Effective management of a contingent workforce: a brief overview of using contingent workers

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Introduction: the contingent workforce

As business competition continues to rage at a breakneck pace, companies operate under constant pressure to explore novel ways for engaging workers more efficiently to accomplish critical objectives such as meeting urgent client demands, expanding sales or repairing a weakened administrative infrastructure. Such workers are generally referred to as 'contingent workers' as long as they are not engaged as full-time employees by the company for whom they perform services.

From a strictly legal perspective, a company's obligations to a worker depend principally on whether the worker is an employee or an independent contractor with respect to the company. There are no other options. Thus, a company can engage a worker in four ways:

- directly as its own employee;
- directly as an independent contractor;
- through a third party as its employee; or
- through a third party as an independent contractor.

This article briefly discusses these options. The first two options are discussed below under the heading 'Independent contractors' and the last two options are discussed below under the heading 'Leased employees and PEOs'. This article will not discuss the numerous tax consequences that pertain to the independent contractor classification.

Independent contractors

In the United States – like in most countries – determining independent contractor status remains a complicated area for review. The case law continues to be very fact-sensitive. While the use of Professional Employee Organisations (PEOs) has become more common, both PEOs and their clients need to be very careful, both in the operation and formalities of structuring such relationships.

Advantages of the independent contractor relationship

From a company's perspective, the ability to engage independent contractors allows the company to react nimbly to marketplace demands by quickly expanding its service capabilities in specific areas where demand is hot and by precipitously contracting its service capabilities in reaction to cooling demand. Likewise, when a particular problem demands a rapid solution, the availability of independent contractors allows a company to engage highly trained and specialised professionals to remedy the problem quickly.

From an independent contractor's perspective, the status provides an opportunity to focus his or her entire efforts on the individual's area of expertise, and to maintain control over when, where and for whom he or she will perform services. It also affords the individual an opportunity to grow professionally at a rapid pace by obtaining broad exposure to different clients with unique needs.

Risks of the independent contractor relationship

While independent contractor status clearly benefits companies and individuals, it draws fierce opposition from governmental regulatory agencies. Traditionally, tax collection agencies around the world have been the most hostile towards independent contractors. Companies and agencies found by the Internal Revenue Service (IRS) to have misclassified workers as independent contractors may be subject to employment tax liabilities, including 100 per cent of the combined worker–employer contribution under the Federal Insurance Contributions Act (FICA), comprised of both social security and Medicare taxes (up to 15.3 per cent), federal income tax not withheld, and unemployment insurance tax (FUTA), as well as penalties and interest.

Another growing source of attack comes from the independent contractors themselves. As evidenced by the widely reported class action lawsuit filed against Microsoft Corporation (*Vizcaino v Microsoft Corp*, 142 F Supp 2d 1299 (W D Wash 2001)), some independent contractors contest their status in order to gain access to employee benefit programmes maintained by the company for which they perform services (for more details, see 'Contingent workers' claims for benefits' below).

How to determine a worker status: an overview

For federal employment taxes purposes, the IRS is responsible for determining whether a worker qualifies as an employee or an independent contractor. Federal employment taxes are imposed only on wages paid to employees.

According to the IRS Manual (paragraph 5(10)43): 'Under the common law test, a worker is an employee if the person for whom he works has the right to direct and control him in the way he works both as to the final results and as to the details of when, where and how the work is to be done. The employer need not actually exercise control. It is sufficient that he has the right to do so.'

In 1987, the IRS identified 20 factors to help determine whether the engaging entity retains the requisite right to control the means and methods of worker performance to qualify such worker as an employee. The 20 common law factors can be found at the following address: **www.irs.gov/pub/irs-pdf/p15a.pdf**.

Leased employees and PEOs

Employee leasing firms and professional employer organisations (PEOs) are firms that contract with workers and refer or assign them to perform services for clients. These firms treat the workers as employees of the firm for certain purposes. Another type of firm within this category is a referral agency which refers workers and treats the workers as independent contractors with respect to the firm. For the purposes of this article, the third-party firm that assigns or refers the worker is referred to as the *firm* and the company for which the worker performs services is referred to as the *client company*.

There are four possible arrangements when another firm is interposed between a worker and a client company:

(1) the worker is an employee of both the firm and the client company;
(2) the worker is an employee of the firm and an independent contractor of the company;
(3) the worker is an independent contractor of the firm and an employee of the client company; or
(4) the worker is an independent contractor of both the firm and the client company.

