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Use Caution When Reclassifying Employees

Those who are wise will learn lessons from those who came before. Northwestern Mutual Life Insurance Company is one from whose experience you may benefit. A \$200 million lawsuit filed by three former employees who claim their employment status was misclassified will, at a minimum, cost the company considerable money to defend. If Northwestern loses the lawsuit, it will cost considerably more, and the company's reputation may be tarnished either way. If you are considering reclassifying employees as exempt employees or as independent contractors, remember: While your company is reacting to economic hard times, your employees are doing the same.

Bad Economy Increases Wage and Hour Disputes

As an employment law attorney with Rutter Hobbs and Davidoff (www.rutterhobbs.com), Wendy E. Lane is familiar with disputes over employee classification, like the one in the Northwestern case. The economy has created what she calls a "double perfect storm" in wage and hour litigation.

"When there are layoffs, as has been the case recently, employees may become desperate as they run out of unemployment coverage and they can't find new employment," she says. "Adding to the problem, there may be a bad taste left in employees' mouths about the way they were terminated. What you end up with is employees who want some sort of payback from the company that let them go."

One lawsuit from one individual may be more of a nuisance than a catastrophe. But a truly disgruntled former employee may take the situation to an extreme—a

class action suit. Most of the time, lawyers will take such a case on contingency, so there is no disincentive for filing suit, Lane says. And plaintiffs' lawyers love class actions, because if they win, they get part of the overall settlement rather than of just one individual's settlement.

"The bigger the company, the bigger the potential class," she says. "It's a potential land mine for employers."

Truly Independent Contractors?

"Lots of employers are tempted, now more than ever, to classify their workers as independent contractors because they think it will eliminate unemployment insurance, workers' compensation, or meal and rest break issues," Lane says.

"It's very attractive to employers to not have to worry about employment issues by classifying somebody as an independent contractor."

However, misclassification comes at a price. "The Northwestern lawsuit illustrates one of the two different types of misclassification we see a lot. The issue in that case is whether employees were misclassified as independent contractors."

The caution for you: Look very closely at who is classified as an independent contractor, calling on your plan's counsel or other appropriate expertise as you make the decision.

If you have some independent contractors working for you and you have a signed agreement to that effect, you have more work to do. Lane says, "The law is much more complex than that."

"In California, there are up to six different agencies, including the Internal

(continued on page 2)

Revenue Service (IRS) and the Employment Development Department, which will look at whether a company is properly categorizing its workers as independent contractors versus employees. The IRS looks at up to 20 different factors to make their determination as to whether a worker is properly classified.”

Lane illustrates some of the factors involved in deciding whether a worker is an independent contractor by describing a plumbing problem.

“You call in a plumber to come to your house. The plumber tells you what time he’s going to be there. He’ll tell you how he’s going to fix the toilet, what tools he’ll use for the job, and what he’s going to wear while fixing it. The plumber is a true independent contractor and not an employee of the homeowner,” she says.

“Those are some of the same factors a business needs to look at to determine whether a worker is an independent contractor or an employee. For example, do you provide the worker with a work space, tell them when to work and what to wear, or provide them the tools to get the job done?”

Exempt or Nonexempt Employee?

“The other area of concern is misclassification of nonexempt employees as exempt,” says Lane. “Again, it is very tempting to classify employees as being exempt because then they’re not subject to the laws regarding meal and rest periods and overtime pay requirements.

“But there are considerable limitations on which employees can be designated as exempt under the various exempt classifications.”

Just one of many misclassification pitfalls that companies fall into is the

temptation to categorize as exempt any employee who has “supervisor” in his or her title.

“In the grocery and retail industry, we’ve seen allegations of employees who are designated as exempt supervisors,” Lane says. “These employees claim that they are misclassified, that they should not be exempt because they did not regularly and customarily exercise discretion and independent judgment. They then claim that they failed to receive meal or rest breaks because they always had to be on call to unlock cash registers for their employees if they need an override.”

When employees are happily employed, they may not complain. But upon termination, the same employees may claim to have been misclassified and seek pay for overtime or meal periods for their period of employment.

“Class actions are filed every day, based on facts like these, in many different industries. Not just retail, but in restaurants, financial institutions, and sales and delivery companies. We’ve seen this situation sweep through companies ranging from Walmart to FedEx to Starbucks.”

Consider Necessary Changes

Lane recommends often taking a careful look at job classifications, especially any time you make a big change.

“If there has been a big shake-up at the company, if new positions have been created, if there have been layoffs, if you’ve established new positions that didn’t exist before, or if you’ve transferred people from one position to another, you should definitely review your job classifications.

“Any time those things occur, I think it is best to consult with counsel, or at least become very knowledgeable about the law before you take action. It is easier to prevent problems if you

know what you’re getting into in advance,” she says.

She also recommends frequent reviews of employee handbooks. “Handbooks should be reviewed every year for changes in company practice and changes in the law.”

What can you take away from Lane’s expertise?

- Have a written contract. “In an independent contractor situation, having a very clearly written contract that fulfills the various factors that are going to be examined by a court or a government agency is critical.”
- Understand that having a piece of paper whereon you and the employee agree to a contractor relationship is not enough. “It’s good to have in writing, but a lot of factors determine whether or not it is valid.”
- Do internal audits. “Look at who is classified as exempt and nonexempt to make sure they are properly classified.”
- Consult with an expert in these matters, Lane says. “There is something to the adage that an ounce of prevention is worth a pound of cure.”

Stay on Top of HR's #1 Compliance Headache—FMLA

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