

# Building Your Team: Employers, Employees and Contractors

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## Agenda

- Introduction
- Hiring an Employee
- Classification of Workers and Significance
- Terms of Employment Relationship/Covenants
- Employee Equity
- Questions and Answers (but don't wait)

## Employee or . . . Not?



## Are We Having Fun Yet?



## Employees or Something Else

Employees

Laws  
Taxes  
Work Comp  
Pay + Benefits

Regulate

Contractors

The  
Wild  
West!

## Types of Workers

### Employees

- Regular or Part-Time/Casual/Seasonal
- Unpaid Interns
- Paid Interns
- Apprentices
- Owners
- Trainees

### Volunteers

- Employees or strictly volunteers

### Independent Contractors

## Employee . . . Or Not?

Why does it matter?

- Many laws apply to employees but not other types of workers
  - Employee gets W2, not 1099 like contractor
  - Wage & Hour (no minimum pay for non-employee)
  - ERISA/Benefits/ACA (no benefits required)
  - Employment Discrimination (laws don't apply to IC, but be careful in PA)
  - Labor Laws (can only unionize employees)
  - Workers Comp/Unemployment Comp (no for IC)
- Treatment of worker may change

## Example – Fair Labor Standards Act

- FLSA only applies to employees.
- Employee: “any individual employed by an employer.” 29 USC s.203(e)(1).
- Employer: “any person acting directly or indirectly in the interest of an employer in relation to an employee . . . .” 29 USC s.203(d).
- Employ: “to suffer or permit to work.” 29 USC s.203(g).
- The FLSA has “the broadest definition . . . ever included in any one act.” *United States v. Rosenwasser*, 323 U.S. 360 (1945) (quoting from Sen. Hugo Black).



## Employee v. Independent Contractor

Independent contractor status is “holy grail,” because of lack of regulation, but also strictly scrutinized

- IC arrangement should be reduced to writing
- Multiple tests for determining employee status
  - Right to Control (IRC, NLRA, ERISA, ADA)
  - Economic Reality (FLSA, SSA, FMLA)
  - Hybrid (Title VII, ADEA)
    - As a practical matter, the lines often blur between the tests, and courts, while purporting to apply either Right to Control or Economic Reality, often end up utilizing a hybrid test.

## A Unified Approach

### Murray v. Principal Financial Group (9<sup>th</sup> Cir. 2010)

- “[T]here is no functional difference between the three formulations.”
- 12 factors identified:
  - Skill required
  - Source of instrumentalities/tools
  - Location of work
  - Duration of relationship
  - Can hiring party assign additional projects
  - Hired party’s discretion over when and how long to work
  - Method of payment
  - Hired party’s role in hiring and paying assistants
  - Work part of regular business of hiring party
  - Hiring party is in business/can work elsewhere
  - Provision of employee benefits
  - Tax treatment of the hired party

## ABC Test

California ABC test is considered skewed towards finding that worker is an employee

- Under the ABC test, a worker is considered an employee unless three conditions are satisfied:
  - Worker is free from control and direction of hiring entity in connection with performance of the work
  - Worker performs work that is outside the usual course of hiring entity's business; and
  - Worker is customarily engaged in an independently established trade, occupation, or business of same nature as that involved in the work being performed

## Hiring an Employee

### Additional Considerations

- You must carry worker's compensation for employees
- You must set up an account with the state unemployment compensation agency and withhold from wages for UC tax
- You must withhold federal and other state taxes (and in some instances local taxes)
- You must provide health benefits under ACA (threshold is typically 50 employees)

## Hiring an Employee

### Preliminary Considerations

- Background checks
  - Pros (can learn important information) and Cons (can learn information which can form the basis of a lawsuit, e.g., arrest record, participation in a group associated with a certain religion)
  - Pre-offer or post-offer, pre-hire
  - Authorization to work in the U.S.
    - Compare to asking about immigration/citizenship status
  - Don't discriminate

