Employee or Indep

endent Contractor?

Historical Perspective, Current Risks, and Practical Tips

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History

In 1869, using the lexicon of the times, the Court of Appeals of Maryland concluded that the most important factor in determining whether an individual was the "servant" of another "depends upon the control and direction that he could rightfully exercise over them." *Deford v. State*, 30 Md. 179, 203 (1869). Some 34 years later, in 1903, a worker by the name of Albert N. Hall was painting the grill work in the basement of an elevator shaft when the elevator descended upon him and he sustained injuries that led to his death. His widow filed a negligence action against the company alleged to have employed him. Again, using the terminology of the day, one of the issues before the Court of Appeals of Maryland was whether the relationship of "master and servant" existed between Mr. Hall and the defendant. *State, Use of Isabel M. Hall v. Trimble, et al.*, 104 Md. 317 (1906). In reversing the directed verdict of the circuit court for a variety of reasons, the Court of Appeals found that the trial court had improperly limited the inquiry of the plaintiff into the issue of whether the defendant paid, or was reimbursed for, Mr. Hall's wages. The court also considered the authority of the defendant to "employ and discharge" the worker and the direction provided to the worker. *Id*.

Century-old tort cases, such as *Deford* and *Trimble*, addressed the vicarious liability of an employer for the actions of its employees while also creating the context of the law that defined the employer/employee relationship before the enactment of the Maryland Workers' Compensation Act in 1914. Prior to that date, employees could sue their employers in tort for work-related injuries, and, just as today, often the threshold issue was whether the worker was properly classified as an employee or an independent contractor.

The Tests — Maryland Law

With the enactment of the Maryland Workers' Compensation Act in 1914, the determination of whether a worker was an employee or an independent contractor became a crucial preliminary inquiry to establish coverage under the Act. *See* Md. Code Ann., Lab. & Empl. § 9-202 (establishing the criteria for covered employment). Thus began a long line of cases, in the context of protective labor laws, establishing the common law for what distinguishes an employee from an independent contractor. As the Court of Appeals of Maryland noted in *Mackall v. Zayre Corp.*, there are five factors to be considered in making that determination: (1) the power to select and hire the employee; (2) the payment of wages; (3) the power to discharge; (4) the power to direct and control the employee's conduct; (5) and whether the work is part of the regular business of the employer. 293 Md. 221 (1982). The Court in *Mackall* held that the fourth element – direction and control – was the most important factor in the context of the Workers' Compensation Act.

In the late 1930s and early 1940s, as part of the "New Deal," protective labor laws, including the Fair Labor Standards Act and unemployment insurance laws, were enacted by Congress and state legislatures. Each of these laws exclude from coverage legitimate independent contractors, but chose very different approaches for how to perform that analysis. Under the Fair Labor Standards Act, as well as Maryland's wage and hour and wage payment laws, the issue has been left to the interpretation by the courts and the development of the "economic realities test." This is often described as a six (or sometimes seven) part test that includes the following factors: (1) whether the work performed is outside the usual course of business of the enterprise for which the work is performed; (2) whether the employer exercised or had the right to exercise control over the performance of the individual's work; (3) whether the individual is customarily engaged in an independently established trade, occupation, profession or business; (4) whether it is the employer or the employee who supplies the instrumentalities, tools, and location for the work; (5) whether the individual receives wages directly from the employer or from a third party; and 6) whether the individual held an ownership interest in the business such that he had the ability and discretion to affect policies and procedures of the business. *See Baltimore Harbor v. Ayd*, 365 Md. 352 (1995) (using the test in its interpretation of the Wage Payment and Collection Law, and indicating that the right to control is the most important factor.) A very similar economic realities test is used by the federal Department of Labor for cases under the Fair Labor Standards Act (FLSA). *See e.g., Goldberg v. Whitaker House Cooperative, Inc.*, 366 U.S. 28 (1961) (finding that members of a cooperative are employees under the FLSA because of the "economic reality" of the employment relationship). As a practical matter, there is little difference between factors considered in the economic realities test as compared to the workers' compensation test under Maryland law.

