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Misclassification Headaches

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Understand the difference between employees and independent contractors.

By Jill Cohen 12/1/2015

Government officials don't agree on much these days. So when they do agree, it's probably a good idea to pay attention. What issue is uniting them, you ask? Who will make the best president? Whether the U.S. deal with Iran is good or bad? Whether Tom Brady deflated footballs?

Not even close. Rather, it's the desire to stop the misclassification of workers as independent contractors.

The U.S. Department of Labor (DOL) is leading the charge by enforcing the Fair Labor Standards Act (FLSA) and partnering with the Internal Revenue Service (IRS) and 26 states to stop this widespread practice. Here's why all businesses and human resource professionals should take heed.

What Is Misclassification?

Someone who performs work for a company is either an employee or an independent contractor. Boiled down to a single word, the difference between the two is control. In the former case, the control lies with the employer; in the latter, it's with the individual. Of course, very few legal concepts can be clarified using only one word—which is why we have a variety of tests, each applied by different agencies in varying contexts, to aid in making the determination.

In enforcing the FLSA, the DOL uses the "economic realities" test, which "focuses on whether the worker is economically dependent on the employer or in business for him or herself," according to DOL Administrator's Interpretation No. 2015-1, issued July 15, 2015.

The FLSA defines "employ" as "to suffer or permit to work." Under this assessment, a worker who is "economically dependent" on an employer is suffered or permitted to work by the employer, and is therefore an employee of the employer. HR professionals, take note: This incredibly broad definition captures many workers as employees who are not classified as such under other tests.

According to the U.S. Supreme Court, the "economic realities" test includes six broad considerations:

- The extent to which the work performed is an integral part of the hiring entity's business.
- Whether the worker's managerial skills affect his or her opportunity for profit and loss.
- The relative investments in facilities and equipment by the worker and the hiring entity.
- The worker's skill and initiative.
- The permanency of the relationship.
- The nature and degree of control by the employer.

Shortsighted employers may think they will save a lot of money and aggravation if they misclassify workers as independent contractors because contractors are not subject to minimum wage or overtime requirements under the FLSA or state wage and hour laws. Contractors are also not subject to most employment-related tax withholdings, such as employment taxes, Social Security and Medicare, or unemployment insurance. Moreover, employers are generally not obligated to give them benefits.

But whatever savings employers think they could realize through misclassification will pale in comparison to the harsh realities they will face if they are sued or audited.

Back Pay and Damages

Ask Microsoft executives why employers should care about misclassification, and they will give you 97 million reasons. That's the dollar amount the company had to pay in 2000 when it settled *Vizcaino v. Microsoft*, a case alleging the misclassification of temporary workers.

FedEx fared even worse. In one of the largest misclassification settlements ever, the company paid out a whopping $228 million to resolve a case with delivery drivers who FedEx claimed were independent contractors.

Uber's fate is still to be determined, as the cases of drivers alleging misclassification wend their way through the U.S. District Court for the Northern District of California.

Clearly, the penalties can be astronomical—or, in the words of Beth Ross, the plaintiffs' lawyer who pursued FedEx for misclassification, "the cost of independent contractor misclassification can be financially punishing, if not catastrophic, to a business." These damages are even more devastating to small mom and pop shops that don't have the financial resources of behemoths like Microsoft. The DOL touts many six- and seven-figure recoveries in misclassification suits against small, local businesses.

This issue touches nearly all industries and many positions, from IT professionals to janitors. The DOL reported that between 2009 and 2013, it assessed $1.1 billion in back wages against employers resulting from misclassification. That doesn't even include the amounts collected by state departments of labor and employees directly through private civil actions.

Employees have different options for recovering damages from FLSA violations. The DOL can act on an individual's behalf, through an administrative process or litigation, and seek back wages and an equal amount in liquidated damages and penalties. An employee can also opt to file a private lawsuit to recover those funds.

If an employee or the DOL can prove that the employer willfully violated the law, criminal penalties, including fines or imprisonment, may come into play. And don't forget, these penalties represent the consequences under the FLSA only. When an employee is misclassified as an independent contractor, the IRS has its own bone to pick with the employer.

Other Considerations

State wage and hour laws can be just as challenging as federal statutes. New Jersey, for instance, is particularly aggressive about correcting misclassifications. Earlier this year, the New Jersey Supreme Court held that the "ABC" test applies in the wage and hour context to determine whether a worker is an employee or independent contractor. This assessment is largely considered the most stringent; it has a very high threshold for qualifying a worker as an independent contractor. In addition, a variety of New Jersey laws contain very steep penalties for misclassification.

A current litigation trend is the emergence of lawsuits in which workers classified as independent contractors allege that they are actually franchisees of a company. Like employees, franchisees are afforded significant protections that aren't available to contractors.

With numerous federal and state agencies aligned on this issue, it's vital for employers to educate themselves. Whether misclassification is intentional or not, the companies that do it may quickly find themselves on the wrong side of the law.

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