## Hiring an Employee

### Preliminary Considerations

- Employment-at-Will
  - Pennsylvania is traditional at-will state
  - Employee can be terminated at any time for any reason or no reason at all; similarly, employee can leave at any time for any reason
  - “Very strong” presumption of at-will employment
  - Presumption can be overcome if EE has:
    - Employment contract for a term
    - Employment contract which provide for just cause dismissal only

## Hiring an Employee

### Preliminary Considerations

- Employment-at-Will (cont.)
  - May be a written or oral contract, and terms can be implied, but there must be an actual contract
  - Do you want employee to be at-will?
    - Offers flexibility, which is desirable
    - Main reason for taking relationship out of at-will realm is because employee is key to success of business and you don't want him to leave suddenly

## Hiring an Employee

### Compensating the Employee

- Exempt or Non-Exempt
  - Non-exempt employees must be paid minimum wage and overtime (1.5x) for hours worked in excess of 40 in a week (comp time not permitted in private sector)
    - Federal minimum wage is \$7.25/hour, but note that state law may be higher, and employer must pay higher wage/follow law more beneficial to employee
  - Exempt employees need not be paid minimum wage or overtime



## Hiring an Employee

### Exempt Employees

- While exempt employees need not be paid overtime, they must be paid a “salary” of at least \$684/week.
  - A salary is a weekly payment that does not vary based upon quality or quantity of work
    - Only limited deductions permitted to salary
  - One exception to salary requirement: if the employee is at least a 20% owner
- Must meet duties requirement
  - There is such a thing as “salaried non-exempt,” i.e., not all salaried employees are exempt

## Employment Agencies - Joint Employment

- Under joint employment doctrine, employee of Company A can be classified as employee of Company B even though B intends to retain employee as independent contractor
- Example: Worker hired through employment agency
- Analysis may change depending on circumstances, but factors are similar to independent contractor tests described earlier
- New NLRB test focuses on right to control rather than actual control

## Unpaid Interns/Trainees

Primary Beneficiary Test (no single factor determinative):

- Parties understand intern is not entitled to comp.;
- Internship training similar to that in education env.;
- The intern's completion of the program entitled him or her to academic credit;
- The internship corresponds with academic calendar;
- The internship's duration is limited to the period where the internship educates the intern;
- The intern's work complements rather than displaces the work of paid employees while providing significant educational benefits; and
- Understanding that intern is not entitled to paid job.

## Unpaid Interns/Trainees

### Additional Considerations

- May pay interns if hiring entity wants to (can be subminimum)
  - But if you pay them, you will likely need to withhold and deduct payroll taxes
- Interns likely not entitled to UC benefits if not paid or hire is for a project or a specific duration
- Interns may need to be covered by workers compensation unless unpaid and work sporadically or occasionally, e.g., casual employee
- Regulatory change?

## Volunteers

For profit versus non-profit

- Volunteer provisions of FLSA limited to individuals who perform hours of service for public agency for civic, charitable or humanitarian reasons, without promise, expectation or receipt of compensation for services rendered.
- Charitable entities may also utilize the help of volunteers outside FLSA coverage (DOL: volunteer status applies to “those individuals performing charitable activities for not-for-profit organizations.”).
- DOL: “Employees may not donate their services to their for-profit employers.”
- Volunteers not treated as employees.

## Volunteer Considerations

Relevant factors for distinguishing between volunteers and employees:

- Expectation of compensation;
- Immediate/primary benefit;
- Integral to business;
- Coercion/pressure;
- Time of activity;
- Similarity between volunteer activity and job duties;
- Length of relationship;
- Part-time/Full time.

## For-Profit Volunteers?

“[T]o say that one cannot under any circumstance volunteer for a for-profit entity might be too sweeping a statement.”

- Charitable or civic activity;
- Activities occur outside of normal working hours;
- No obligation to participate or ramifications for choosing not to participate;
- No expectation of compensation;
- Activities performed are different from duties normally performed by employees.

