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Obligations of the Corporate Status

By James Irving

One of the principal reasons business owners form a corporation (or an LLC) is to shield the owners' personal assets from attack by creditors of the business. However, the corporate shield is not absolute; while judges are loath to pierce it, they will – and may have an obligation to – if the owners of the entity fail to comply with corporate formalities and/or treat its assets as their own. Atron and Karen Rowe learned this difficult lesson when Judge James C. Cacheris entered judgment against them individually upon Plaintiff's Motion for Summary Judgment in Heitech Services v. Front Rowe, Inc. The case arose in the United States District Court for the Eastern District of Virginia.

In 1997, the Rowes, husband and wife, formed Front Rowe, Inc. ("FRI"), an information technology company operating in Fairfax, Virginia. In the regular course of business, Front Rowe entered into a contract with Heitech Services, Inc. FRI allegedly breached the contract and Heitech sued for damages. In December 2014, judgment was entered in favor of Heitech and against FRI in the amount of $450,421, but the court deferred a ruling on the Plaintiff's request to pierce the corporate veil until June 5, 2015, when the Court issued its final ruling. In it, Judge Cacheris found it appropriate to "pierce the corporate veil and hold the individual defendants liable" for FRI's contractual obligation to Heitech.

The June ruling contained the court's findings that, among other things, the Rowe's commingled their personal funds with FRI's, "regularly siphoned business assets into their personal accounts," and took money out of the company account to pay their basic living expenses. Evidence also showed that FRI was undercapitalized during this period, that FRI was not making payments on its invoices when due and that the company was not observing the business formalities prescribed by law.

The Rowes' absence of any apparent effort to comply with the requirements of proper corporate governance seems to make Front Rowe an easy case, which it may be, but that conclusion may obscure the risk that every company exposes itself to when it fails to adhere scrupulously to the niceties of corporate formality. At the most obvious level, co-mingling personal and corporate assets courts a degree of legal risk that no rational businessperson should accept.

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It's equally true that prudent management requires careful maintenance of reasonable capitalization and attentiveness to the corporate formalities required by statute - such as conducting annual meetings, electing officers and directors annually and maintaining compliance with SCC filing requirements.

Corporate status and the liability shield it provides is a common law development of ancient pedigree. It persists because lawgivers continue to recognize that immunity from personal liability facilitates commerce which benefits our society as a whole. It's a mistake, however, to assume that this freedom comes without responsibilities.

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The Financial Risks to Employers of Misclassification of Employees as Independent Contractors

By Doug Taylor

Employers, from well-established corporations to start-ups, continue to struggle to understand the legal distinctions between an employee of the business and an independent contractor. The differences can be fundamentally important to the financial well-being of businesses of all sizes, and the difficulties in comprehending the legal nuances go back many decades. More than half a century ago, the U.S. Supreme Court observed in a dispute over whether newspaper boys should be classified as employees of a publisher for purposes of collective bargaining:

> Few problems in the law have given greater variety of application and conflict in results than the cases arising in the border between what is clearly an employer-employee relationship, and what is clearly one of independent entrepreneurial dealing.

Fast forward to the present, and worker misclassification remains a huge headache for employers. Uber Technologies, Inc., the rapidly expanding company providing on-demand vehicular transportation, lost in federal district court in its bid to defeat class certification in a class action lawsuit filed against it by its California "independent contractor drivers" – individuals who utilize their own vehicles, while using Uber's software, to connect with those looking for a ride. Uber estimates that the ruling will result in a potential class of about 15,000 drivers against which it will have to defend. A similar lawsuit brought by "independent contractor" drivers is pending in Massachusetts against Uber's business rival, Lyft. Recently, FedEx agreed to a $228 million settlement fund to resolve a class action lawsuit in California brought on behalf of more than 2,000 of its Ground and Home delivery drivers who claimed damages stemming from FedEx's alleged misclassification of them as independent contractors, instead of employees. Clearly, the financial stakes for employers in all sectors of the U.S. economy is significant.

