Is Your Partner a Plaintiff?

Evolving Employment Laws for Partners and Shareholders

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I. INTRODUCTION

Determining whether partners and shareholders of professional service firms can bring claims as "employees" under federal and state antidiscrimination laws is an issue that only recently has become worthy of study. In decades past, this topic could have been addressed with a 30-second presentation: "equity partners and shareholders are owners, and employers, and therefore cannot sue as 'employees.'"

Today, thanks to initiatives by the United States Equal Employment Opportunity Commission ("EEOC"), a 2003 Supreme Court decision on what constitutes an "employee" under the Americans with Disabilities Act, and the ever-changing nature of professional partnerships and corporations, the issue has become much more complex and fact-specific. As a result, more and more partners and shareholders may in fact be deemed "employees" under such laws, regardless of whether they or their firms intended it.

This article and presentation addresses this evolving issue, which is of special, selfish interest to most lawyers -- who are employed by either partnerships or professional corporations that could be subject to attack. First, we begin with an overview of past and current federal case law on this issue. Case law is really the only substantial area to analyze, as most statutory definitions of "employee," if they exist at all, are circular and unhelpful. This analysis includes the Supreme Court's groundbreaking decision in *Clackamas Gastroenterology Associates, P.C. v. Wells*, 538 U.S. 440 (2003), which greatly complicated the issue -- and requires an ever-expanding, contextual and multi-factored analysis.

Second, we focus on the EEOC's role in all of this, including the six factors articulated in its Compliance Manual guidelines, which the Supreme Court expressly endorsed in *Clackamas*.

Third, we move to a more focused analysis of the EEOC's role in pushing this issue with law firms, specifically the case of *EEOC v. Sidley Austin Brown & Wood*, in which Sidley Austin is under attack by the EEOC (and to a lesser extent the Seventh Circuit Court of Appeals) for allegedly discriminating against older "partners" in both demotion decisions and in its mandatory age-based retirement plan.

Fourth, we look at how Pennsylvania and New Jersey courts have grappled with this issue. The bottom line: if you are a law firm, you are safer in Pennsylvania; if you are itching to sue your firm, you may be better off in New Jersey.

Fifth, and finally, we address what law firms and professional corporations can do to mitigate the risk that their partners and shareholders will be deemed "employees," and try to sue them for discrimination. This includes specific recommendations to protect age-based retirement plans against attack by their partner/shareholder participants.

II. FEDERAL LAW ON PARTNERS & SHAREHOLDERS AS "EMPLOYEES"

Most federal antidiscrimination laws (e.g., Title VII of the Civil Rights Act of 1964, the Americans with Disabilities Act, the Age Discrimination in Employment Act, the Equal Pay Act and the Pregnancy Discrimination Act) limit their protections to "employees," without adequately defining that term. For decades courts consistently ruled that partners (and, to a lesser extent, shareholders of professional service firms) could not sue as “employees” because they owned and controlled the firms, and therefore were more like employers than employees. However, just as the nature of law firms has changed over the past 40 years -- and in part, because of that change -- the law has evolved. This section gives a brief overview of that evolution, including the present state of the law.

A. Historic Standards and Evolution of Law, Prior to *Clackamas*

Before jumping to the current standards, it is beneficial to review the historic trends and standards on this issue.

1. The per se rule -- if the law calls me a partner, I’m not an employee

a. *Burke v. Friedman,* 556 F.2d 867 (7th Cir. 1977): This seminal decision looked to partnership statutes and the language of Title VII in determining that partners are, as a matter of law, distinct and different from employees because, *inter alia*, partners share in the management, profits and losses of a business. The Seventh Circuit later held that the roles of partners and employees are mutually exclusive, and later expanded the reasoning of *Burke* to shareholders of professional corporations.

b. *Hishon v. King & Spalding,* 467 U.S. 69 (1984) (Powell, J., concurring): Justice *Powell* emphasized that the relationship among law partners is not an “employment” relationship for the purposes of Title VII:

> The relationship among law partners differs markedly from that between employer and employee -- including that between the partnership and its associates. The judgmental and sensitive decisions that must be made among the partners embrace a wide range of subjects. The essence of the law partnership is the common conduct of a shared enterprise. The relationship among law partners contemplates that decisions important to the partnership normally will be made by common agreement or consent among the partners.

Id. at 79-80 (record references and footnotes omitted)

> Perhaps presciently seeing the changes that were beginning to take place in large accounting firms and law firms, Justice Powell dropped a footnote to his opinion stating: “Of course, an employer may not evade the strictures of Title VII simply by labeling its employees as ‘partners.’” *Id.* at 79 n.2.

2. Economic realities test -- show me the money

Courts gradually began to take a more sophisticated view of the partner-employee issue in the mid-1980s, looking beyond corporate form to the underlying economic realities of the relationship. *See generally* David A. Rappaport, *A Coming of Age?: Why Revised EEOC Guidelines May Force Firms To Protect Against Partner Age Discrimination Suits*, 59 Wash. & Lee L. Rev. 1013 (2002). The "economic realities" test originally developed as a way to distinguish between employees and independent contractors under laws such as the Fair Labor Standards Act. As the name implies, the test focuses on the pecuniary relationship between the business and the so-called employee.

a. *Wheeler v. Hurdman*, 825 F.2d 257 (10th Cir. 1987): Rejecting the per se rule as applied to partnerships, and holding instead that the "economic realities" of the relationship must be analyzed. Under this test, relevant factors include: "(1) the degree of control exerted by the alleged employer over the worker; (2) the worker's opportunity for profit or loss; (3) the workers' investment in the business; (4) the permanence of the working relationship; and (5) the degree of skill required to perform the work." *Id.* at 277.

b. *EEOC v. Dowd & Dowd, Ltd.*, 736 F.2d 1177 (7th Cir. 1984): Holding that alleged pregnancy discrimination case could not be pursued because shareholders of law firm did not count as "employees" to meet Title VII's 15-employee threshold. The "economic reality" of being a shareholder in a law firm under Illinois law established that the "management, control, and ownership of the corporation is much like the management, control, and ownership of a partnership." Therefore, like partners, shareholders could not be counted as "employees."