In contrast, the Maryland Unemployment Insurance Act has adopted a statutory test, which has come to be known as the "ABC" test. This test has been used in Maryland for more than 70 years. In order for an employer to establish that a worker is a legitimate independent contractor, and thus avoid coverage for unemployment insurance purposes, it must establish all three elements of the test. Under Maryland law, an individual performing services for an employer is presumed to be a covered employee unless the individual: 1) is free from direction and control over performance of the work both in fact and under the contract; 2) is customarily engaged in an independent business or occupation of the same nature as that involved in the work performed; and 3) works outside the employer's usual course of business or performs the work outside the employer's place of business. Md. Code Ann., Lab. & Empl. § 8-205. Case law and agency regulations provide guidance on how this statutory provision is applied and interpreted. *See, e.g., DLLR v. Fox*, 346 Md. 484 (1997); COMAR 09.32.01.18.

The "ABC" test is also used under the Workplace Fraud Act of 2009. Md. Code Ann., Lab. & Empl. § 3-901 through § 3-920. Enforced by Maryland's Department of Labor, Licensing and Regulation, the Workplace Fraud Act created a new and distinct violation of Maryland law for misclassifying

a worker as an independent contractor in a construction or landscaping business. Sanctions for such violations are issued through a citation process set forth in Md. Code Ann., Lab. & Empl. § 3-903 through § 3-909. Initially, no monetary penalties are assessed for "non-knowing" violations if an employer comes into compliance by meeting all its obligations for back payroll taxes, unemployment insurance taxes, and workers' compensation premiums. However, if an employer fails to come into compliance, it can be fined up to $1,000 per employee. If an employer is issued a citation for a "knowing" violation, it can be fined up to $5,000 per employee. The Workplace Fraud Act also codified the presumption of employment in the context of the Unemployment Insurance Act and the Workers' Compensation Act, and added to each statute penalties for misclassification. Importantly, the changes to these two laws apply to all businesses, not just construction and landscaping. In 2012, Maryland's General Assembly amended the law to include a "safe harbor" provision which eliminates the presumption of employment if a business entity meets certain enumerated criteria. *See* Md. Code Ann., Lab. & Empl. § 3-903.1 (2012).

Federal and Tax Law Implications

Misclassification also presents a major concern for federal and state taxing authorities. For years, the Internal Revenue Service (IRS) had used a somewhat complicated and unwieldy 20-part test to distinguish employees from independent contractors. That test has been simplified to a three-part analysis focusing on degree of control and independence, which includes the following factors: 1) Behavioral – Does company control or have right to control what the worker does and how the worker does his or her job? 2) Financial – Are the business aspects of the worker's job (including how the worker is paid, reimbursements, providing of tools and supplies) controlled by the payor? 3) Type of Relationship – Are there written contracts or employee type benefits? Will the relationship continue and is the work performed a key aspect of the business? If this analysis does not provide a clear answer, the IRS suggests filing a Form SS-8, which asks approximately 30 questions to assist with a determination of the worker's status. The Maryland Office of the

Comptroller has recently followed the IRS three-part analysis for evaluating whether a worker is properly classified as an employee or independent contractor. Generally, an employer must withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment taxes on wages paid to an employee.

There are numerous other protective labor laws where the case law has developed tests for determining whether coverage is excluded for independent contractors. Most of those tests, however, are simply variations on the same theme found in the economic realities test. *See, e.g., NLRB v. United Ins. Co.*, 390 U.S. 254 (1968) (holding that the common law agency test is used for NLRA coverage, with no one factor being determinative); *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318 (1992) (using the common law agency test to be used for ERISA cases); *Clackamas Gastroenterology Associates, P.C. v. Wells*, 538 U.S. 440 (2003) (applying the common law agency test with an emphasis on the control factor used for cases under the ADA); *Murray v. Principal Fin. Group, Inc.*, 613 F.3d 943 (9th Cir. 2010) (holding that there is no reason the *Darden* test should not be used when interpreting Tile VII); and *Secretary of Labor v. Griffin & Brand of McAllen, Inc.*, 6 O.S.H. Cas. (BNA) 1702 (R.C. 1978) (OSH Review Commission applying the economic realities test to occupational safety and health cases). Despite the variety of tests, in most instances, the conclusion regarding whether an individual is an employee or independent contractor will be the same under any test.