## Apprentices

- Over 950 occupations recognized as apprenticeable.
- Apprentice program must be registered with either DOL or state apprenticeship agency (half of the states have such agencies).
- Program provides some opportunity for unpaid training, but work is paid.
- Potential sources of funding exist for apprenticeship programs.
- Likely covered by WC and UC laws



## Employment Agreements for Start-ups

- Start-ups should always have written agreements with employees
  - Oral agreements are enforceable
  - Avoid misunderstanding (potential litigation)
  - Enforceable covenants



Review carefully!!!!



## Key Terms

- Roles and responsibilities/expectations
- Compensation
  - Base
  - Bonus
  - Expenses
- Benefits
- Term and termination
  - At-will
  - Severance (don't overdo this)
  - Accrued Compensation (e.g., commissions)

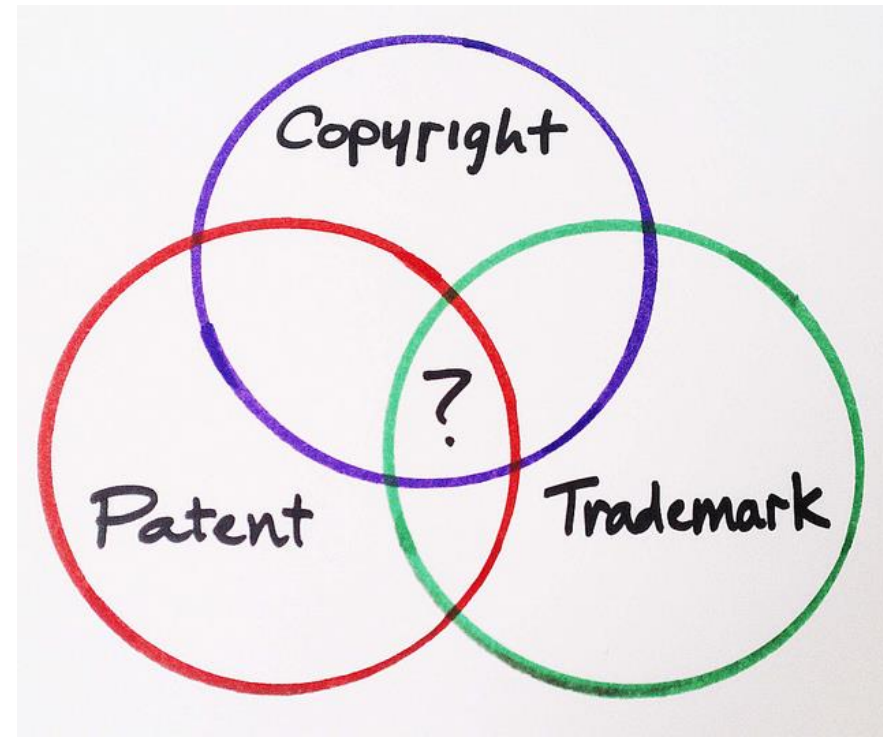
## Important Provisions for Start-Ups

- Invention Assignment
- Confidentiality
- Non-Competition
- Non-Solicitation



## Intellectual Property

- Use of Third Party Confidential Information
  - Representation
  - License
- Invention Assignment
  - Significance
  - Current
  - Prospective obligation
- Definition of “Invention”





## Confidentiality Provisions

- Definition of “Confidential Information”
  - In general
  - Typical exceptions
  - Customer confidential information
- Covenants
  - Maintain confidentiality
  - Restriction on use for other purposes

## Non-Competition

- Consideration (sign before employment)
- Length of time
- Substantive scope
- Geographic scope
- Reasonableness
- Recent developments



## Proposed Federal Trade Commission Rule

- Non-compete provisions would be unfair methods of competition
- Applies to employees and contractors
- Existing non-competes would need to be rescinded
- Would not affect non-competes by sellers of businesses
- Supersedes state laws
- Permanently enjoined
- NLRA consideration