3. Organizational form controls -- the second circuit's former approach

a. *EEOC v. Johnson & Higgins, Inc.*, 91 F.3d 1529 (2d Cir. 1996): Swinging the pendulum in a direction opposite the Seventh Circuit's per se rule that partners are not employees, the Second Circuit held that an insurance brokerage and consulting firm that chose to organize itself as a professional corporation had forfeited its right to assert that its shareholder/directors were *de facto* partners, and exempt from coverage as employees under the Age Discrimination in Employment Act. The court rejected the employer's argument that the shareholders were analogous to partners, and quoted its prior decision in *Hyland v. New Haven Radiology Assocs.*, 794 F.2d 793, 798 (2d Cir. 1986):

> The fact that certain modern partnerships and corporations are practically indistinguishable in structure and operation .

> . . is no reason for ignoring a form of business organization freely chosen and established. . . . Having made the election to incorporate, they should not now be heard to say that their corporation is "essentially a medical partnership . . ."

4. Totality of the circumstances approach -- precursor to C*lackamas*

Driven by the ever-changing forms of partnerships, limited partnerships and professional corporations under state law, courts eventually began returning to a more traditional common-law, fact-specific analysis -- rather than fixed rules -- in determining "employee" status under federal anti-discrimination laws.

a. *Simpson v. Ernst & Young*, 100 F.3d 436 (6th Cir. 1997): Former managing partner of accounting firm was discharged as part of firm-wide reduction in "excess staff capacity" ordered by secret vote of management committee. Plaintiff sued for age discrimination. The Sixth Circuit reviewed various standards used to determine whether a partner or owner is also an employee for purposes of various employment laws, endorsed a "case-by-case resolution based on the totality of the circumstances," and held that it was best to apply common-law principles to assess whether Simpson was truly an "owner" of the large accounting firm. The court noted that despite various partnership agreements, "partners" in Simpson's position had "no bona fide ownership interest, no fiduciary relationship, no share in the profits and losses, no significant management control . . . and no job security." *Id.* at 442 (quoting district court decision).

- Large national law firms, though much smaller than Ernst & Young, took notice of this case and filed 16 *amici curiae* briefs in support of the unsuccessful petition for Supreme Court review. Today, even more national law firms have reason to be worried, as they have grown larger and more like national accounting firms than the nostalgic notion of a small, democratic law partnership, as described in Powell's concurrence in *Hishon v. King & Spalding*, *supra*.

b. *Serapion v. Martinez*, 119 F.3d 982 (1st Cir. 1997): Former equity partner in five-partner law firm sued for sex discrimination under Title VII. The First Circuit rejected making coverage decisions based on partner "labels" and instead focused on the critical attributes of "ownership, remuneration, and management" in determining that plaintiff, despite her smaller equity share, was a bona fide partner, and not an employee.

B. *Clackamas Gastroenterology*: Common Law and EEOC Factors Must Be Analyzed To Determine Whether Shareholders Are "Employees" Under ADA.

The evolving and difficult issue of determining whether a partner or shareholder of a professional firm should count as an "employee" under the nation's anti-discrimination laws came to head in the case of *Clackamas Gastroenterology Associates, P.C. v. Wells,* 538 U.S. 440 (2003).

In *Clackamas*, the United States Supreme Court faced the issue of whether four physician-shareholders of a small medical clinic in Oregon should be considered "employees" under the Americans with Disabilities Act of 1990 ("ADA") for purposes of determining whether the petitioner, Clackamas Gastroenterology Associates, was an ADA-covered "employer" with a workforce of "15 or more employees . . ." In deciding that such physician-shareholders could be counted as "employees" under the ADA's definition of employer, 42 U.S.C. § 12111(5), the Supreme Court opened the door for lower courts to reexamine the related issue of whether shareholders and partners of employers could sue as "employees" under federal anti-discrimination laws.

In *Clackamas*, the plaintiff was not a physician-shareholder, but rather a bookkeeper terminated by the medical clinic. The clinic denied that it was covered by the ADA, claiming it did not have 15 or more employees, as the ADA requires for coverage. The clinic excluded from its definition of employees the four physician-shareholders who owned, managed and worked at the clinic. The district court granted summary judgment to the clinic, holding that the "economic realities" test applied, and concluding that the four doctors were "more analogous to partners in a partnership than to shareholders in a general corporation," and therefore were "not employees for purposes of the federal antidiscrimination laws." *Id.* at 442. The Ninth Circuit reversed, holding that it was improper to treat a professional corporation as a partnership. 271 F.3d 903.

The Supreme Court noted that the ADA, like most federal antidiscrimination statutes, did not helpfully define "employee." As a result the court followed its precedent in *Nationwide Mut. Ins. Co. v. Darden,* 503 U.S. 318 (1992) (determining issue of whether an independent contractor is an "employee" under ERISA), and held that courts must apply a common-law test, including traditional notions of the master-servant relationship, in determining who is an employee under the ADA.

The court expressly rejected the petitioner's argument analogizing the shareholder-employees to partners in a partnership, and clearly communicated that today's large law firms and other partnerships may be subject to viable claims by partners as "employees":

> The question whether a shareholder-director is an employee, however, cannot be answered by asking whether the shareholder-director appears to be the functional equivalent of a partner. **Today there are partnerships that include hundreds of members, some of whom may well qualify as "employees"**

> **because control is concentrated in a small number of managing partners.**

Id. at 446 (emphasis added).

In setting the new standard for determining whether a partner or shareholder is an "employee," the court held that "the common-law element of control is the principal guidepost that should be followed." *Id.* at 448. The court then endorsed the six, non-exhaustive factors identified by the EEOC as relevant in determining whether a shareholder-director is an employee:

- Whether the organization can hire or fire the individual or set the rules and regulations of the individual's work
- Whether and, if so, to what extent the organization supervises the individual's work
- Whether the individual reports to someone higher in the organization
- Whether and, if so, to what extent the individual is able to influence the organization
- Whether the parties intended that the individual be an employee, as expressed in written agreements or contracts
- Whether the individual shares in the profits, losses, and liabilities of the organization

Id. at 449-50 (quoting EEOC Compliance Manual § 605:0009).

