"Workers" *versus* "Employees" and the ERISA Problem

by
Wayne E. Borgeest
Barbara-Ann M. Costello
of Kaufman, Borgeest & Ryan

The Problem

Subcontracting, the outsourcing of jobs, and the use of temporary employees are all techniques used increasingly by employers to increase flexibility, streamline functions, and reduce costs. Because employee benefits are protected in certain respects by ERISA, a number of disputes have arisen concerning the obligation of employers to provide benefits to these "non-employee" workers.

Contingent worker positions, including seasonal, temporary, project and leased employees, or independent contractor positions, extended for long periods of time, can lead to "workers" becoming "employees" when the contingent workers perform the same tasks and work alongside regular salaried employees who receive ERISA governed benefits. This is particularly so if the independent contractors are virtually indistinguishable from the salaried employees, but for the label placed on them by the corporation.

In fact, in recent years, a number of corporations have been subjected to class action litigation by contingent workers claiming entitlement to ERISA governed benefits, among others. A number of cases illustrate the importance of carefully drafting employment benefit documents if the employer wants to limit employee benefit obligations to only intended recipients. Although not all of the cases resulted in a finding of liability, the mere filing of a class action suit for ERISA benefits can result in defense expenses well into six figures.

✓ Some tips for avoiding reclassification of contingent workers as employees for the purposes of ERISA include: ✓

- ☑ Have independent contractors execute agreements, which include disclaimers that they are not employees and expressly waiving any right or entitlement to benefits.
- ☑ Hire self-employed staff and part-time workers through a third-party payroll service that employs these individuals and takes care of tax withholding and reporting at a separate facility.
- ☑ Avoid providing excessive instruction to avoid the inference of control similar to an employer – employee relationship.
- ☑ Avoid providing tools, office space, or reimbursing expenses for individuals you have classified as self-employed workers or independent contractors.
- ☑ Refrain from hiring back former employees on a contract basis as consultants or other type of independent contractors. Such individuals are best treated as employees.

The Cases

In December 2000, Microsoft agreed to pay $96.9 million to settle two class actions brought by temporary workers who alleged that the company employed them as "permatemps" through temporary staffing agencies and as independent contractors to avoid paying them benefits. It is estimated that between 8,000-12,000 class members could receive compensation from the settlement.

In *Vizcaino v. Microsoft*, 120 F.3d 1006 (9th Cir. 1997), Microsoft employed regular employees who were eligible to participate in Microsoft's Savings Plus Plan ("SPP"), an ERISA governed pension plan, and also contracted with freelance workers who were classified by Microsoft as independent contractors, and were not eligible to participate in the SPP.

The freelancers worked the same hours and at the same locations as the regular employees, but rather than being paid for their services through the payroll department, they submitted invoices to, and were paid through, the accounts payable department. The freelancers also entered into agreements with Microsoft, which actually stated that the freelancers were independent contractors and that they had waived any right to benefits from or through Microsoft.

Following a tax-related audit, however, the Internal Revenue Service concluded that the freelancers were not independent contractors in substance, but were "employees" according to a list of 20 factors set forth in IRS Regulations (*26 C.F.R. §31.3401(c)- 1 (b)).* After this finding, the freelancers sued as a class claiming an entitlement to ERISA benefits and eventually, Microsoft had to acknowledge that they were entitled to some amount of benefits—even though it was never Microsoft's intention to provide such benefits.

The problem was that the Microsoft ERISA plan at issue provided that "each *employee*... was eligible to participate" in the plan (emphasis added). The plan defined "employee" as "any *common law employee* who receives remuneration for personal services rendered to the employer and who is on the Untied States payroll of the employer," without other qualification (emphasis added). Since the IRS had determined that the freelancers were common-law "employees" for IRS purposes, the court held that the independent contractors also could be common-law "employees" for the purposes of the ERISA plan, which resulted in Microsoft incurring substantial liability for ERISA governed benefits for the independent contractors, which benefits were not apparently anticipated when Microsoft contracted with the freelancers.