Current Perspective and Risks

Over the last few years, there has been a significant increase in regulatory vigilance – both at the state and federal level – in this area of the law. From the perspective of government agencies, the enhanced enforcement implicates three policy considerations: (1) protecting workers who are entitled to the coverage intended by the various labor laws; (2) ensuring collection of all taxes that are due, and appropriately spreading the insurance risk for both workers' compensation and unemployment insurance; and (3) leveling the playing field for businesses that abide by the rules and do not undercut their competition by misclassifying workers without a legitimate basis to do so. From a business perspective, there is a desire to cut costs, shift the burden of certain payments (such as Social Security and workers' compensation premiums), and avoid the application of protective labor laws.

Misclassifying workers as independent contractors instead of employees subjects a business to a cornucopia of significant legal risks, such as liability for unpaid withholding, Social Security and Medicare taxes; unemployment insurance contributions; breach of contract claims by private workers' compensation insurers; liability for unpaid wages, overtime and benefits; benefit plan disqualification; an unfair labor practice claim; and uninsured common law tort claims for the acts and omissions of contractors. The business may also be unknowingly exposing themselves to claims for discrimination, harassment and retaliation. Moreover, many of the controlling statutes provide for liquidated or treble damages and attorney fees.

As widely reported in the mainstream media coverage concerning the Affordable Care Act, more and more businesses are exploring the use of an independent contractor work force in an attempt to avoid the perceived additional expense of hiring traditional employees. Ultimately, however, such an approach may be a very costly mistake.

Practical Tips

The first step for any Maryland employer considering whether to hire a worker as an independent contractor or employee is to conduct an accurate self-assessment using the Unemployment Insurance Act's ABC test. It is widely considered the strictest test. If an employer-independent contractor relationship can pass scrutiny

under the ABC test, it will likely pass muster under the common law agency analysis, economic realities test, economic dependence test, right of control analysis or other applicable test.

Although having an independent contractor agreement is not dispositive in a misclassification dispute, a properly drafted agreement adhered to in practice will assist all parties, including any potential enforcement agency, in understanding the true nature of the relationship. Many businesses make the mistake of dusting off and modifying an employment agreement template. The problem with that approach is that the employer is starting from the wrong end of the spectrum and may fail to discard terms and conditions appropriate for an employment relationship, not an independent contractor one. The better starting point is a vendor or business-to-business contract, which should more accurately reflect the nature of a true independent contractor relationship.

From the viewpoint of a regulatory agency, a business does not have a "choice" regarding whether to hire employees or independent contractors. Rather, it is the true nature of the work, and whether it meets the criteria of the applicable test, that will dictate whether it is appropriate and legitimate to classify a worker as an independent contractor. Hiring an independent contractor is a trade-off for a company. An employer must be willing to cede control over an independent contractor in exchange for the economic benefit that it may achieve by using a contractor. To that end, a well-drafted agreement might include, among other things: a clear statement that the parties are entering into an independent contractor relationship, not an employment relationship, joint venture or partnership; compensation that is project-based, not salaried or hourly: a clear statement of the scope of work, emphasizing the project nature of the work and the end result, rather than the means by which the result is achieved; and a provision acknowledging that the contractor's services require a particular skill that is not part of the regular business of the company. Generally, independent contractor agreements with restrictive covenants, non-compete clauses, and at-will termination clauses may be viewed as suspect by regulatory agencies because those provisions are usually found in employment contracts.

In the final analysis, Maryland employers must pay special attention to the laws with presumptions (workers' compensation, unemployment insurance, and workplace fraud) because they present the toughest tests and burdens to overcome. It is important to keep in mind that courts liberally construe protective labor laws to effectuate their remedial purpose – to protect employees. *See, e.g., Friolo v. Frankel*, 373 Md. 501, 517 (2003) (interpreting the counsel fees provision of the Wage Payment and Collection Law). Although there are many legitimate uses of independent contractors, given the heightened scrutiny of regulatory agencies, the availability of private causes of action, and the significant consequences of misclassification, employers should proceed with caution in this complex area of the law.

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