These six factors do not create a "shorthand formula or magic phrase" to resolve these issues, the court warned. *Id.* at 450, n.10. The court also rejected any standard that relies on position titles and corporate form: "The mere fact that a person has a particular title -- such as partner, director, or vice president -- should not necessarily be used to determine whether he or she is an employee or a proprietor." *Id.* at 450. Likewise, the court anticipated and rejected the argument that the "mere existence of a document styled 'employment agreement'" would "lead inexorably to the conclusion that either party is an employee." *Id.* Instead, the court ensured that employment lawyers will be kept busy for years to come on this issue, holding that in determining partner- or shareholder-versus-employee disputes, as with those relating to independent-contractor-versus-employee, "all of the incidents of the relationship" are relevant "with no one factor being decisive." *Id.* at 450-51.

1. Courts have since applied *Clackamas* to the determination of whether partners and shareholders may sue as "employees" under EEO laws

- *Panepucci v. Honigman Miller Schwartz and Cohn, LLP*, 408 F. Supp. 2d 374 (E.D. Mich. 2005): Applying *Clackamas* in the context of a law firm partner claiming gender and disability discrimination to determine whether a partner can sue for discrimination as an employee (as opposed to *Clackamas'* focus on whether non-plaintiff shareholders were employees for purposes of the 15-employee requirement), the court held that the complex issue of determining whether plaintiff was an "employee" was not appropriately determined on a motion to dismiss.

    - ***Observation:*** *Panepucci* exemplifies the increased litigation that can be expected as a result of *Clackamas*. Even when the plaintiff is a bona fide partner, and the law firms and partnerships are confident they can ultimately prevail under the six-factor analysis set forth in *Clackamas*, the required review of "all of the incidents of the relationship" may embolden even bona fide partners to sue for discrimination. Moreover, even frivolous litigation on this point is likely to continue beyond a motion to dismiss, due to the fact-specific analysis the court must apply.

- *Solon v. Kaplan*, 398 F.3d 629 (7th Cir. 2005): Summary judgment granted to *employer*/law firm on plaintiff's Title VII discrimination claims where evidence showed plaintiff was a general partner in a four-partner law *firm*, and had been managing partner. Plaintiff's argument that partnership agreement was ignored frequently by the other partners rejected as evidence showed "informal" process by which the other partners decided to terminate Solon's partnership did not violate agreement or partnership status. The Seventh Circuit rejected the plaintiff's attempt to limit *Clackamas* to the narrow question of whether a shareholder-director is an employee, noting that the decision was based in part on the EEOC compliance manual which identifies the six factors as relevant to determining whether "partners, officers, members of boards of directors, and major shareholders qualify as employees." *Id.* at 632-33.

- *Rodal v. Anesthesia Group of Onondaga*, *P.C.*, 379 F.3d 113 (2d Cir. 2004): Summary judgment reversed and remanded because, in part, the *Clackamas* decision overruled longstanding Second Circuit precedent that working "shareholders" who elected to incorporate, rather than form a partnership, were generally seen as employees, rather than employee-partners. In this case, *Clackamas* had the result of rolling back plaintiff-friendly precedent that automatically deemed working shareholders to be employees under antidiscrimination laws.

2. Third Circuit endorses fact-specific analysis under *Clackamas*

Although the Third Circuit has yet to address a post-*Clackamas* situation in which a partner or shareholder is suing as an "employee" under an anti-discrimination law, the court has affirmed an Eastern District of Pennsylvania decision applying *Clackamas* and determining that 19 shareholder-employees of a medical clinic were not employees for purposes of meeting the 15-employee requirement of Title VII of the Civil Rights Act of 1964, as amended.

In *Ziegler v. Anesthesia Associates of Lancaster, Ltd.*, 74 Fed. Appx. 197 (3d Cir. Aug. 29, 2003) (not precedential), two non-shareholder physicians sued their employer for gender discrimination. The district court (Judge Waldman) dismissed the case, finding that Anesthesia Associates of Lancaster, Ltd. did not have the requisite 15 employees because its 19 shareholder-physicians were not "employees." In reaching this conclusion, which the Third Circuit affirmed, the district court applied *Clackamas* to a detailed factual analysis. These facts, as set forth below, help demonstrate the types of evidence a partnership or professional corporation will want to develop in discovery (and make a reality before any litigation erupts) in order to avoid liability for shareholders or partners as employees:

- Defendant's shareholders share ownership and are accorded equal voting rights in virtually all matters including hiring, termination, offers of partnership and contracting with outside parties.;

- Each shareholder makes a capital contribution;

- Shareholder compensation is not tied to individual performance;

- No shareholder is evaluated or supervised by anyone;

- Shareholders received compensation based on defendant's profits, and as determined by a board comprised of all shareholders;

- In contrast, all non-shareholder employees are paid fixed annual salaries;

- Shareholders are liable for their acts of professional negligence and for those acting under their supervision;

- The use of “employment agreements” with each shareholder was not decisive, as the shareholders referred to each other as “partners” internally and externally.

These facts provide helpful guidance and precedent for similar partnerships and professional corporations seeking to avoid liability based on partners or shareholders alleging “employee” status. (See Section V, *infra*.) On the other hand, plaintiffs may find this decision helpful in that it illustrates a small, democratic professional corporation -- as opposed to some larger, less democratic professional firms, which will not be able to match the facts in *Ziegler*.

C. EEOC Compliance Guidelines Shaped *Clackamas*, Reflect Proactive Stance

As noted in *Clackamas*, the United States Equal Employment Opportunity Commission (“EEOC”) has been a leader in pushing for a broader, more aggressive, fact-specific analysis in determining whether partners, shareholders, officers and directors are “employees” under federal anti-discrimination laws.

In addition to prosecuting the *Sidley Austin* case (*infra*), *Johnson & Higgins* (*supra*), *Dowd & Dowd* (*supra*), and others, the EEOC has helped establish national guidance on the issue through its Compliance Manual, used by EEOC staff in investigating and prosecuting discrimination claims.