## Non-Solicitation

- Employees (current; former)
- Customers
  - Current customers (note: What are current customers?)
  - Prospective customers
- Suppliers
- Length of Time

## Enforcement

- Remedies
  - Injunctive Relief
  - Extension
  - Buy-back stock (see equity plan)
  - Collection of legal fees/costs
- Forum for litigation
  - Arbitration v. Courts
- Governing Law



## Employee Equity – Types of equity

- Restricted Stock
- Options
  - Qualified options
  - Non-qualified options
- Profits Interests
- Phantom Equity Plans



## Important Terms

- Vesting
  - Time vesting
  - Performance vesting
- Repurchase Right
  - Vested
  - Non-vested



## Restricted Stock

- Taxed upon receipt
- Section 83 and Section 83(b) Election
- Potential capital gain treatment
- Current Ownership
  - Participate in dividends
  - Voting
- Most useful early
- Consider funding the tax liability

## Non-Qualified Stock Options

- No tax upon receipt
- Taxed upon exercise at ordinary income rates (fair market value less exercise price)
- Taxed upon sale (capital gain) (sale price less fair market value at time of exercise)
- No ownership of stock until option is exercised
  - No participation in dividends
  - No voting

## Illusive Qualified Stock Options

- No tax upon receipt
- No tax upon exercise (subject to alternative minimum tax on fair market value over exercise price)
- Tax at capital gain upon sale
- No ownership of stock until option is exercised
  - No participation in dividends
  - No voting

## Restrictions for Qualified Options (among others)

- C Corporations only
- Option price must be at fair market value
- **Must hold stock for at least one year after exercise**
- Shareholder approval of plan
- Employees only
- Non-transferable
- Must be exercised within 90 days after termination of employment
- Special rules for 10% shareholders (exercise price of 110% of fair market value; 5 year exercise period)



## **Profits Interests (LLC's and Partnerships Only)**

- Share in value in excess of value upon receipt
- No tax upon issuance
- Treated as a member (share in distributions)
- Voting v. non-voting
- Issue regarding employee v. partner (K-1 v. W-2)
- Potentially confusing to recipients

## Example

### Assumptions:

|                        |                                         |
|------------------------|-----------------------------------------|
| Company initial value: | \$500,000                               |
| Sale at 3 years:       | \$5,000,000 valuation                   |
| Employee:              | 1% (1,000 shares out of 100,000 shares) |

### Tax Rates:

|                  |     |
|------------------|-----|
| Ordinary Income: | 32% |
| Capital gain:    | 20% |

## Example

### Restricted Stock

- Tax on receipt:  $32\% \text{ of } \$5,000 = \$1,600$
- Tax on sale:  $(\$50,000 - \$5,000) \times 20\% = \$9,000$
- Proceeds to Employee:

|                            |
|----------------------------|
| \$50,000                   |
| (1,600) initial tax        |
| <u>(9,000) tax on sale</u> |
| \$39,400                   |

## Example

### Non-qualified Options

- No tax on receipt
- Exercise Price: \$5,000
- Tax on exercise:  $(\$50,000 - \$5,000) \times 32\% = \$14,400$
- Proceeds to Employee:

|                        |
|------------------------|
| \$ 50,000              |
| (5,000) exercise price |
| <u>(14,400) tax</u>    |
| \$ 30,600              |

## Example

### Comparison of After - Tax Proceeds

|                       |          |
|-----------------------|----------|
| Restricted Stock:     | \$39,400 |
| Non-Qualified Option: | \$30,600 |
| Profits Interest:     | \$36,000 |

## Bottom Line on Equity

- Restricted stock is best if company has low value
- Profits interests are attractive if entity is a limited liability company (but, again, are confusing)
- Non-qualified options are an attractive vehicle
- Don't forget about 83(b) elections



## Considerations in the Amount of Equity

- The purpose is to attract and maintain talent
- Think about the future
- Many employees do not value equity
- An option pool can be replenished
- 10-15% employee option pool is “standard”
- A large pool may work against the Company in a financing

