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LEGAL ALERT

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The High Costs of Misclassifying Colorado Workers as Independent Contractors

On June 3, 2009, Colorado's Governor A. William Ritter signed legislation intended to crack down on employers who misclassify their workers as independent contractors rather than employees. The legislation, known as House Bill 1310 (the "Act"), imposes stiff penalties on employers: fines of up to $5,000 for the first misclassifying offense, and up to $25,000 for each subsequent offense. Perhaps more importantly, an employer found to have misclassified workers willingly two or more times may be prohibited from contracting with the State for a period of up to two years.

Employees v. Independent Contractors – What is the Test?

The law sets forth various factors to be considered in determining whether an individual is properly characterized as an employee or an independent contractor. In general, the key principle is control. **In an independent contractor relationship, a company has the right to control or direct only the result of the work of the independent contractor. In an employment scenario, a company can control the results, as well as the means and methods of accomplishing the results of its employees.**

Under the Colorado Wage Act, for example, "an individual primarily free from control and direction in the performance of the service, both under his or her contract for the performance of service and in fact . . . is not an 'employee.'"[1] Guidance from the IRS is similar: "if you have the right to control or direct not only

1 C.R.S. § 8-4-101(4).

what is to be done but also how it is to be done then your workers are most likely employees. If you can direct or control only the result of the work done, and not the means and methods of accomplishing the result, then your workers are probably independent contractors."[2]

Colorado's Workers' Compensation Act, which applies to all employees within the state, excludes from the definition of "employee" any individual who is "free from control and direction in the performance of the service, both under the contract for performance of service and in fact and such individual is customarily engaged in an independent trade, occupation, profession, or business related to the service performed."[3] The statute sets out several factors that should be shown in order to prove independence, including that the company **does not**:

(A) Require the individual to work exclusively for the person for whom services are performed; except that the individual may choose to work exclusively for such person for a finite period of time specified in the document;

(B) Establish a quality standard for the individual; except that the person may provide plans and specifications regarding the work but cannot oversee the actual work or instruct the individual as to how the work will be performed;

(C) Pay a salary or at an hourly rate instead of at a fixed or contract rate;

(D) Terminate the work of the service provider during the contract period unless such service provider violates the terms of the contract or fails to produce a result that meets the specifications of the contract;

(E) Provide more than minimal training for the individual;

(F) Provide tools or benefits to the individual; except that materials and equipment may be supplied;

(G) Dictate the time of performance; except that a completion schedule and a range of negotiated and mutually agreeable work hours may be established;

(H) Pay the service provider personally instead of making checks payable to the trade or business name of such service provider; and

(I) Combine the business operations of the person for whom service is provided in any way with the business operations of the service provider instead of maintaining all such operations separately and distinctly.

Misclassification – What are the Risks?

Employers can reap large savings on employment taxes, workers' compensation, unemployment insurance, health insurance, and other benefits by classifying workers as independent contractors rather than employees. In fact, a study by the U.S. Government Accountability Office ("GAO") in July 2006 found that employers can save upward of 30 percent of their payroll costs by classifying workers as independent contractors.

While misclassification of a worker is not, per se, a violation of the law, it can lead to several illegal practices, including failing to pay mini-

2 Summertime Tax Time 2007-24, August 31, 2007.
3 C.R.S. § 8-40-202(2)(a).

mum wages or overtime as required by the Fair Labor Standards Act, failing to provide family or medical leave as required by the Family and Medical Leave Act, and failing to properly pay state and federal taxes.

The Act intends to end misclassification problems by subjecting violating employers to the penalties described above. Pursuant to the Act, Colorado's Department of Labor and Employment will conduct a statewide study to: a) determine how widespread the problem is, b) estimate lost revenues, and c) recommend whether the state should enact uniform definitions of "employee" and "independent contractor" to be applied in employment relationships.

Passage of the Act is consistent with the federal Department of Labor's statement recently that addressing the issues related to the misclassification of workers is its number one priority. Other states, including California and Utah, also have increased their efforts recently to investigate and address this issue.

Responses to the Act – What Should Employers Do?

Employers who work with independent contractors should conduct a thorough audit of those relationships, considering the factors described above, to determine whether they might have misclassified workers who are truly employees. Additionally, before entering into new independent contractor agreements, employers should seek the advice of legal counsel to determine whether their classifications of workers will withstand legal scrutiny on this issue.

Katrin Miller Rothgery, Esq.
303.634.2047
krothgery@swlaw.com

Kati is an Associate at the Denver office of Snell & Wilmer. She practices in the Labor & Employment and Commercial Litigation groups.

Elizabeth J. McNamee, Esq.
303.634.2092
emcnamee@swlaw.com

Elizabeth is Of Counsel at the Denver office of Snell & Wilmer. Her practice is concentrated in employment and labor law and she has extensive trial experience, having begun her litigation career in 1991.