At Section 2, “Threshold Issues,” on the issue of “Who Is an ‘Employee’?”, the EEOC Compliance Manual provides the following:

> d. Partners, Officers, Members of Boards of Directors, and Major Shareholders
>
> In most circumstances, individuals who are partners, officers, members of boards of directors, or major shareholders will not qualify as employees. An individual's title, however, does not determine whether the individual is a partner, officer, member of a board of directors, or major shareholder, as opposed to an employee. The investigator should determine whether the individual acts independently and participates in managing the organization, or whether the individual is subject to the organization's control. If the individual is subject to the organization's control, s/he is an employee. The following factors should be considered:
>
> FACTORS TO BE CONSIDERED WITH REGARD TO COVERAGE OF PARTNERS, OFFICERS, MEMBERS OF BOARDS OF DIRECTORS, AND MAJOR SHAREHOLDERS
>
> Whether the organization can hire or fire the individual or set the rules and regulations of the individual's work

Whether and, if so, to what extent the organization supervises the individual's work

Whether the individual reports to someone higher in the organization

Whether and, if so, to what extent the individual is able to influence the organization

Whether the parties intended that the individual be an employee, as expressed in written agreements or contracts

Whether the individual shares in the profits, losses, and liabilities of the organization

As noted above, the Supreme Court adopted these identical factors in *Clackamas*, and what were once internal guidelines of the EEOC have become mandatory, but not exhaustive, factors to consider when deciding this issue.

As part of its Compliance Manual, the EEOC has set forth several examples to illustrate its position on the issue of whether partners or small corporation shareholders are "employees."

- **Example 1** - CP works for an accounting firm and has the title of partner. The firm pays CP a salary, and CP is supervised by an individual at a higher level. CP receives a share of the firm's profits in addition to his salary, but he does not have any input into decisions made by the firm, which are made by higher-level partners. *While CP has the title of partner, he is in fact an employee.*

- **Example 2** - CP is an officer with Respondent, a small corporation. She is the head of one of the corporation's divisions and has no supervisor, although her actions are reviewed by the board of directors. She does not draw a salary, but receives a share of the profits made by Respondent. **CP** has the right to vote on decisions taken by Respondent, although her vote does not count as much as those of other individuals. *CP is not an employee, and therefore is not protected by the EEO statutes.*

  Practice pointer: This second example highlights a fact that defense counsel sometimes ignore -- a high-level officer of a small corporation may be exempt from coverage by antidiscrimination laws. Armed with the EEOC's own Compliance Manual as ammunition, defendants should fight to dismiss or obtain summary judgment against any similarly situated high-level officer/shareholder of a small corporation who seeks to bring employment discrimination claims. *See generally Devine v. Stone, Leyton & Gershman, P.C.*, 100 F.3d 78, 81-82 (8th Cir. 1996) (shareholder-directors were not "employees" where they participated in management decisions, made capital contributions, and were compensated based on firm's profits), *cert. denied*, 520 U.S. 1211 (1997).

D. A Case Study In What Can Go Wrong: *EEOC v. Sidley Austin Brown & Wood*

Anyone hoping to learn the current state of the law and litigation on the issue of "partners" as discrimination employees need look no further than *EEOC v. Sidley Austin Brown & Wood*, a federal age-discrimination lawsuit that has been grinding away in Illinois for nearly six years.

The background facts are not in dispute: Sidley Austin Brown & Wood ("Sidley Austin") is a Chicago-based law firm of more than 500 partners. Sidley Austin is controlled by a self-perpetuating executive committee of 36 members. Partners who are not members of the committee have some powers delegated to them with respect to hiring, firing, promotion and compensation of their subordinates, but are at the "committee's mercy" as far as their own status. The only issue upon which all partners have voted in the last quarter century was the merger with Brown & Wood.

In 1999, Sidley Austin demoted 32 of its equity partners (most of whom were in their late 50s and early 60s) to "counsel" or "senior counsel." In legal publication articles relating to these changes, the firm's management was reported to have stated that it was making changes to free up opportunities for growth, especially for its newer, younger partners.

1. Round 1: seventh circuit grants discovery to determine if "partners" are employees

This case began in 2001 with an investigation by the EEOC -- not a charge or lawsuit by any employee or partner of Sidley Austin. Consistent with its updated Compliance Manual, noted above, the EEOC apparently saw this as a classic test case to attack age-discriminatory treatment of so-called "partners," including mandatory retirement policies. When the EEOC subpoenaed all records relating to the decision to demote the 32 partners, Sidley Austin provided some -- but not all -- of the requested information as to whether these individuals were partners or employees. However, Sidley Austin tried to block further discovery into the decisions, claiming that it had produced more than sufficient evidence to establish that these were bona fide partners, and therefore not protected by the ADEA as "employees." Sidley Austin's evidence on this point included that (1) the individuals were partners under Illinois partnership law; (2) the individuals' income included a share of the firm's profits; (3) the individuals made a contribution to the capital of the firm; (4) the individuals were liable for the firm's debts; and (5) the individuals had some administrative or managerial responsibilities.

The EEOC countered that the evidence indicated that the 32 were not "real partners" and that their classification under state law (the per se rule) was "not dispositive of their status under federal antidiscrimination laws." Although it was a preliminary decision on discovery issues, with mixed results, the EEOC clearly got the better of the decision.

In the panel decision by Judge Posner, the Seventh Circuit rejected the plea for a blanket rule that anyone called a "partner" under state law could not be an "employee" under the ADEA. The court noted that in *Hishon v. King & Spalding*, 467 U.S. 69, 78 (1984), involving a large Atlanta-based law firm, the Supreme Court rejected the argument that the intimate nature of the partnership relation precluded a challenge under Title VII to a discriminatory refusal to promote an employee to partner.

Addressing each of Sidley Austin's claims, the court noted that (1) the designation of "partner" under state law and "employer" under federal antidiscrimination law may not coincide, so the former designation was not decisive; (2) sharing in firm profits was not decisive, because many employees of corporations share in company profits while remaining "employees" under the law; (3) likewise owning a share of the firm capital was not materially different than executive-level employees who often own stock in their corporations, the court noted; (4) on the issue of being liable for firm debts, while this was distinct from corporate executives who have no such liability, the court observed that the partners "were not empowered [as owners] by virtue of bearing large potential liabilities!" [emphasis in original]; and, finally, (5) the court noted that due to the executive committee's self-perpetuating stranglehold on real power and decision-making at Sidley Austin, the minor management duties were not decisive.

