Under suspicion

Preventing pseudo self-employment: do's and don'ts for multinationals

By Dr. Thilo Mahnhold and Dr. Daniel Klösel

A multinational challenge

Whether in Germany or the United States, contracting models have recently been receiving widespread attention in both the media and the legal arena. The global transportation network company Uber just settled a class-action employee misclassification suit in California by paying $100 million to 385,000 Uber drivers. And FedEx, to name another multinational, has to deal with several contractor misclassification suits (of package drivers) in the United States.

Part of the team? It depends on the daily business with the contractor.

The situation in Germany is no less controversial. The classification of Ryanair pilots as contractors has just been questioned, and even public prosecutors have picked up the Ryanair case. Daimler has agreed to pay an administrative fine of €9.5 million for the misclassification of its test drivers. New laws with the intention of further restricting the hiring of employees and regulating contracting models are now on the way. Crowd work and other forms of "work on demand" are the next major topics German politicians, trade unions and other stakeholders are focusing on.

To make a long story short, contracting is under suspicion and is full of pitfalls: not only in Germany, but also in other European countries and in the United States. A new challenge for multinationals' contractor compliance – established in light of CSR and fraud prevention – is making its mark!

What is the motivation for prevention?

To understand the significance of and motivation for prevention strategies, it should be sufficient to apply a legal perspective in taking a brief look at the large variety of liability risks arising from a misclassification.

- *Employment law:* In the event of misclassification, the very strict German employment law standards would →

apply to the relationship with the purported contractor. This includes, but is not limited to, termination protection and the application of any employment-law statutes governing working time, sick pay, vacation, maternity leave and the like.

- *Social security law:* In addition, the company would also be obliged to pay both the employer's and the employee's social security contributions for up to approximately 40% of the contractor's gross salary (up to the contribution assessment ceiling) retroactively for up to four years (should the employer act deliberately, for up to 30 years).

- *Tax law:* Furthermore, the company could be generally liable for outstanding income taxes the contractor may not have paid in the past. In addition, VAT might also be a major issue: Someone who is in truth an employee is neither authorized to show VAT in his or her invoices nor is she or he entitled to deduct input tax.

- *Criminal law:* There is a criminal law provision that stipulates that company's representatives who withhold employee contributions to the social security system could face incarceration of up to five years or a fine if found guilty, regardless of whether or not wages or salaries are actually being paid.

The wording of the contract and the will of both parties to enter into an independent contractor relationship can, however, only provide a preliminary orientation.

Aside from these legal consideration, protection of a company's reputation is an important goal when a multinational tries to prevent pseudo self-employment. Companies have to anticipate they might be the subject of negative media attention if they retain "illegal" employees. Another aspect that especially multinationals should consider is the fact that a negative media campaign could quickly spread across national borders, possibly making it harder to enter new local markets. Uber, for example, is facing serious difficulties in developing its European business.

What does pseudo self-employment mean?

The German statutory law, and even case law, do not sufficiently define selective criteria for distinguishing between "dependent" employees and "independent" contractors. For this reason, all relevant indications for dependent or independent work performance must be checked and evaluated in an overall assessment process. The following circumstances could indicate pseudo self-employment:

- Probably the strongest indication of pseudo self-employment is the employer's right to issue directives on both the place and time as well as the details of the contractor's work.

- Another important indication is the involvement of the pseudo self-employed contractor in the employer's organization insofar as he or she performs services alongside regular employees and/or uses the employer's facilities for his or her work.

- Pseudo self-employment is also indicated if the contractor is obliged to render the services in person. Here, the contractor's use of his or her own employees or those of third parties is a particularly strong indication that he or she is self-employed and will be the decisive indicator in most cases.

- Another major factor within the context of an overall assessment is the extent of the contractor's work performance in comparison with regular full-time and part-time employees.

- Further elements indicating either employment or pseudo self-employment include: (a) the employer has regular employees who perform the same or similar work, (b) restricted liability in the case of default in performance, (c) absence of typical features indicating entrepreneurial activity, (d) inclusion in the vacation and substitution plan.

In summary, it can be said that the agreement on and the organization of the contractor's services within the daily business are relevant to the overall assessment process. The wording of the contract and the will of both parties to enter into an independent contractor relationship can, however, only provide a preliminary orientation. The ultimate deciding factor is the organization of the contractor's work performance within the day-to-day business.

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Misclassification a new challenge for contractor compliance

So what can one do? In particular, those companies that outsource core functions of their business will easily face severe compliance risks if they do not review their business relationships with contractors in light of the aforementioned criteria. Due to financial exposure, the risk of criminal liability and threats to the company's image, it is merely a logical step to integrate contractor misclassification risks into a multinational's compliance strategies. New laws such as those currently being planned in Germany, modern forms of labor such as crowd work and scrum, or specific conflicts with contractors can serve as driving factors to assess contracting models from a compliance perspective.

The outcome of such initiatives depends very much on the risks, the degree of contractor involvement in the company and the specific compliance approach of the respective multinational. Accordingly, a risk assessment must be the starting point for such compliance strategies. Of course, the contracts with contractors are the first ones that will need to be assessed and will typically provide the first source of surprises: In some cases, written contracts will be missing or the contracts will be comprised of wording that is typically used to describe the duties of employees.

The next step – more challenging and, in the end, more decisive – is assessment of the everyday business with the respective contractors. Even a perfectly drafted contract will not prevent misclassification if the contractor is treated as an employee in fact. Tools to detect such deviations are, for example, interviews, visits to sites in order to understand the collaboration interfaces with contractors, or training measures. Risk prioritization can play a key role in making such risk assessments feasible and reasonable.

Key elements of contractor compliance

The final step is to consider the question of what compliance measures need to be taken after the risk assessment. The answer is simple: There is no-one-size-fits-all approach. Drawing from the risk assessment, the respective compliance tools will have to be customized. There is a wide range of potential measures, and the discussion on CSR and fraud prevention teaches the lesson that it would be short-sighted to limit this approach to the principal. The higher the compliance risk and the more complex the organization of the contractor, the greater the interest is in including the contractor in any compliance strategy. Internally, ongoing information about the do's and don'ts of collaboration with contractors is a typical component of any compliance strategy, at least for employees who work at interface points with contractors, regular training is another.

Furthermore, multinationals are well advised to establish effective contract and compliance management. Potential cases of misclassification should be investigated, solved and documented. Contracts should be in writing and documented comprehensively. If appropriate and in correlation with the risk assessment, such contracts could also oblige the contractor to execute compliance measures in relation to his or her own employees. This could comprise the duty to inform and train at least key personnel on an ongoing basis about their do's and don'ts and their role as employees of the contractor and not of the principal. Before contracting with new third parties, contractor due diligence should be executed. And especially in the case of outsourcing a company's own core functions, organizational measures limiting and controlling interfaces between the employees of the principal and the contractor can make sense.

All in all, such strategies are no guarantee that cases of misclassification will never occur. But these kinds of strategies can serve as important tools for preventing and mitigating risks and would definitely serve to build a strong line of defense if the public prosecutor or the tax and social security authorities knock on a multinational's door. <–

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