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A Start-Up's Hiring Attracts Unwanted Attention

BY ABBY ELLIN

Like a lot of start-ups, Cardima Inc., a maker of medical devices in Fremont Calif., found it hard to predict how big a permanent staff it would need. So, in 1993, the company hired mostly independent contractors to fill the gap.

Independent contractors work for a specified length of time for specified pay, and the move made good business sense. But it also created a management problem. Because companies do not withhold taxes or make Social Security payments on the earnings of such workers, any decision to rely on large numbers of them usually sounds an alarm bell at the Internal Revenue Service and state employment agencies. And that is exactly what happened.

Four years later, the Employment Development Authority of California investigated Cardima, reviewing records, sifting through accounts and interviewing employees, to determine if the company was unwittingly misclassifying its independent contractors on tax forms. Instead of being independent contractors, the agency wondered, perhaps they were doing the job of a traditional employee and should be classified as such? It turns out that some of Cardima's workers were not correctly classified.

"This is a usual thing with companies, especially start-ups," said Ron Bourquin, Cardima's chief financial officer. While he was confident it had not purposely done anything illegal, he says, he ended up hiring PrO Unlimited, a company in Burlingame, Calif., that manages contingent workers for clients just to be on the safe side. (Contingent workers include independent contractors; freelancers, who do occasional work for companies at a set fee; outside consultants; and temporary, part-time seasonal employees.)

Hiring PrO Unlimited was probably a smart move, legal specialists say, because the law is so complicated and executives can probably spend their time more fruitfully planning strategy than trying to figure out all the rules.

"It's very important for business entities to be advised of how independent contractors are properly engaged," said Scott Brenner, an employment lawyer with Barton Barton & Plotkin, in Manhattan. "If a company improperly characterizes employees as independent contractors, or consultants, there is risk that the arrangements could be recharacterized by the

I.R.S., sometimes having grave unforeseen financial consequences. We advise clients that this is not generally an area to take great risk."

Indeed, the question of how to classify members of a company's work force has become more pressing as the hiring of independent contractors has become more common. The American Management Association said that 93 percent of the companies it surveyed last year employed some kind of outside workers. The study found that twice as many employers reported more use of temps and contract workers in 1999 than they had in 1996. As of February 1999, a total of 8.2 million workers — or 6.3 percent of the work force — were independent contractors, according to the Bureau of Labor Statistics.

"Management is recalibrating its relationship with labor, and changing it to be more flexible," said Barrie Peterson, associate director of Seton Hall University's Institute on Work in South Orange, N.J. He helped write the American Management Association study.

Terrie Weinand, the chief operating officer of PrO Unlimited, the company hired by Cardima, says it is easy for managers to become confused. After all, they are focused on putting out a product, not interpreting tax law. What they ought to do is to avoid even the appearance of impropriety, Ms. Weinand says.

"We try to tell people that if they know they are doing something looked upon as shady, don't mess with the I.R.S.," she said. "In 90 percent of the companies they investigate, they do find at least some that misclassify workers."

Some specialists estimate that in Silicon Valley alone, employers have paid nearly \$50 million in back taxes and fines to the I.R.S. as a result of misclassifying workers. And though many companies have policies on handling contingent workers, "the I.R.S. doesn't care what you wrote down in a policy manual, they want to know what you did," Ms. Weinand said.

"Under the law, independent contractors are

not a worker, they are a business," she added. "But when they walk across your lobby and start acting like employees, that's when the trouble starts. If they sit in a cube all day, bill hourly, have no financial investment in the business and do similar work to what your full-time employees do, then they are, technically, an employee."

It is not just the I.R.S. that is becoming involved, either. Because independent contractors receive no company benefits, the Labor Department is quick to step in if it suspects abuses. Two years ago, for example, it sued Time Warner for failure to pay health and

retirement benefits to scores of workers. A company spokesman said the matter was in litigation and declined to comment.

And in 1996, the United States Court of Appeals for the Ninth Circuit in San Francisco ordered Microsoft to pay benefits to hundred of workers that the company said were independent contractors but that the courts found otherwise. Since then, Microsoft has begun reclassifying

temporary workers as company employees if 12-month assignments have to be extended.

"This is Microsoft's way of saying to managers, 'Don't just make this a temporary assignment because it could be looked at that way. Is it a temporary assignment?'" said Kimberly Kuresman, a Microsoft spokeswoman. "If you need someone longer, let's make it a real position and hire someone full time."

She will not get any argument from Mr. Bourquin, Cardima's chief financial officer. Cardima had to pay about \$25,000 in back taxes for independent contractors found to be employees, and he does not want to have to repeat that painful experience.

"The important part is going forward and knowing you are in compliance with the law," he said. "The state then sees that you made an effort and it makes everything you do more credible."

Playing It Safe

Five tips for employers who hire independent contractors.

Make sure all new independent contractors classify themselves as businesses for tax purposes.

Keep track of how long they stay with your company.

Pay them a set fee for specified projects, not an hourly wage.

Make sure they return all company badges, keys and passes at the end of each day.

Make them sign nondisclosure agreements.

Source: PrO Unlimited

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