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The U.S. Department of Labor and the State of California Join Forces to Crack Down on Employers: Avoid the Pitfalls of Employee Misclassification

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Introduction

Employers continue to face costly misclassification claims related to whether a worker is an independent contractor or an employee. In general, an employee is any person who provides actual service to an individual or business entity for wages.[1] Alternatively, an independent contractor is a worker who contracts with an individual or business entity to provide specialized services. Independent contractors are not considered employees as they typically work pursuant to a specific contract, for a specific length of time, and for a specific fee. California law defines an independent contractor as "any person who renders service for a specified recompense for a specified result, under the control of his principal as to the result of his work only and not as to the means by which such result is accomplished."[2]

Because the distinction between employee and independent contractor can be unclear, workers may be misclassified, thereby exposing the employer to significant penalties and other liabilities. Therefore, for any individual or business entity entering into an independent contractor service relationship, it is essential to

[1] Cal. Lab. Code § 350(b).

[2] Cal. Lab. Code § 3353.

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avoid the pitfalls associated with misclassifying a worker as an independent contractor versus an employee. This is particularly true in light of the following developments: (1) the Ninth Circuit Court of Appeal's decision in *Ruiz v. Affinity Logistics Corporation*,[3] which highlights the rebuttable presumption of employee status under California law; (2) the United States Department of Labor's ("DOL") recent announcement that it has entered into a Memorandum of Understanding ("MOU") with the State of California intended to "end the misclassification" of employees as independent contractors;[4] and (3) new California legislation (SB 459) that significantly increases the penalties for misclassification.[5] These three important developments will be reviewed in greater detail below, beginning with an overview of the standards used in determining independent contractor versus employee status.

Criteria for Properly Establishing Independent Contractor Status

Part of the problem with misclassification of employees is that numerous state and federal agencies are involved with the question of independent contractor versus employee status and, thus, varying criteria exist for establishing whether a worker is properly classified. These agencies include California's Employment Development Department ("EDD"), which handles employment-related taxes; California's Division of Labor Standards Enforcement ("DLSE"), which enforces California wage and hour laws; the DOL, which enforces federal wage and hour laws; and the Internal Revenue Service ("IRS"). In addition, agencies such as California's Franchise Tax Board ("FTB"), the Division of Workers' Compensation ("DWC"), and the Contractor's State Licensing Board ("CSLB") also have requirements pertaining to independent contractor status. Since a workplace event such as an employee termination might trigger a multitude of laws, it is possible that the same worker could be considered an employee under one law and an independent contractor under another law. For purposes of this article, the DLSE (California law) and IRS (federal law) criteria will be reviewed.

DLSE and the "Multi-Factor" Test

Although the DLSE does not have any specific definition for the term "independent contractor" it is important to note that the DLSE begins with the presumption of "employee" status.[6] This is a rebuttable presumption, however, and determining whether a worker is an employee or independent contractor depends upon a number of factors, all of which must be considered. It is therefore necessary to analyze the facts of each service relationship, which means applying the "multi-factor" test adopted by the California Supreme Court in *S. G. Borello& Sons, Inc. v. Department of Industrial Relations.*[7] Under the "multi-factor" test, the most important factor in determining independent contractor status is the worker's "right to control" (1) the work to be accomplished, and (2) the manner and means in which the work is performed. The factors listed below are considered in establishing whether the worker has the requisite control:

1. Is the worker performing the services engaged in an occupation or business apart from that of the alleged employer?
2. Is the work being performed as part of the regular business of the alleged employer?
3. Who is supplying the instrumentalities, tools, and location for the worker?
4. What is the worker's investment in the equipment or materials required by his or her task, or his or her employment of helpers?

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3 No. 10-55581, 2012 U.S. App. LEXIS 2450 (9th Cir. Feb. 8, 2012).

4 DOL, Wage & Hour Division ("WHD") News Release No. 12-0257-SAN, *US Labor Department, California Sign Agreement to Reduce Misclassification of Employees as Independent Contractors* (Feb. 9, 2012) ("WHD News Release"), *available at* http://www.dol.gov/opa/media/press/whd/WHD20120257.htm.

5 SB 459, codified at Cal. Lab. Code §§ 226.8 and 2753 (effective Jan. 12, 2012).

6 Cal. Lab. Code § 3357.

7 8 Cal. 3d 341 (1989).

5. Does the service being provided by the worker require a special skill?
6. Is the worker engaged in an occupation in which the work performed is usually done under the direction of another or by a specialist without supervision?
7. Is the worker's opportunity for profit or loss dependent on his or her managerial skill?
8. What is the length of time for which the services are to be performed?
9. What is the degree of permanence of the working relationship?
10. What is the method of payment (i.e. whether by time or by the job)?
11. Does the alleged employer have the right to terminate at-will without cause?
12. Do the parties believe they are creating an employer-employee relationship? (Note: This factor is not conclusive on the issue of independent contractor status since this is a question of law based on objective criteria).

Even in situations where the alleged employer does not exercise control over work details, an employer-employee relationship may exist if (1) the alleged employer maintains pervasive control over the job as a whole, (2) the worker's duties are an integral part of the job, and (3) the nature of the work being performed makes detailed control unnecessary.[8] Further, as noted above, the existence of a written agreement between the worker and the alleged employer declaring the existence of an independent contractor relationship is *not* determinative of independent contractor status, nor is the fact that the alleged employer issues an IRS 1099 form, as opposed to a W-2 form, to the worker.