What is the motivation behind these workers' complaints? In most situations, an employer will benefit by classifying its workers as "independent contractors" rather than "employees," which would subject the employer to federal, state and local anti-discrimination laws and trigger a host of other requirements of employers, including payroll tax withholdings, workers' compensation, unemployment insurance, health care and pension obligations. The Internal Revenue Service claims that employers misclassify millions of workers nationally as independent contractors.

The U.S. Department of Labor's Wage and Hour Division ("WHD") has taken an increased interest in the issue of misclassification of employees as independent contractors, in part because it lowers overall tax revenues for the government and creates an uneven playing field for employers who properly classify their workers. In 2012 the WHD began to hire hundreds of additional investigators to pursue worker misclassification claims, the Obama

administration concluding that a federal crackdown on misclassification would yield more than $7 billion in revenue over a ten year period. At the state level, Virginia estimated in 2010 that approximately 40,000 workers throughout the state were misclassified, leading to a loss of $28 million in general fund revenue.

In July 2015, the WHD published Administrator's Interpretation No. 2015-1 for the purpose of clarifying what it believes is the test for properly classifying workers under the Fair Labor Standards Act ("FLSA"), which governs the payment of minimum wage and overtime to non-exempt employees. Rejecting as too narrow the common law "control test" which analyzes whether a worker is an employee based on the "employer's control over the worker," the WHD instead adopted a more expansive, multi-factor analysis -- the "economic realities" test -- which focuses on "whether the worker is economically dependent on the employer or in business for him or herself." The factors typically include the following:

(1) The extent to which the work performed is an integral part of the employer's business. If the work performed by a worker is integral to the employer's business, it is more likely that the worker is economically dependent on the employer and thus more likely to be classified by the WHD as an employee. The worker's work can be integral to a business, even if the work is just one component of the business or is performed by hundreds or thousands of workers.

(2) The worker's opportunity for profit or loss, depending on his or her managerial skill. This factor looks at whether the worker's managerial skill can affect his or her profit or loss, i.e., whether the worker makes decisions such as hiring others, purchasing materials or equipment, advertising and renting space.

(3) The extent of the relative investments of the employer and the worker. A worker who is really an independent contractor typically makes investments that support his or her business beyond any particular job, by making investments that would further the business's capacity to expand, reducing overhead and costs or expanding market reach. In application, the WHD will compare both the nature of the worker's investment but also compare the worker's investment relative to the employer's investment to determine whether the worker is an independent business.

(4) Whether the work performed requires special skills and initiative. The worker's business skills, judgment and initiative, as opposed to his or her technical skills, should be considered in determining whether the worker is economically independent of the employer.

(5) The permanency of the relationship. In the view of the WHD, permanency or indefiniteness in a worker's relationship with the employer is indicative that an employment relationship exists between the parties. An independent contractor typically works on one project for an employer and does not necessarily work continuously or repeatedly for an employer. A worker who is truly in business for him or herself will shy away from a permanent or indefinite relationship and the economic dependence that a relationship of that kind fosters.

(6) The degree of control exercised or retained by the employer. A worker stands alone as a separate economic entity – an independent contractor – when he or she is in control over a meaningful part of the work performed. When a worker has the authority to control the hours they work, and are subject to little or no supervision during those work

hours, the worker can be viewed as a person conducting his or her own business, according to the WHD. The worker's control over meaningful aspects of the work must be more than theoretical; the worker must actually exercise it.

In determining whether a worker is an employee or independent contractor, the WHD suggests that all of the factors encompassing the economic realities test must be considered in each case and no one factor should be determinative of whether a worker is an employee. Ultimately, according to the WHD:

> [I]ndependent contractors are those workers with economic independence who are operating a business of their own. A worker who depends on someone else's business – who is economically dependent upon the alleged employer -- is very likely to be classified as an employee.

The consequences for businesses that utilize but misclassify workers as independent contractors, especially on a large scale, can be financially debilitating and fundamentally disruptive to business operations. In the case of FedEx, for one, the recent $228 million settlement covers only affected delivery drivers in California. It is unclear what the overall financial impact on the company may ultimately turn out to be to settle similar claims nationwide, but there is little doubt that the outlay will be substantial. With increasingly aggressive enforcement by the WHD and large-scale litigation of worker misclassification claims on the rise, employers should exercise great care when making decisions about how to characterize relationships with workers.

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