In sum, the Seventh Circuit -- like the EEOC -- rejected any simplified or mechanical test, and instead suggested that an "unavoidably multi-factored" functional test was most appropriate in determining whether the relationship was that of a true partnership, versus that of an employer-employee. Under this approach, as advocated by the EEOC, the court would look at not only the economic realities, but also at the power relationships at the firm, and the many factors used to determine whether a hired party is an employee under the general common law of agency (e.g., direction and control, right to assign projects, tax treatment, agreement of the parties, etc.).

a. ***<u>Practice Pointer:</u>*** Although Sidley Austin failed in getting the lawsuit dismissed, it prevailed in limiting discovery at the initial stage to whether the demoted partners at issue were "employees," thus subject to protection under the ADEA. It therefore avoided (albeit temporarily) early discovery on the reasons for it demotion of each partner. Firms that are sued by partners or shareholders, and have a better defense on the point than Sidley Austin, should seek to limit discovery to the jurisdictional issue ("are the partners employees?"). If the employer can prevail on that point, the ADEA claim should be dismissed, thus avoiding full-blown litigation on all issues.

2. Round 2: seventh circuit allows EEOC to proceed without partners as plaintiffs

Another interesting aspect of the Sidley Austin case -- and one that some may see as tantamount to George Orwell's *1984* -- is that the firm finds itself in a war over alleged unjust treatment of older partners, even though no older partners are bringing a claim. Instead, "Big Brother," in the form of the EEOC, is leading the charge.

Nevertheless, relying on the statutory mandate of the EEOC and the Supreme Court's recognition of the EEOC's power to obtain injunctive and monetary relief on behalf of the demoted or retired partners (even if those partners did not timely pursue such relief themselves), as set forth in *EEOC v. Waffle House, Inc.*, 534 U.S. 279 (2002), the Seventh Circuit rejected Sidley Austin's effort to dismiss the case for lack of standing by the EEOC to bring the suit.

3. Round 3: will Sidley Austin and the EEOC kiss and make up?

Although the facts that come out in discovery could dictate otherwise, it seems clear from the decisions in Round 1 and Round 2 that Sidley Austin's case is not destined for dismissal on summary judgment. The firm has now lost a total of five decisions, including two appeals, in its efforts to get the case thrown out on preliminary coverage and jurisdictional grounds. On top of that, the Seventh Circuit has made clear that the factual analysis will be multi-faceted and complex, consistent with *Clackamas.*

And now the EEOC has become bullish on the case, boasting in a recent press release that, with the latest decision by the Seventh Circuit, "Now we can turn our full attention to the task of assuring that the jury requires Sidley to respond to the discrimination claims against it with significant and meaningful monetary and other relief." EEOC Press Release, *All EEOC Age Bias Claims Against Sidley & Austin [sic] To Go Forward, Federal Appeals Court Rules* (Feb. 17, 2006)).

The prospects for Sidley Austin or any firm in its shoes are not pretty. Trial before a jury examining the complex and subjective nature of partnership decisions; challenges to its mandatory retirement plan; public discovery and debate as to the amounts it pays its partners and employees; and the specter of reinstatement of rejected partners and/or damages running into the tens of the millions of dollars. On the latter issue, damages, if the EEOC does prevail, one would assume that many of the 32 demoted partners will be able to show large monetary losses over the past five years. Even if the damages were $100,000 per lawyer per year, Sidley Austin could face a $16 million verdict, plus attorneys' fees and interest, on the issue of back pay alone.

It will be interesting to see how the case unfolds, whether by trial or settlement. If it does settle, the resolution will be public, consistent with EEOC policy. In either event, the case serves as a real-life nightmare scenario for a professional services

> firm. Those partnerships and professional service corporations that ignore Sidley Austin are setting themselves up for a similar fate.

III. PENNSYLVANIA LAW ON PARTNERS/SHAREHOLDERS AS EMPLOYEES

Pennsylvania's anti-discrimination law, the Pennsylvania Human Relations Act ("PHRA"), defines "employer" as follows:

> The term "employer" includes the Commonwealth or any political subdivision or board, department, commission or school district thereof and any person employing four or more persons within the Commonwealth, but except as hereinafter provided, does not include religious, fraternal, charitable or sectarian corporations or associations, except such corporations or associations supported, in whole or in part, by governmental appropriations. The term "employer" with respect to discriminatory practices based on race, color, age, sex, nation origin or non-job related handicap or disability includes religious, fraternal, charitable and sectarian cooperations [sic] and associations employing four or more persons within the Commonwealth.

43 P.S. § 954(b).

As with the federal statutes, the PHRA is not helpful in determining whether a partner or shareholder is an "employee" under the Act. Only one state appellate decision has addressed the issue.

In *Hull v. Rose, Schmidt, Hasley & DiSalle P.C.*, 700 A.2d 996 (Pa. Super. 1997), a former general partner in a 22-partner Pittsburgh law firm claimed the firm discriminated against him as an "employee" on the basis of his disability, alcoholism, in violation of the PHRA. Hull shared in the firm's profits, paid capital into the firm, controlled portions of the partnership's business, generated new business and was deemed personally liable for the partnership's debt. *Id.* at 1001.

In determining whether Hull was covered by the PHRA, the court first noted the lack of statutory guidance or Pennsylvania case law interpreting the definitions of employer and employee in the context of a general partnership under the PHRA. *Id.* at 999. The court then proceeded through an analysis of the partner as "employee" issue, drawing on federal antidiscrimination law precedents, as is common in PHRA analysis. In particular, the court relied on *Wheeler v. Hurdman*, 825 F.2d 257 (10th Cir. 1987), involving claims under Title VII and the ADEA. *Wheeler*, as noted above, rested its analysis primarily on a general holding that "bona fide general partners are not employees" under Title VII and the ADEA, and explicated the differences between the two. *Id.* at 1000-01. The *Hull* court adopted this analysis in holding that the plaintiff, as a bona fide partner, was not an "employee" under the PHRA:

> [I]n order to preserve the delineation established by the legislature in the PHRA, and in anti-discrimination laws in general, we find it necessary to maintain the traditional line between partners (or employers) and employees. . . . Thus, we conclude that Hull's

> status as a general partner equates him with employer status and, therefore, makes him ineligible to seek relief under the PHRA

Id. at 1001-02.