The aspect of *Microsoft* that is perhaps most relevant to employers is the effect of, and weight given to, the language in the plan documents. For example, because the plan itself did not appear to exclude the freelancers from participation, the court held that they could not be excluded even in light of extrinsic evidence, such as the freelancers' "agreements" with Microsoft, which indicated Microsoft's intention to exclude them. While the court reasonably could have recognized the company's intention to exclude the freelancers on the basis of the contract language with them individually, the plain terms of the plan were held to control. Thus, the Court remanded the matter back to the plan administrator for a determination of what benefits Microsoft owed, exactly.

Based on the foregoing, it appears that Microsoft might easily have avoided a massive liability, at least with respect to the SPP, by taking care to place language right into the plan document that excluded any person classified by agreement with Microsoft as an independent contractor, instead of allowing language that could be interpreted to include common-law employees. Furthermore, a more specific provision in the employment agreement indicating that the employed independent contractors waived any right or entitlement to specific benefits also would have aided in clarifying the ambiguity that led to a finding of liability.

In *George Montesano et al. v. Xerox Corporation Retirement Income Guarantee Plan, et al.*, 117 F. Supp.2d 147 (D. Conn. 2000) the plaintiffs were contract workers for Xerox through third party leasing agencies. The plaintiffs filed a petition for benefits under the defendant-plan claiming they were eligible to receive benefits as common-law employees. The plan administrator took the position that the plaintiffs were not employees, were not on Xerox's payroll, and were excluded from participation in the plan because they were merely leased employees. The court found that the plans properly reserved discretion in the plan administrator and that the administrator was interpreting the plans, not the law. As long as the administrator's determination was not arbitrary or capricious, the court found, the administrator had the right to interpret the eligibility requirements of the plan. The court further found that the plan administrator conducted a reasoned analysis of the plan's eligibility requirements in finding that the plaintiffs did not meet them.

Some Guidelines

In *Montesano*, as in *Microsoft*, the determination of whether benefits were available to non-traditional workers came down to an analysis of the particular plan language at issue. The *least* relevant factor was extrinsic indications of worker status, such as disclaimers in agreements with the employees or arbitrary titles given to the workers. Thus, it appears that a basic understanding of ERISA's approach to determining participant or employee status in ERISA governed plans, and observation of a number of caveats can assist employers who want to avoid a suit by one or more non-traditional workers claiming entitlement to ERISA benefits, the mere defense costs for which can be extraordinary.

ERISA imposes a two-part test that an individual must meet to qualify for participant status under an ERISA plan. *Casey v. Atlantic Richfield et al.*, 2000 U.S. Dist. Lexis 6836 (C.D. Cal., March 29, 2000). First, the plaintiff must be an employee. Second, the plaintiff must be, according to the language of the plan itself, eligible to receive benefits under the plan. An individual who fails to establish either prong lacks standing to bring a claim for benefits under ERISA.

In Microsoft, the courts looked to the Internal Revenue Code's "20 Part Test" to aid in the determination of whether the plaintiffs were independent contractors or employees for the purpose of entitlement to ERISA benefits. In this regard, in making its determination of "employee" versus "independent contractor," Internal Revenue Code normally refers to an established list of factors, which we have attached for your review.

In Nationwide Mutual Insurance Company v. Darden 503 U.S. 318 (1992), the Supreme Court looked to a list of factors to determine whether an individual is an employee or independent contractor. As a result many courts have adopted the abbreviated "Darden" test in lieu of the IRS Test (see insert). *Wolf v. Coca Cola Company*, 200 F.3d 1337 (11th Cir. 2000); *Casey et al. v. Atlantic Richfield Co. et al.*, 2000 U.S. Dist. Lexis 6836, 25 E.B.C. 1187 6836 (C.D. Cal., March 29, 2000). We note however both the *Darden* test and IRS test are excellent places to start in determining, before litigation or dispute arises, or when creating a new ERISA-governed benefit plan, which segments of a particular organization's workforce, if any, are at risk of being reclassified from freelance or independent contractor status to a status as common-law, and therefore ERISA "employee."

