Employee Misclassification: The Employment Law Issue *du Jour*

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Introduction

After the midterm elections Congress will likely take up and pass a comprehensive employee misclassification bill.[1] Twenty-two states have already enacted, or are likely to pass, similar legislation. At least seven states have created taskforces to address the problem on a comprehensive basis.[2] "Employee misclassification" websites and blogs[3] offering commentary and advice appear daily; one creative law firm has developed a unique 48-point test for determining proper employee classifications.[4]

"Employee misclassification" is *the* employment law issue *du jour*.

In this article, we will consider two questions: (1) what is the difference between an independent contractor and an employee; and (2) what is the likely impact of pending legislation on current employment practices.

The Difference Between an Independent Contractor and an Employee

Justice Potter Stewart was onto something when he famously observed of obscenity, in *Jacobellis v. Ohio*[5] that "I shall not today attempt further to define the kinds of material I understand to be embraced within that shorthand description, and perhaps I could never succeed in intelligibly doing so. *But I know it when I see it*,[6] and the motion picture involved in this case is not that."[7] This too is true in trying to determine, with any sense of precision, who is and who is not an independent contractor.

Most employers are confused by the lack of clarity in the standards for classifying workers at the time of hire as there is no single definitive test. Different laws[8] define "employee" differently and use different tests to distinguish between employees and independent contractors.

Indeed, a 2007 report by Cornell University's prestigious School of Industrial and Labor Relations,[9] pointed out that:

> First, there is no uniform guideline, rule or regulation that sets out the criteria to be used in determining an employment or independent contractor relationship. Second, there is often no effort among State regulators to reach consistent determinations. Third, State agencies do not recognize each other's determinations. (Footnote omitted)

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Federal agencies apply their own tests. The Internal Revenue Service (the "IRS"), for example, having abandoned its venerable "20-Factor Test" for determining a worker's status, applies a "right of control" test. The IRS web site[10] states that:

> The general rule is that an individual is an *independent contractor* if (the person for whom the services are performed) has the right to control or direct only the result of the work, *and not what will be done and how it will be done or method of accomplishing the result.*
>
> People such as lawyers, contractors, subcontractors, public stenographers, and auctioneers, who follow an independent trade, business, or profession in which they offer their ser-vices to the public, are *generally* not employees. (Emphasis in original)

The U.S. Department of Labor, however, applies yet another test when conducting its classification audits. The U.S. Supreme Court has held[11] that there is no single rule or test for determining employee status. Instead, it has approved a common law "right of control" test resting principally on these "behavioral" factors:

- the extent to which the services rendered are an integral part of the principal's business;
- the permanency of the relationship;
- the amount of the alleged contractor's investment in facilities and equipment;
- the nature and degree of control by the principal;
- the alleged contractor's opportunities for profit and loss; and
- the amount of initiative, judgment, or foresight in open market competition with others required for the success of the claimed independent contractor.

Independent contractors, of course, are not subject to control over the manner in which they perform their services.

Application of these factors is intensely fact-specific and, even in the best of cases, the tests are not easily applied.

The Likely Impact of Pending Legislation on Current Employment Practices

Why do employers misclassify employees? For the money, of course. In Minnesota, for example, a 2007 report from the Office of the Legislative Auditor[12] pointed up the savings to employers who misclassify their employees:

> To illustrate the impact of misclassification on labor costs, we developed a hypothetical scenario involving drywall installation. The base pay for drywall installers in Minnesota is about $30 per hour. We estimated that mandatory costs, including federal employment taxes, workers' compensation insurance premiums, and state unemployment insurance taxes add another $7.82 per hour for employees. The resulting hourly rate ($37.82) is 26 percent higher than the employer's cost if the employee were misclassified as an independent contractor.

The *New York Times* reported[13] that in a mere 15 enforcement sweeps, investigating just 117 companies, New York investigators found $19 million in unreported wages and $3 million in minimum wage and overtime underpayments. The state's investigators also uncovered nearly $1 million in taxes that had not been paid to the state's unemployment insurance fund. Even in states with relatively small work-forces, the numbers are sobering.

The legislation is coming, and it will continue to roll out across the country. Old ways of doing business will be altered by greater reporting requirements, notice to worker provisions, increased civil penalties and more effective interdepartmental taskforce enforcement. The near-term future will see a significant impact on employers as state legislatures, in particular, examine and adopt:

- legislation streamlining the misclassification issue by presuming employee status and then requiring the employer to rebut the presumption;[14]
- legislation extending worker protection (such as unemployment insurance and workers' compensation) to independent contractors, thus eliminating cost savings for them and their employers; and
- uniform definitions, consistently applied.

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[1] The Employee Misclassification Act (the "Act"), introduced in the House (HR 5107) and Senate (SB 3254), would amend the Fair Labor Standards Act (the "FLSA"), 29 U.S.C. §201, et seq. It would give employers six months from the Act's effective date to notify their current employees/independent contractors of their respective classifications while new hires would have to be notified of their status at their time of hire. Failure to comply with the Act's notification requirements would result in the imposition of a presumption that workers whom employers have characterized as non-employees or independent contractors are employees. Rebuttal of this presumption would require clear and convincing evidence to the contrary, a very high standard. The Act would provide for civil penalties ranging from $1,100 to $5,000 per violation.

[2] See Iowa, Massachusetts, Maine, Michigan, New Hampshire, New York and Vermont. New York's Joint Enforcement Strike Force, which is typical, includes staff from the Department of Labor, the Attorney General's Office, the Department of Taxation and Finance, the Workers' Compensation Board and the New York City Comptroller's office.

[3] See, e.g., the Independent Contractor Compliance Blog at http://www.independentcontractorcompliance.com.

[4] Pepper Hamilton, LLP.

[5] 378 U.S. 184 (1964).

[6] Emphasis added.

[7] *Id.* at 197.

[8] Such as the National Labor Relations Act (29 U.S.C. §157, *et seq.*), the FLSA (29 U.S.C. §201, et seq.) and the Employee Retirement Income Security Act (29 U.S.C. §1001, et seq.).

[9] Donahue, L. H., Lamare, J. R., & Kotler, F. B. (2007). *The cost of worker misclassification in New York State* [Electronic version]. Ithaca, NY: Cornell University, School of Industrial and Labor Relations. http://digitalcommons.ilr.cornell.edu/reports/9/.

[10] http://www.irs.gov/businesses/small.

[11] In *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318 (1992).

[12] *Misclassification of Employees as Independent Contractors.* http://www.auditor.leg.state.mn.us/ped/2007/missclasssum.htm.

[13] The **New York Times** (February 12, 2008).

[14] The Cornell Report notes (at p. 12) that:

Recently enacted legislation in Massachusetts [M.G.L. Chapter 149, Section 148b. http://www.mass.gov/legis/laws/mgl/149-148b.htm] seeks to clarify and streamline the determination process by presuming employee status so that independent contractor classification is recognized only if all three elements of a three-part test are met:

> (1) the individual is free from control and direction in connection with the performance of the service, both under his contract for the performance of service and in fact;
>
> (2) the service is performed outside the usual course of the business of the employer; and,
>
> (3) the individual is customarily engaged in an independently established trade, occupation, profession or business of the same nature as that involved in the service performed.