Although *Hull* at first glance appears to be a strong case for protecting partnerships against PHRA liability, the decision's pre-*Clackamas* reliance on *Wheeler* and federal precedent make its holding questionable. If the Superior Court were to decide the same issue today, one would suspect that it would look to the U.S. Supreme Court's guidance in *Clackamas*, apply each of the six factors and look at all relevant details of the relationship. Even so, one would expect that given the strong facts in *Hull*, non-employee status would be affirmed.

Moreover, a federal decision post-*Hull* has narrowed its application. In *Siko v. Kassab, Archbold & O'Brien, L.L.P.*, 1998 WL 464900, n.5 (E.D. Pa. Aug. 5, 1998), the court held that *Hull* was not controlling in a partner/employee jurisdictional determination under the Family and Medical Leave Act, because *Hull* involved a general partnership, with unlimited liability and benefits from that form of partnership, whereas the plaintiff in *Siko* worked for a limited liability partnership. The *Siko* court also applied a broader standard than *Hull* in determining employment status, noting that the determination must be "on a case-by-case basis based on the totality of the circumstances." *Id.* at *5 (citing *Nationwide Mutual Ins. Co. v. Darden*, 503 U.S. 318, 323 (1992)).

In short, the issue is not clearly decided in Pennsylvania. Smaller firms with bona fide general partnerships that share profits, liabilities and other indicia of ownership with their partners can take heart in the *Hull* decision. That will be cold comfort to larger firms, with less equitable treatment of partners. As with the federal law, one can assume that the PHRA definition of "employee" may be stretched in the future to include some partners and shareholders of larger and/or less democratically governed firms.

IV. NEW JERSEY PARTNERS AND SHAREHOLDERS OFTEN GIVEN RIGHT TO SUE AS EMPLOYEES

A. New Jersey's Law Against Discrimination Applies 12-factor Test

In determining whether a plaintiff is an "employee" within the meaning of LAD, N.J.S.A. 10:5-1 to -42, New Jersey courts have applied a twelve-factor test:

(1) the employer's right to control the means and manner of the worker's performance; (2) the kind of occupation -- supervised or unsupervised; (3) skill; (4) who furnishes the equipment and workplace; (5) the length of time in which the individual has worked; (6) the method of payment; (7) the manner of termination of the work relationship; (8) whether there is annual leave; (9) whether the work is an integral part of the business of the "employer;" (10) whether the worker accrues retirement benefits; (11) whether the "employer" pays social security taxes; and (12) the intention of the parties.

Crisanthis v. County of Atlantic, 361 N.J. Super. 448, 455 (App. Div.), cert. Denied, 178 N.J. 31 (2003). *See also Pukowsky v. Caruso*, 312 N.J. Super. 171 (App. Div. 1998).[1]

In analyzing these twelve factors -- taken largely from the Restatement (Second) of Agency § 220(2) (1958) -- New Jersey courts have noted that the "most important" factor is the first -- "the employer's right to control the means and manner of the worker's performance." *Crisanthis*, 361 N.J. Super. at 455.

B. CEPA -- "Liberal" Construction To Protect Whistle-blowers Has Led To 2005 Decision Holding Physician-Shareholder Could Be Protected Employee

New Jersey's Conscientious Employee Protection Act, N.J.S.A. 34:19-1 et seq. ("CEPA"), is one of the most protective whistleblower statutes in the nation. Frighteningly for employers, New Jersey law mandates that CEPA is to be "construed liberally to effectuate its important social goal," *Abbamont v. Piscataway Tp. Bd. of Educ.*, 138 N.J. 405, 431 (1994), of providing "broad protections against employer retaliation for workers whose whistle-blowing actions benefit the health, safety and welfare of the public." *Mehlman v. Mobil Oil Corp.*, 153 N.J. 163, 179 (1998).

This "liberal" and far-reaching construction has been extended to the definition of "employee[s]" protected under CEPA. *See, e.g., D'Annunzio v. Prudential Ins. Co. of America et al.*, 383 N.J. Super. 270, 891 A.2d 673 (2006) (holding that an independent contractor could bring a claim under CEPA as an "employee"); *Feldman v. Hunterdon Radiological Associates et al.*, (App. Div. August 15, 2005) (not approved for publication) (discussed below and holding that a physician-shareholder of a small medical practice could be an "employee" under CEPA), *pet. granted*, 185 N.J. 391, 886 A.2d 662 (2006).

CEPA defines an "employee" as "any individual who performs services for and under the control and direction of employers for wages or other remuneration." N.J.S.A. 34:19-2(b).

In interpreting this "control and direction" definition, New Jersey courts have looked to the United States Supreme Court for guidance, in particular the above-noted decision, *Clackamas Gastroenterology Associates, P.C. v. Wells*, 538 U.S. 440, 442 (2003) (holding that four physician-shareholders who owned the professional corporation and constituted its board of directors, and who worked full-time for the corporation, might be counted as employees under the ADA for purposes of meeting the 15-employee threshold of coverage under the ADA since they received salaries, were requir4ed to comply with standards of the employer, and reported to a manager). *See, e.g., Feldman v. Hunterdon Radiological Associates et al., supra* (citing and applying *Clackamas* standards).

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[1] This analysis, taken from precedents determining whether an independent contractor is an employee, does not apply precisely to the partner-versus-employee issue. For example, the presence of "annual leave" does not strongly suggest employee or partner status. As the case law matures, one would expect a more refined analysis in the partner/shareholder context, taking from the factors adopted in *Clackamas*.

Feldman held that a plaintiff, who was a physician-shareholder of a six-shareholder radiological clinic, could sue as an "employee" under CEPA. The trial court granted the employer summary judgment on the CEPA claim with a traditional analysis that "[a]t all times relevant to this litigation, plaintiff was a shareholder with [the employer]," and concluded that plaintiff therefore "does not qualify as an 'employee' under . . . CEPA."

