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Misclassification: Employee or independent contractor?

THE CONFUSING FIGHT OVER WHETHER A WORKER IS AN EMPLOYEE OR AN INDEPENDENT CONTRACTOR, AND WHY IT MATTERS

Whether someone is an employee or an independent contractor is the subject of extensive and probably growing litigation. The result of this dispute is frequently outcome determinative for the case. Many wage-and-hour class actions and single-plaintiff cases revolve around this issue. When an employer illegally calls an employee an independent contractor, this is called "misclassification."

This issue usually arises when a company or person hires someone and classifies them as an independent contractor rather than an employee. There may be sound reasons for this. The hired person may actually be an independent contractor. However, all too frequently the independent-contractor classification is a subterfuge to save money or skirt legal obligations, as the person may really be an employee.

Misclassification of employees as independent contractors is a huge and growing problem. A 2016 study by economists at Harvard and Princeton Universities estimated 12.5 million people were considered independent contractors, or 8.4% of the U.S. workforce. Misclassification deprives state and federal treasuries of billions of dollars in tax revenue every year. According to the California Labor Commissioner's website, the misclassification of workers as independent contractors costs the state roughly $7 billion in lost payroll taxes each year.

Despite this, public policy favors people being classified as employees. The law in this area is complex and confusing. In 2018, the California Supreme Court in *Dynamex Operations West, Inc. v. Superior Court* (2018) 4 Cal.5th 903, recognizing the growing problem, made misclassification much more difficult for employers, at least in some contexts. There will undoubtedly be much more litigation as a result of this case, which makes it much easier for the plaintiff to prove they were an employee.

Why do employers misclassify employees as independent contractors?

The overriding reason that employers misclassify employees is financial. Treating someone as an independent contractor saves employers money – sometimes a lot of money. Employees have a whole panoply of rights granted by various statutory schemes and the common law. This includes wage-and-hour rights, anti-discrimination rights, and workers' compensation rights among others. The employer has corresponding duties. Independent contractors have few, if any, of these rights. The independent contractor's rights are mostly contained in the independent-contractor agreement. These rights are usually highly circumscribed.

In addition, the government requires the employer to make various contributions on behalf of employees.

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This includes workers' compensation, unemployment-insurance premiums, Social Security and Medicare contributions. None of these things are required for independent contractors.

Another reason employers misclassify employees is to avoid potential liability. Employees are protected by a variety of laws: Antidiscrimination laws, wage-and-hour laws, and family and medical leave laws. Independent contractors typically are not. By misclassifying an employee as an independent contractor, employers often seek to avoid complying with these laws and to avoid liability for violating them.

The reason can be more directly financial. Employees are protected by governmental programs designed to help them. This includes unemployment benefits and workers' compensation benefits. Independent contractors are not. By misclassifying an employee, the employer can avoid paying into these programs or paying insurance premiums.

Similarly, misclassification can allow the employer to avoid having to pay payroll taxes, Social Security taxes, Medicare taxes, or contributing to retirement accounts. These are required for employees but not independent contractors. Often employers misclassify their employees intentionally in order to reduce labor costs and avoid paying state and federal taxes. This can leave misclassified employees with large tax bills.

Passing along the cost of doing business

A structural financial reason is that misclassifying employees as independent contractors allows the employer to pass the cost of doing business onto the misclassified employee. Normally, an employer pays the costs of doing business. This includes reimbursing the employee for money spent by the employee on the employer's behalf for things like mileage, cell phone use, or purchasing supplies. (Lab. Code, § 2802.) An independent contractor does not receive reimbursement for money spent on behalf of the employer. Wouldn't it be great for profits if the employer could pass the costs of doing business onto their employees? Many employers try to do exactly that.

Misclassification also does great societal harm. "Given the potential economic incentives a business might have to avoid legal obligations, the risk of misclassifying employees as Independent Contractors is significant." (*Dynamex*, *supra*, 4 Cal.5th at p. 913.) Violations of labor standards remain commonplace. In addition to passing the cost of doing business from the employer to the misclassified employee, other societal harms include loss of substantial tax revenue and placing law-abiding employers at a competitive disadvantage. (Lab. Code, § 90.5(a).)

The source of classification laws

The laws governing this area are a bit of a hash; historically, various tests and standards have been used to determine whether someone is an employee or an independent contractor. The reason for this is that the laws in this area come from various sources with different public policies and purposes. You will accordingly find various formulations depending on how the case arose.

The first set of laws is derived from common-law tort principles concerning vicarious liability. The fact pattern would be that the employer would classify someone as an independent contractor, and that person would injure somebody in the course and scope of what they were doing for the employer. In that context, the victim would try to establish that the tortfeasor was misclassified and was an employee in order to reach deeper pockets. The putative employer would usually try to establish that the tortfeasor was an independent contractor so it would not be liable for the tort. There was no public policy favoring a finding that the tortfeasor was an employee so you could say the standard was somewhat neutral.

