they believe they are owed because of misclassification. Therefore, it's imperative that companies take some of the steps I mentioned to reduce misclassification.

Editor: Do you have any parting remarks for our readers?

Schmidt: The standards and tests used for determining both overtime exemptions and independent contractor classifications are not only strictly interpreted but, in many cases, difficult to apply. It's critical that companies, either with the assistance of in-house or outside counsel, develop a working understanding of what the tests are, and whether those tests are being accurately and consistently applied to the current workforce.

Please email the interviewee at mschmidt@cozen.com with questions about this interview.