

The Successful Emerging Growth Technology Company Establishes Procedures To Comply With Worker Classification Laws

**by John Scalia
Shareholder
Greenberg Traurig LLP**

Amidst the excitement and demands of creating a business to bring a new concept to market, many emerging growth technology companies rush into hiring a workforce without adequately understanding federal (and state) worker classification laws. Failure to implement effective worker classification compliance guidelines at the outset risks putting the company out of business before it can mature into a profitable enterprise.

Worker classification requirements fall into two related categories. First, companies must properly classify their workforce as between independent contractors (consultants) and employees. Second, employers must properly classify their employees as between those who are exempt from minimum wage and overtime wage and those who are not.

Independent Contractor v. Employee

Emerging growth companies often use independent contractors as a flexible, cost-effective way of performing work. This is legally permissible as long as certain requirements are met. All too often, however, emerging growth companies fail to meet those requirements. Many companies believe, innocently albeit incorrectly, that a worker is an independent contractor simply because the parties agree to a “1099” relationship. Quite often, this is done with the full agreement or even insistence of the worker. The law doesn’t care. Misclassifying an employee as an independent contractor creates several legal risks.

The Internal Revenue Service (or equivalent state agency) could audit your company, determine that you have violated the law, and impose various monetary assessments and penalties. Under Internal Revenue laws, companies are required to pay payroll taxes on their employees, but not their independent contractors. The IRS is charged with ensuring that companies are not skirting their employment tax obligations by misclassifying workers as independent contractors. For years the IRS has targeted the employment tax area as a high priority, auditing companies and imposing substantial tax assessments, penalties and interest for misclassification. The IRS has a specific test for determining whether a worker is an independent contractor or employee.

Improper independent contractor classification also can lead to Department of Labor investigations under the Fair Labor Standards Act. The FLSA, which does not apply to true independent contractors, requires that employers pay their employees minimum wage for every hour worked as well as overtime pay (at a rate of one and a half times the regular rate of pay) for every hour worked in excess of 40 hours in a workweek. The

DOL is responsible for enforcing these statutory requirements, and in recent years has doing so with increased vigor. These investigations often start with one employee but expand into the company's entire workforce. The DOL applies its own test (different from the IRS') for determining whether a company has misclassified an employee as an independent contractor. If the DOL determines that the worker was misclassified, and otherwise would have been entitled to minimum wage and overtime pay under the FLSA, the company may be required to pay the employee back wages and prospectively re-classify the worker as an employee entitled to minimum wage and overtime. These expenses can be cost-prohibitive for a developing company.

Finally, a worker (or group of workers) could sue the company in civil court based on the misclassification. The courts may apply yet a third test in determining whether the worker was misclassified. If the worker prevails, the company could be required to pay the "employee" back wages in the form of minimum wage and overtime pay, to provide him with some or all benefits offered to the company's "other" employees, and to reimburse him for his attorneys' fees and litigation costs.

Exempt v. Non-Exempt Employee

Companies must properly classify their employees as either exempt or non-exempt from the FLSA's minimum wage and overtime pay requirements. These requirements do not apply to those employees whom the company can prove qualify for certain statutorily allowed exemptions (i.e., "executive," "administrative," "professional" and "outside sales" exemptions). These exemptions are too complex to fully explain here. Suffice it to say that the exemptions generally require the employer to show that the employee is performing certain specific functions as his primary duty.

If the DOL determines that a company has misclassified an employee as exempt and failed to pay minimum wage and overtime pay, the company may be required to reimburse the employee for those wages as far back as three years and to reclassify the employee as non-exempt going forward. And the company may be required to pay a penalty equal to the amount of back wages owed. Again, these investigations often begin with one employee but expand into all employees in the same job class or even the company's entire workforce. The back wage payments can be enormous, and prospectively reclassifying a class of employees as non-exempt can make the company's labor costs uncompetitive.

Companies also face minimum wage and overtime liability in the form of civil lawsuits brought by employees or former employees. Such lawsuits are increasingly common. If the company is found liable, it will be required to pay back wages, potentially doubled, and also pay for the plaintiff's attorneys' fees and costs of litigation.

Bottom Line: It's Not Worth the Risk

While a small, emerging company may consider itself an unlikely target of regulatory audits or employee lawsuits, these risks grow along with the company. Once mature and

profitable, a company may be held liable for non-compliance that occurred years before. And even if a company successfully fends off the audit or lawsuit, in so doing it will have expended significant resources in the form of key personnel's time and energy and outside attorneys' fees. The successful emerging growth company avoids these risks by implementing worker classification compliance guidelines at the very outset.

Mr. Scalia's practice includes advising emerging growth companies in employment law compliance. He can be reached at 703-749-1380 or scaliaj@gtlaw.com.