A dangerous practice

Independent contractors vs. employees – A serious HR compliance issue

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Despite recent efforts by the German legislature to deter companies from using independent contractors instead of hiring employees as part of their own work force, many companies persist in this practice. To these companies, it seems, the advantages of using independent contractors (including the lack of obligation to pay social security contributions, pay minimum wages, grant vacation or paid sick leave, provide employment termination protection, etc.) still outweigh the significant risks that come with engaging independent contractors to perform tasks traditionally carried out by employees. Not only can those contractors or workers ultimately be considered employees of the company in the eyes of the law, but the possible consequences can be severe — including substantial financial damages and even criminal penalties, as well as occupational bans for the managers responsible. Companies face these kinds of repercussions on a regular basis, and investigations by the competent authorities have even been on the rise. In light of this,

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observers might ask whether those risks are being taken deliberately, or if the managers in charge simply are not fully aware of them. In any event, the trend raises two major questions: How can a company avoid legal trouble in the first place? And what should a company do if the authorities are already investigating?

What is at stake?

Before answering these two major questions, it is important to first expound on what precisely is at stake if independent contractors are engaged and classification issues arise. In such cases, the essential compliance risk stems from the fact that under the law, individuals working as independent contractors are considered protected employees of the company for whom they are engaged. Consequently, the company is obligated to pay social security contributions for those individuals (past and present). This can be especially damaging when the independent contractor has either not paid social security contributions or not paid them in full (for example, as a result of divergent work requirements on the part of the independent contractor and that of the company). Apart from the significant financial claims made by social security authorities (including the 50% share of the contributions otherwise considered the responsibility of the individual) and the accrual of default interest, intentional failure to pay social security contributions constitutes a criminal offense. The requirements for "intent" are easily met — for example, when a company's managers see a classification issue but persist in treating the individuals as independent contractors (or employees of independent contractors). An offense of this kind can result in up to five years imprisonment, and in particularly serious cases, even up to 10 years. In addition, if the offense is committed by a managing director of a German limited liability company *(GmbH)* or a board member of a corporation and if the individual concerned is sentenced to at least one year in prison for failure to pay social security contributions, he or she is prohibited from serving as a managing director or board member for a term of five years (even if the prison sentence is suspended).

How to avoid legal trouble in the first place

To avoid legal trouble altogether when engaging independent contractors, the first step is to look at the criteria developed by the courts and the legislature to differentiate between independent contractors and protected employees. The second step is to comply with those criteria. Under the law, an individual working for a company is considered an employee of that company if the individual is (a) subject to the control of the company in terms of content, execution, time and location of their work; and (b) integrated into the company's work organization. Whether those criteria are met is determined by examining a number of sub-criteria with the totality of the circumstances under consideration. The criteria tend toward qualifying an individual as an employee if he or she:

- Works on the company premises
- Appears in the company's shift schedule
- Must ask the company for approval vacation time
- Uses a company email address
- Uses the company's work equipment
- Works together with regular employees of the company
- Does the same work that employees of the company do or have done
- Is not liable for any work outcomes or damages he or she causes to the company and/or third parties while working on behalf of the company.

Whether the above criteria and sub-criteria are met depends on actual practice, not what is written down in the contract. However, when a written contract is indicative of an employment relationship rather than an independent contractor relationship, the courts tend to qualify the relationship as employment relationship without examining how it looks in practice.

While there are certainly cases where classification by means of the aforementioned criteria and subcriteria is fairly straightforward, in many situations, classification is tricky. Indeed, there is only one reliable way for a company to be perfectly safe in this realm: Hire your own employees or engage temp workers! If neither is an option (for economic or regulatory reasons, for example) and though a responsible legal adviser can do very little, he or she can at least mitigate risks by carefully analyzing situations on a case-by-case basis. Drawing on the legal adviser's recommendations, the company can fulfill the criteria to the fullest feasible extent. Where possible, the company can also take advantage of one or more of the very few loopholes the legislature has left open in certain circumstances. Depending on the client's risk affinity, this may help create a situation where the risk is deemed acceptable.

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What to do if authorities are already investigating

Sometimes it is too late to take measures to prevent legal issues: the authorities are already investigating. The most important thing for a company to do in these circumstances is to immediately seek legal advice from experienced counsel — ideally from an external law firm that not only provides outstanding legal advice on employment and social security law, but also has experience defending companies in the course of investigations performed by the special division of the customs office tasked with prosecuting these cases. A team of employment law experts and criminal lawyers is needed to generate the best possible outcome for the company. It is vital to be aware that the biggest mistakes are typically made at the beginning of the investigation. For example, critical information is often shared with investigators, even though there is no obligation to share it. Conversely, many companies try to cover up the compliance breach by talking to potential witnesses or destroying documents or emails — actions that can very easily land the managers responsible in investigative custody. Invariably, the best way to proceed during an investigation is to work on a compre-hensive defense strategy that encompasses the relevant substantive legal issues in employ-ment and social security law, the relevant criminal procedural issues, and a well-deliberated level of cooperation with the investigating authorities.

Conclusion

In summary, companies should be aware of the substantial compliance issues linked to the engagement of independent contractors. When working to distinguish independent contractors (or employees of independent contractors) from employees of the company, only a detailed legal analysis can mitigate risks (namely, financial damages and criminal penalties). If authorities are already investigating a company, two things are necessary: a comprehensive strategy that encompasses substantive legal issues in employment and social security as well as procedural and tactical questions, and a defense team that comprises both employ-ment and social security law experts and criminal lawyers. <–

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