The second set of laws governing this area arose from the workers' compensation system. Generally, the workers' compensation system is the exclusive remedy for employees injured in the course and scope of their work. Workers' compensation is "social welfare legislation," so the courts have uniformly found that public policy favors a finding of employment. The standard in cases arising from the workers' compensation context is much more favorable towards a finding of employment.

The third set of laws governing the issue is from the IRS or taxing authorities. As you can imagine, the public policy is once again to find employment.

The fourth set of laws governing the issue arises from the Labor Code and wage orders, which govern minimum wage, overtime, and meal and rest breaks. Once again, public policy favors a finding that the person is an employee.

The last set of laws governing the issue arises from the anti-discrimination laws set forth in The Fair Employment and Housing Act ("FEHA").

The net result of this is that you can get different results depending on how the case arose.

A way to think about the issue and explain it to a jury

Our firm has handled many misclassification cases, both for individuals and groups of people. We naturally are always trying to prove that plaintiffs are employees. This is a jury question. We like to simplify things as much as possible for the jury, because at the end of the day it is pretty much a common-sense analysis. Most people understand, walking into the courtroom, what an employee is and what an independent contractor is, based on their own life experiences. It is difficult to move people off that common-sense understanding.

We like to use real-life examples to explain the difference. We often use the idea of a plumber who comes to your house to fix your plumbing as an example of what an independent contractor really looks like. In contrast, we often use the example of a factory worker or legal assistant to show what an employee looks like. Everybody gets this.

We also like to point out how much money the employer saves by misclassifying employees. As the saying goes: "follow the money." Everybody gets this as well.

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We especially like to talk to the jury about how misclassification allows the employer not to pay unemployment or Social Security taxes. This can be a subtle use of the Reptile Theory because nobody likes to believe that they pay their fair share of taxes and others don't.

The applicable law

The old basic common-law test focused on who had the right to control how the work was done. Under the common law: "The principal test of an employment relationship is whether the person to whom service is rendered has the right to control the manner and means of accomplishing the result desired." (*Isenberg v. California Emp. Stab. Com.* (1947) 30 Cal.2d 34, 39.) "If control may be exercised only as to the result of the work and not the means by which it is accomplished, an independent contractor relationship is established." (*Moody v. Industrial Acc. Com.* (1928) 204 Cal. 668, 670).

Stated more simply: if the defendant employer controls how plaintiffs perform the work, there is an employment relationship. If, on the other hand, the defendant employer only specifies the result, there is no employment relationship. This is frequently called "the control test."

Historically, this was the test used in tort cases where the issue was vicarious liability.

One huge advantage for plaintiffs in the tort context: Labor Code section 3706

The workers' compensation scheme is generally the exclusive remedy for employees injured in the course and scope of their work. This generally precludes an employee from suing their employer in tort. This rule frequently inures to the plaintiff's benefit when there has been misclassification. That is because when an employer misclassifies an employee, it will not purchase workers' compensation insurance for the misclassified employee.

That common situation implicates Labor Code section 3706. If the employer does not have workers' compensation insurance, the plaintiff really holds all the cards if they have been injured by the employer's negligence. This section allows employees *to sue their employer directly in tort*, if the employer has neither workers' compensation insurance nor self-insurance. There are other fantastic advantages. First, the employer bears the burden of proof of demonstrating that the plaintiff is an independent contractor. (Lab. Code, §§ 335 and 5705(a).) Second, once it is established that plaintiffs are employees, a presumption of employer negligence arises and the burden of proof shifts to the employer to prove that it was not negligent. (Lab. Code, § 3706.) Even better, the employer also cannot avail itself of comparative negligence, assumption of the risk, and co-employee negligence defenses. (Lab. Code, § 3708.) Finally, allowable damages also include attorney fees. (Lab. Code, § 3709.)

The IRS test

For federal tax purposes, the IRS uses three tests to determine worker classification: the behavioral control test, the financial control test, and the relationship between the parties. These tests consider factors similar to the common-law test described above, also focusing on the right to control factor.

The *Borello* case

Finally, in 1989, the California Supreme Court brought the pieces together and defined a general approach to determine whether a worker is an employee or an independent contractor. (*S.G. Borello & Sons, Inc. v. Department of Industrial Relations* (1989) 48 Cal.3d 341.) *Borello* arose in the workers' compensation context. Prior to *Borello*, the common-law standard chiefly relied on what level of control companies had over the worker – something that could be interpreted in many different ways.