Darden Test

- The hiring party's right to control the manner and means by which the product is accomplished;
- The skills required;
- The source of the instrumentalities and tools;
- The location of the work;
- The duration of the relationship between the parties;
- Whether the hiring party has the right to assign additional projects to the hired party;
- The extent of the hired party's discretion over when and how long to work;
- The method of payment;
- The hired party's role in hiring and paying assistants;
- Whether the work is part of the regular business of the hiring party;
- Whether the hiring party is in business;
- The provision of employee benefits;
- The tax treatment of the hired party.

The second prong of the ERISA test, whether the plaintiff is eligible for benefits, is an explanation of the terms of the company's ERISA plan. The plaintiff must be eligible for benefits under the terms of the plan itself. This requirement is necessary because companies are not required by ERISA to make their ERISA plans available to all common-law employees. Some tips that may assist in limiting potential liability under the Plan documents include:

- Verify that benefit plans specifically exclude "Independent Contractors", "Freelancers", and "Temporary Employees" from the definition of employees qualified to receive benefits under the Plan.

- Include language in your employee benefit plan reserving discretion in the plan administrator to interpret plan language to avoid plan interpretation by the courts.

Nothing in ERISA precludes an employer from placing language right into a plan document that excludes any group of individuals to whom the company does not wish to extend participation in ERISA governed plans as long as the requirements for eligibility are not based on an eligibility are not based on an age older than 21 or length of service longer than one year.

Developing benefit plan language and appropriate employment contract language that accurately reflects the company's intentions is an important measure to avoid potential ERISA exposure for contingent workers. By merely carefully wording plan documents and employee contracts, companies can avoid the risk of potential massive liability arising from workers intended to be employed as freelancers being deemed employees for purposes of ERISA.

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IRS 20 Point Test

1. Instructions – A worker who is required to comply with other persons' instructions is ordinarily an employee.
2. Training – Training a worker indicates that the person or persons want the services performed in a particular method or manner.
3. Integration – Integration of the worker's services into the business shows direction and control.
4. Services Rendered Personally.
5. Hiring, Supervising, and Paying Assistants – generally shows control. However, if one worker is responsible only for the attainment of a result, this factor indicates an independent contractor status.
6. Continuing Relationship indicates that an employer-employee relationship exists.
7. Set Hours of Work.
8. Full Time Required – If the worker must devote substantially full time to the business and the employer has control over the amount of time the individual spends working, an employee status may be inferred. An independent contractor, on the other hand, is free to work when and for whom he or she chooses.
9. Doing Work on Employer's Premises – suggests control over the worker. Work done off the premises indicates some freedom from control. The importance of this factor depends on the nature of the service involved and the extent to which an employer generally would require that employees perform such services. Control is indicated when the person or persons for whom the services are performed have the right to compel the worker to travel a designated route, to canvass a territory within a certain time, or to work at specific places as required.
10. Order or Sequence Set – If a worker must perform services in the order or sequence set by the person or persons for whom the services are performed, that factor shows that the worker is not free to follow the worker's own pattern of work.
11. Oral or Written Reports – A requirement that the worker submit regular or written reports indicates a degree of control.
12. Payment by Hour, Week, Month – generally points to an employer-employee relationship. Payment on a straight commission generally indicates that the worker is an independent contractor.
13. Payment of Business and/or Traveling Expenses – the worker is ordinarily an employee.
14. Furnishing of Tools and Materials – tends to show the existence of an employer-employee relationship.
15. Significant Investment – such as the maintenance of an office rented at fair value from an unrelated party, that factor tends to indicate that the worker is an independent contractor.
16. Realization of Profit or Loss – A worker who can realize a profit or suffer a loss as a result of the worker's services is generally an independent contractor such as salary payments to unrelated employees.
17. Working for More than One Firm at a Time – If a worker performs more than de minimis services for a multiple of unrelated persons or firms that factor generally indicates that the worker is an independent contractor.
18. Making Service Available to General Public – indicates an independent contractor relationship.
19. Right to Discharge – The right to discharge a worker is a factor indicating that the worker is an employee. An independent contractor cannot be fired so long as the independent contractor produces a result.
20. Right to Terminate – If the worker has the right to end his or her relationship with the person at any time he or she wishes without that factor indicates an employer-employee relationship.