While the foregoing possibilities represent all the potential options for contingent workers, an arrangement can fall under different categories for purposes of different laws. For example, a worker may qualify as an independent contractor of both the firm and the client company for federal employment tax purposes, but may qualify as an independent contractor of the firm and an employee of the client company for employee benefits purposes.

In determining the proper status under a specific law, a worker's status relative to the firm and relative to the client company generally must be determined separately. One significant exception to this general rule applies for purposes of certain labour and employment laws that define an employment relationship by taking into account a concept known as 'joint employment'. This concept requires that both the firm and the client company be considered together in determining whether a worker qualifies as an employee. Consequently, both may be jointly responsible.

While both a PEO and an employee leasing firm assign workers to a client company, a PEO offers a client company an opportunity to effectively 'outsource' its entire human resources function. A PEO can take over as employer (and assign back to the client company) a client company's entire workforce. An employee leasing firm, by contrast, commonly assigns to a client company workers that represent a smaller portion of the client company's entire workforce. From a legal analysis standpoint, however, both are variations on the same concept.

Benefits of using a PEO

While most large corporations have the financial resources and expertise to maintain familiarity and compliance with the already vast, and growing, array of federal, state and local employment-related laws and regulations, few small- and medium-sized businesses can afford to do so. PEOs offer small- and medium-sized businesses a solution by providing them with the services and expertise of a large, experienced personnel department. This, in turn, enables those businesses to concentrate on their core business and thereby increase their profitability. PEOs can also save companies money due to economies of scale. A PEO that employs thousands of workers can obtain more affordable health insurance rates and workers' compensation premiums than a small employer with, for example, 50 employees. Moreover, PEOs often handle the benefits and human resource functions for scores of companies, and are therefore able to administer these functions more economically than the individual companies could.

The benefits of utilising a PEO often inure not only to the client–company but also to the company's workforce. For example, in many cases, employees will receive a greater quality and quantity of benefits from a PEO than they would receive from a small employer. This win–win arrangement is particularly valuable in competitive labour markets. Although the benefits of PEOs outlined above are compelling, these firms, as well as traditional employee leasing firms, can also present significant legal risks to client companies and to the workers who contract with such firms if the arrangements are not structured carefully.

For the purposes of most laws, the model that the parties commonly anticipate creating in an employee leasing/PEO arrangement is that of the worker being an employee of the firm, and an independent contractor of the client company. For the reasons discussed below, there are legal impediments that make it very difficult to establish those relationships without careful planning.

Transition to a leased/PEO workforce: overview of considerations

A leasing firm/PEO and client company that enter into a leasing arrangement should carefully consider all the ramifications of changing the employment relationship and the legal obligations it may trigger. This is particularly true in situations where most or all of the workers formerly employed by the client company are being hired by the firm and assigned back to fill the same job positions.

If the parties hope to establish separate-employer status (ie. causing the workers to cease being employees of the client company and to commence employment with the firm), they should observe all of the regular formalities of such a transfer of employment. First, the change of employment status must be clearly communicated to all of the affected employees. The employees should be formally laid off from the client company and hired by the firm. The firm should comply with all normal hiring procedures, including the immigration law requirements under the Immigration Reform and Control Act (IRCA). To the extent that client companies fail to respect the formalities of the change in employers, they will risk undermining separate-employer status.

The workers' transition from being employees of the client company to becoming employees of the firm can give rise to questions concerning fringe-benefit rights. One example would be whether or not transferred employees are entitled to severance pay under the client company's severance policy. Employees laid off by the client company, even if hired immediately by the firm, have severed their employment relationship with the client company. In such circumstances, affected employees could claim that the terms of the client company's severance plan entitle them to severance pay.

Affected employees might also claim entitlement to other post-employment rights such as COBRA (Consolidated Omnibus Budget Reconciliation Act) health benefits or distributions from individual retirement accounts, profit sharing, stock purchase and other benefit plans maintained by the client company.

After the transition, employees should receive final payment from the client company in compliance with standard company practice and state and federal law. The payments may include accrued commissions, vacation, sick pay and other such benefits to the extent required upon termination. Although employees can be offered a cash payout of these monies or a carry over of the accrued rights to the new employer, a carry over policy may undermine separate-employer status. Another problem is presented by the existence of employment rights based on seniority. Allowing transferred employees to carry over seniority may undermine separate-employer status. On the other hand, potential morale problems may motivate parties to accept the risk.