Borello changed much of that. The Court initially recognized that the Workers' Compensation Act must be liberally construed to extend benefits to persons injured in their employment. The *Borello* court held that the principal test "of an employment relationship is (still) whether the person to whom the service is rendered has the right to control the manner and means of accomplishing the result desired...." (*Borello*, *supra*, 48 Cal.3d at p. 350.) This is the old common-law test. The *Borello* court also added several "secondary indicia" which really make a finding that the person is an employee easier. (*Ibid*.) These include: "(a) whether the one performing services is engaged in a distinct occupation or business; (b) the kind of occupation, with reference to whether, in the locality, the work is usually done under the direction of the principal or by a specialist without supervision; (c) the skill required in the particular occupation; (d) whether the principal or the worker supplies the instrumentalities, tools, and the place of work for the person doing the work; (e) the length of time for which the services are to be performed; (f) the method of payment, whether by the time or by the job; (g) whether or not the work is a part of the regular business of the principal; and (h) whether or not the parties believe they are creating the relationship of employer-employee." (*Id*. at p. 351.) The Court stated that the right to discharge at will without cause is "strong eviden[ce]" of an employment relationship. (*Id*. at p. 367.)

This is obviously a factual question and the determination must be made on a case-by-case basis. In addition, these factors cannot be mechanically applied. "They are intertwined and their weight depends often on particular combinations." (*Borello*, *supra*, 48 Cal.3d at p. 351.)

Employers often believe that an independent-contractor agreement or language will insulate them. We see this in virtually every misclassification case. That is not the case, and if anything, it is likely a weak factor, as the employee usually has no choice but to agree to this language. Although it can be considered, "[t]he label placed by the parties on their relationship is not dispositive." (*Borello*, *supra*, 48 Cal.3d at p. 349.) Additionally, subterfuges are not countenanced. (*Kowalski v. Shell Oil Co.* (1979) 23 Cal.3d 168, 176.)

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This standard is set forth in CACI 3704. One problem with this instruction is that it puts the burden on the employee to prove the nature of the relationship. This appears to be an open question. We have tried to have the CACI changed to make it the employer's burden but have never succeeded.

This is the test used in most situations with the current exception of *Dynamex*.

How employers use misclassification

Employers frequently just label their employees as independent contractors. This is especially true for people who work offsite.

A more sophisticated misclassification scheme is to have employees set up "their own businesses" offsite and have them set up a separate corporate identity. Employers will have their employees sign prolix agreements stating they are independent contractors. The employer will then control most aspects of "the business" and get a cut of the income. This allows the employer to pass on the cost of doing business to the alleged independent contractor. Entire huge businesses are set up in this fashion, especially in the insurance and real estate areas.

This was the situation in *Alexander v. FedEx Ground Package System, Inc.* (9th Cir. 2014) 765 F.3d 981. FedEx's business is package delivery by drivers. FedEx classified its drivers as independent contractors and pretended they ran their own businesses. FedEx set up a scheme where they had the drivers sign a prolix Operating Agreement. However, the drivers had to wear FedEx uniforms, drive FedEx-approved vehicles, and groom themselves according to FedEx's appearance standards. FedEx told its drivers what packages to deliver, on what days, and at what times. The trial court granted summary judgment to the plaintiff drivers. The appellate court agreed.

The *Dynamex* case

In 2018, the California Supreme Court changed the landscape in *Dynamex Operations West, Inc. v. Superior Court,* 4 Cal.5th 903. This case made it significantly harder for employers to classify people as independent contractors, at least in most wage-and-hour cases. The ruling, thus far, only applies to cases involving wage orders.

The *Dynamex* Court held that an "ABC" test applied in these circumstances. Under the ABC test, a worker is presumed to be an employee unless the employer establishes each of the following: "(A) that the worker is free from the control and direction of the hiring entity in connection with the performance of the work, …; and (B) that the worker performs work that is outside the usual course of the hiring entity's business; and (C) that the worker is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed." (*Dynamex*, *supra*, 4 Cal.5th at p. 957.)

This is obviously a much simpler test than the *Borello* test and one that is very difficult for the employer to meet. It would be virtually impossible for an employer to meet all three elements unless the person is a true independent contractor, such as the plumber.

This ruling will likely result in a wave of class actions, at least in the wage-order context.

Dynamex involved a dispute about wages, which are mostly governed by wage orders. Wage orders are promulgated by the Industrial Welfare Commission to regulate wages, hours, and working conditions in certain industries or occupations. There are 17 such orders that are also known as "IWC Orders," or "wage orders." Plaintiffs' employment practitioners were initially hoping that *Dynamex* would apply to all misclassification cases. That did not turn out to be the case. In *Garcia v. Border Transportation Group, LLC* (2018) 28 Cal.App.5th 558, the court held that *Dynamex* did not apply to other types of misclassification claims. The *Garcia* court then applied the *Dynamex* test to the wage claims but applied the *Borello* test to all other claims.

Accordingly, as things stand now, *Dynamex* only applies to cases involving wage orders, while *Borello* and CACI 3704 apply to everything else.

Finally, it is not enough to merely have a misclassification. There need to be damages to pursue a case. Misclassification will usually give rise to the following civil claims: overtime, minimum wage, rest and meal breaks, penalties, and reimbursement claims under Labor Code section 2802.

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