The Appellate Division of the New Jersey Superior Court rejected this rather straightforward analysis, and instead cited a multiplicity of tests, including *Clackamas'* six factors, the twelve-factor test used in *Crisanthis*, *supra*, a LAD case, and the ten factors noted in the Restatement (Second) of Agency § 220(2) (1958). Focusing on the issue of control, the court noted that even though plaintiff was a shareholder, she received an annual salary from the employer, was required to comply with the standards set forth by the employer, and reported to the managing partner. In addition, she had entered into an "Employment Agreement" with the employer, which provided for employer direction and control of her patient services, termination provisions (including with and without cause) and employer control of her professional income from any source whatsoever. *Id.*

Based on these facts, and loosely applying the various factors noted above, the appellate court held that the defendant had failed to demonstrate that Feldman did not qualify as an "employee" under CEPA, and reversed and remanded the matter.

V. HOW DO YOU AVOID THESE PROBLEMS AT YOUR FIRM OR CLIENT?

With the Baby Boomers hitting 60, and a glut of mandatory retirements on the horizon, one can expect an increase in partner and shareholder challenges to mandatory retirement and other unequal treatment based on age. Whereas the dutiful partner of old could be expected to "go along with tradition" and accept mandatory retirement as "the way things are done," this generation will likely buck the Establishment. To avoid costly litigation, a la Sidley Austin, law firms and professional corporations can take a number of steps to mitigate their exposure.

First, they should analyze the status of their equity partners and shareholders under the *Clackamas* factors. If exposure exists, then steps can and should be taken to address and strengthen the firm's position as to each factor. This may require amendment to the partnership or shareholders' agreement, or it may be simple tweaking of the way the partnership or firm operates. In addition, retirement plans and mandates may require adjustment.

A. Analyze The Firm Under The Six *Clackamas* Factors[2]

1. Whether the organization can hire or fire the individual or set the rules and regulations of the individual's work

The issue of hiring and firing is one that will reveal true partnership versus employee status in most cases. If partnership or shareholder status is "at will" and may be terminated at any time for any reason by some action less than a

[2] The six factors outlined in *Clackamas* are not exhaustive, and other facts not explicated here may help push the analysis one way or the other. No single factor is decisive; rather, the "principal guidepost" is "the common-law element of control." 438 U.S. at 448.

shareholder or partnership vote, the person is likely not a true owner of the enterprise. Setting the rules and regulations of the individual's work is a gray area. Law firms and professional corporations are allowed to establish general standards of conduct at work, but should avoid dictates and control that take away the shareholder/partner's ability to determine how the work is done.

Firms looking to enhance their defenses on this point should ensure the partnership or shareholders' agreement does not delegate to too small a group or person the right to hire or terminate a partner or shareholder for any reason. Requiring votes of all shareholders or partners for such decisions, and establishing general bases for such decisions will help establish that the person is not just an employee. *See, e.g., Ziegler*, 74 Fed. Appx. 197 (3d Cir. Aug. 29, 2003) (shareholders not "employees" under *Clackamas* due in part to fact that shareholders accorded equal voting rights in virtually all matters, including hiring, termination and offers of partnership).

2. Whether and, if so, to what extent the organization supervises the individual's work

Some minimal level of supervision can be expected in most professional service firms to ensure consistent quality and client satisfaction. However, if an equity partner or shareholder is supervised to the extent that a typical employee would be, then the status may be in jeopardy. Firms that do not allow their own shareholders and partners to deliver work to clients without supervision probably should consider such shareholders and partners as employees. Of course, an originating partner is allowed to supervise the work of a partner assigned to the client on an as-needed basis without jeopardizing that subordinate partner's status. Likewise, an especially large matter may on occasion require one partner to supervise the work of other partners toiling away on that matter. However, if the subordinate partner is always working under a supervisor, and has no work of his or her own, then he or she is more likely to be considered an employee. It simply is not a defense to say "we are big and we have big matters that require many partners" -- to the contrary, such a situation probably supports the conclusion that the partner is really more like an employee than an owner of the firm.

3. Whether the individual reports to someone higher in the organization

Even large firms with the need for complex management structures can avoid exposure on this factor by ensuring that internal documentation and organizational charts stress the person's status as a member or partner, and do not include statements that the partner or member "reports to" a higher-level partner, or is somehow that person's subordinate. The more that the documents and the reality reflect that all partners are equal members or partners of a group (e.g., the Labor and Employment Department), as opposed to persons who report to a higher-level supervisor or department chair, the better off the firm will be. Many law firms and medical practices are organized exactly this way -- in a very horizontal, non-hierarchical fashion. *See, e.g., Ziegler*, 74 Fed Appx. 197 (3d Cir. Aug. 29, 2003) (dismissal affirmed due in part to fact that no shareholder was evaluated or supervised by anyone). Firms that choose instead to retain greater control of all partners through a "chain of command" or other hierarchy, with regular evaluations and supervision, risk losing on this factor.

4. Whether and, if so, to what extent, the individual is able to influence the organization

This is the Achilles Heel for Sidley Austin in its litigation, as a self-perpetuating executive committee of a few dozen members controls that 500-partner firm, with most partners having almost no role or influence over the organization. Sidley Austin partners have had one partner-wide vote on governance in 25 years.

To avoid a similar fate, firms should provide for regular partnership or shareholder votes on matters of importance to the firm (including without limitation hiring, addition and termination of partners, mergers, and compensation issues). Other opportunities for influence, such as committees and program leadership, should be nurtured and documented. In addition, partners or shareholders should be encouraged to come forward with ideas to improve the firm, and when those ideas are implemented or considered, that fact should be documented and publicized within the firm. Again, the firm's position as to this factor can be strengthened through express language in the partnership or shareholders' agreement.