If a client company is unionised, potential obligations to the union must be considered. A leasing firm may agree to assume all of the obligations under the client company's labour agreement. However, the client company will not necessarily be relieved of joint liability for the leasing firm's compliance unless the union agrees in writing to the assignment of the agreement and releases the client company. Further, the decision to lay off the workforce and to contract with a leasing firm may well trigger an obligation to bargain with the union over the effects of that action. In particular, a duty to negotiate with the union may be triggered if the decision to change to leased employees is based on labour costs.

In the process of transitioning from regular employees to leased employees, both the leasing firm and the client company must carefully observe the appropriate formalities and respect the rights of employees in employment termination with one company and hiring by another.

Some labour and employment law issues to consider

QUALIFYING AS A COMMON LAW EMPLOYER

An employee leasing/PEO relationship involves a contractual allocation and sharing of employer responsibilities between the firm and its client company. The firm generally assumes responsibility and liability for human resources issues and payroll-tax compliance, while the client company retains management and control of the day-to-day operation of its business. In order to shift the underlying legal obligations with respect to leased workers that are imposed on the 'employer', the parties must do more than contractually allocate responsibilities. The parties must also structure their respective relationships with the workers so that the party responsible for a certain employer obligation actually qualifies as the workers' employer under the governing statutes. Doing this is not always easy and in some cases is not possible.

Joint employer status

Under certain labour and employment laws, the concept of joint employment makes it much easier for a firm to qualify as a worker's employer. The concept takes into account elements of control retained by both a firm and a client company in determining whether an employment relationship exists. Joint employment status for both a leasing company and the client company means that both may have the duty to withhold for federal taxes.

The test for identifying joint employers in employee-leasing arrangements is similar to the test used in differentiating between employees and independent contractors (the test can be found at the following address: www.irs.gov/pub/irs-pdf/p15a.pdf).

While the concept is helpful to firms that seek to qualify as a worker's employer, it may create potential pitfalls for client companies that enter into leasing arrangements precisely to avoid employer status. A determination that a leasing firm and its clients are joint employers of leased workers can destroy some of the anticipated benefits of the leasing arrangement. It can also subject clients to substantial liability for the leasing firms' acts or omissions, over which the client has little or no control.

Clients and leasing companies can avoid unexpected joint employer liability in two ways: (1) by structuring the leasing arrangement in such a way that the client exercises little or no control over the leased employees; or (2) by accepting the prospect of joint employer status and including in the leasing agreement the appropriate indemnification provisions that allocate liability in accordance with the parties' expectations. In either case, an indemnification agreement is a prudent precaution.

Contingent workers' claims for benefits

Businesses should cautiously draft all benefit plans to specifically exclude all contingent workers that they do not intend to cover under the plan. In doing so, the company should first consult with legal counsel to ensure that it is permissible to exclude certain groups of employees from any selected benefit plan. They should also ensure that no independent contractors are allowed to participate in the benefit plans that they sponsor and maintain.

One particularly costly example of the repercussions of worker misclassification was the landmark case *Vizcaino v Microsoft* (97 F 3d 1187 (9th Cir 1996), *en banc review granted*, 105 F 3d 1334 (9th Cir 1997), *cert denied*, 522 US 1098 (1998). In October 1996, the US Court of Appeals for the Ninth Circuit held that Microsoft Corporation had improperly classified certain software testers and technical manual writers as independent contractors. The court found that these individuals qualified as employees of Microsoft and, as such, should have been allowed to participate in the company's stock-purchase plan. The court determined that these contract employees had the right to participate despite the fact that the employees had signed agreements acknowledging responsibility for paying their own federal taxes and benefits. In December 2000, Microsoft Corporation settled the class-action lawsuit for US$96.9 million.

Conclusion: employers must get it right

It can be very costly to misclassify an employer's workers or to improperly allocate the sharing of employer responsibilities among a firm and its client company. Employers must be very careful, in both the operation and formalities of structuring the use of their contingent workers. To that end, employers should, of course, not only consult with their legal counsel, but also develop programmes to monitor and verify that the relationships remain – at all times – the ones that were contracted for in the first instance in order to avoid or, at the very least, minimise the legal risks associated with the use of a contingent workforce.

This article first appeared in the April 2008 issue of the *Employment and Industrial Relations Law Committee Newsletter* of the Legal Practice Division of the International Bar Association, and is reproduced by kind permission of the International Bar Association, London, UK.