5. Whether the parties intended that the individual be an employee, as expressed in written agreements or contracts

This is the easiest factor for firms to manipulate. Partnership and shareholder agreements and any related employment contracts should make clear that the person is a partner or shareholder, and such agreements should be titled to reflect this status -- and not simply as "Employment Agreement." The other *Clackamas* factors can be addressed in the contract, providing still more evidence of the parties' intentions. The contract also should include an express waiver and release by the partner or shareholder that he or she agrees with the designation as a partner or shareholder, and will not seek to challenge such designation in court. Contracts are like titles, however, and will not control in a court's analysis of the underlying reality of the arrangement. *See, e.g., Ziegler*, 74 Fed. Appx. 197 (3d Cir. Aug. 29, 23003) (use of "employment agreements" with each shareholder was not decisive, as other evidence showed shareholder-physicians were truly owners and partners, and not employees).

6. Whether the individual shares in profits, losses and liabilities of the organization

Some firms botch this aspect of the analysis by paying shareholders and partners most of their compensation through guaranteed "salaries" -- which sounds like an employee -- rather than "draws," which are then reconciled with profits and losses. A salary that is supplemented by a share in profits or losses is acceptable, but a draw is preferable.

While "control" is the ultimate touchstone, this factor is the proof in the pudding -- if a partner or shareholder does not share substantially in profits or losses, then he or she is unlikely to be found to be anything other than an employee. As a result, one can assume that federal courts will find non-equity partners to be employees protected by the anti-discrimination laws.

To bolster a firm's position on this issue, capital contributions should be required of each shareholder or partner. *See, e.g., Ziegler*, 74 Fed. Appx. 197 (3d Cir. Aug. 29, 23003) (capital contributions and pay based on profits -- not salaries or individual performance -- were factors in determining that physician-shareholders were not employees).

However, it is not enough to have a partner or shareholder share only in the liabilities -- and not in the profits. Courts have held that such a raw deal for the employee does nothing but illustrate how little control he or she had over the employment arrangement. *See, e.g., Sidley Austin, supra.*

B. Mandatory retirement plans: the next battlefield

The ADEA prohibits mandatory retirement ages -- or most any term of employment based on age -- in most circumstances.[3] Nevertheless, law firms and other professional organizations routinely have mandatory retirement ages. If these mandates apply to true, non-employee partners, as defined above, then this is not a problem. However, if a firm's so-called partners or shareholders are determined to be covered "employees" under the ADEA -- as the EEOC is seeking to prove in the *Sidley Austin* case -- then an age-based retirement system applied to them would appear to be a clear violation of the ADEA.

Firms can avoid the prospect of litigation and legal challenges to their retirement systems in a number of ways.

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[3] The ADEA does have exceptions allowing for mandatory retirement of a "bona fide executive or a high policymaking position" who has attained the age of 65 and will receive annual retirement benefits of at least $44,000. 29 U.S.C. § 631(c)(1). To meet the "bona fide executive" exception, the person must manage the organization or a department or subdivision thereof, direct the work of at least two other employees, have the authority to hire or dismiss other employees, regularly exercise discretionary powers and spend no more than 20 percent of his or her time on activities other than the above activities. The "high policymaker" exception refers to top-level employees who are not "bona fide executives," but who nonetheless play a significant role in developing and implementing corporate policy. EEOC examples include a chief economist or chief research scientist. Firms can use these exceptions affirmatively to force the retirement of certain executives and officers, but must ensure that the position held fully complies with the requirements of the exception and the EEOC's guidance on the exception. EEOC Compliance Manual.

First, they can eliminate any age-based retirement systems. Of course, this result is unpalatable to many firms, which want to use mandatory retirement systems to transfer client relationships and free up opportunities for younger partners and avoid the complex problems and exposure that sometimes occur with older partners. According to the admittedly stereotypical views that motivate these mandatory retirement ages, older workers may lose their drive, work less, encounter more "senior moments," make more mistakes, appear less sharp, relate less to younger, cutting-edge clients, and otherwise be less productive. Rather than honor such prejudices and cling to their age-based retirement policies, in violation of the spirit of the ADEA, firms should consider whether they truly need a mandatory retirement policy for partners. *See generally*, Anthony Lin, *Senior Partners Balking at Retirement Policies*, 181 N.J.L.J. 669 (8/22/05) (discussing lawsuits and disputes in New York area relating to forced retirements and alleged underpayment of older partners, including aging rainmakers at Winston & Strawn, Wachtell Lipton and Fried Franck). Some observers suggest that law firms that eliminate mandatory retirement ages may actually benefit from the change, finding that it (1) attracts more hardworking partners, (2) motivates older partners to work harder, (3) helps retain clients who are loyal to older partners, (4) maximizes profits by allowing the hardworking partners to stay on past age 65, and (5) causes few problems because most partners will choose to retire voluntarily at or around the time of Social Security eligibility (ages 65-67). This will become more and more of an issue as the Baby Boomers -- the first of whom turn 60 this year -- begin to butt up against mandatory retirement ages, even though many -- feeling "forever young" -- may want to work well into their 70s and 80s.

Second, firms and other partnerships and professional corporations can include in their partnership or shareholder agreements a waiver, compliant with the Older Workers Benefit Protection Act ("OWBPA"), in which each shareholder or partner agrees in advance to retire at or before a certain age and releasing the firm and its partners from any claim under the ADEA related to its retirement policies. Such a waiver of ADEA rights must be "knowing and voluntary" to comply with the OWBPA, which has numerous express requirements including understandable language, written advice to consult an attorney, express reference to the ADEA, and consideration and revocation periods. 29 U.S.C. § 626(f).

Obtaining such waivers as a contingent part of the partner's or shareholder's initiation into the firm should not be difficult. The challenge is much greater for existing partners or shareholders. An existing firm with a mandatory retirement age that wishes to obtain an OWBPA waiver in advance will need to provide added consideration, and will have to decide in advance what it will do with partners who refuse to sign. Animosity may be created, as well as a loss of partners. Moreover, the simple act of offering such waivers may be seen as evidence that the firm recognizes vulnerability on the issue of whether its partners or shareholders would be viewed as "employees" under the law.

Clearly, this cat will not be easy to skin for large firms with multiple tiers of partners and shareholders who the firm plans to force into retirement in the coming years. Like Sidley Austin, many large firms may find themselves embroiled in litigation with their former partners, the EEOC or both.