The IRS "Common Law" Test

In general, pursuant to the "common law" test, the IRS considers a worker to be an "employee" if the employer has the right to control what will be done and how it will be done. This standard is similar to that of the DLSE, which also centers around the issue of control. The IRS's *Employer's Supplemental Tax Guide*[9] provides the following guidelines related to the issue of control in determining independent contractor status:

- ✓ **Behavioral Control**: Does the employer direct and control how the worker performs the task? In answering this question consider instructions provided by the alleged employer to the worker such as: (1) when and where the worker will perform the work; (2) the tools or equipment the worker will use; (3) what workers will be hired to assist with the work; (4) where the worker will purchase supplies and services; (5) what work must be performed by a specified individual; and (6) the order or sequences the worker must follow. Also, look at training that is provided by the employer, as independent contractors typically use their own methods.
- ✓ **Financial Control**: Does the alleged employer control the business aspects of the worker's job? In determining this consider: (1) the extent to which the worker has unreimbursed business expenses; (2) the extent of the worker's investment; (3) the extent to which the worker is free to seek out other business opportunities; and (4) the alleged employer's method of payment for the services, as independent contractors are usually paid a flat fee.
- ✓ **Relationship of the Parties**: What is the nature of the relationship between the worker and the alleged employer? Specifically, consider: (1) whether the parties have entered into a written employment relationship agreement; (2) whether the alleged employer provides the worker with employee-type benefits, such as insurance, vacation pay or sick pay; and (3) the extent to which services performed by a worker are a key aspect of the employer's business.

For federal tax purposes, while all of the above factors are taken into account when determining employee versus independent contractor status, it is clear that the issue of control is paramount.

Ninth Circuit Decision Highlights California's Presumption of Employee Status

The first notable development regarding misclassification addressed in this article involves a recent decision by the Ninth Circuit Court of Appeals, *Ruiz v. Affinity Logistics Corporation*,[10] in which the court held that California law, as opposed to Georgia law, applied in a misclassification case, even though the employer and employee signed an agreement stating that Georgia law

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[8] Yellow Cab Cooperative v. Workers Compensation Appeals Board, 226 Cal. App. 3d 1288 (1991).

[9] IRS Publication 15-A, (2012) (Supplement to Publication 15 (Circular E), *Employer's Tax Guide*), *available at* http://www.irs.gov/publications/p15a/index.html.

[10] No. 10-55581, 2012 U.S. App. LEXIS 2450 (9th Cir. Feb. 8, 2012).

would apply in any employment-related dispute, including wage and hour claims.

In *Ruiz*, a truck driver, Fernando Ruiz, worked for Affinity Logistics Corporation ("Affinity"), a company that provides home delivery and transportation logistical support services to various home furnishing retailers, including Sears. In order to work as a driver for Affinity, workers must enter into the "Independent Truckman's Agreement" and the "Equipment Lease Agreement (collectively the "Agreements") with Affinity. The Agreements include provisions stating that the parties are entering into an independent contractor relationship, as opposed to an employer-employee relationship, and that Georgia law applies to employment-related disputes.

Ruiz and other drivers filed a class action against Affinity, alleging violations of the Fair Labor Standards Act ("FLSA")[11] and California wage and hour laws, including failure to pay overtime, failure to pay wages, failure to properly charge for workers' compensation insurance, and failure to properly classify its California drivers.

The district court initially granted partial summary judgment to Affinity on Ruiz's causes of action for the FLSA violations. Affinity then moved for summary judgment on the remainder of Ruiz's claims, which the court granted only as to Ruiz's cause of action for overtime pay under California law.

The remainder of Ruiz's claims centered on whether Ruiz should be classified as an independent contractor or as an Affinity employee. Based upon the choice of law clause in the Agreements, the district court concluded that Georgia law should apply on the issue.

In reaching its decision, the district court applied California's choice of law framework in which the courts enforce choice-of-law clauses provided the state in question has a substantial relationship to the parties or transaction. The district court concluded that a substantial relationship existed because Affinity was incorporated in Georgia and its principal office is also located in the state.

The district court then applied Georgia law to resolve the independent contractor issue, holding that Ruiz had overcome the presumption of "independent contractor" status, thereby establishing that Ruiz was Affinity's employee. The court thus denied Affinity's motion for summary judgment on the claims related to whether Ruiz should be classified as an independent contractor or as an Affinity employee. The matter was then set for trial on the remaining claims.

After a three-day trial, the district court concluded that unlike California law (where there is a presumption that an individual is an employee), under Georgia law there is a presumption of independent contractor status. Thus, in order to rebut the presumption, Ruiz needed to establish the existence of an employer-employee relationship. The district court concluded, however, that Ruiz could not establish an employer-employee relationship and, thus, held that Ruiz failed to rebut the presumption of independent contractor status.

Ruiz appealed, arguing that the district court erred when it applied Georgia law. The Ninth Circuit agreed, holding that California law should apply in determining whether the drivers are employees or independent contractors because Georgia law "is contrary to a *fundamental* policy of California."[12]

Specifically, under Georgia law if a contract specifies that the relationship between the parties is one of principal and independent contractor, there is a presumption of independent contractor status. Alternatively, under California law if a worker presents evidence that he or she has provided services for an employer, there is a presumption of employee status. The burden then shifts to the employer to prove that the presumed employee was in fact an independent contractor. The Ninth Circuit observed that "Georgia law directly conflicts with a fundamental California policy that seeks to protect its workers," and cited the "multi-factor" test for determining employment status developed by the California Supreme Court in *S.G. Borello & Sons, Inc. v. Department of Industrial Relations*.[13]

The *Ruiz* case serves as an important reminder that in California, there is a rebuttable presumption that a worker is an employee versus an independent contractor.

DOL Enters into a "Memorandum of Understanding" with California

The next development of interest in the area of misclassification relates to the DOL's Wage and Hour Division, which has entered into a Memorandum of Understanding ("MOU") with the IRS intended to "improve department efforts to end the business practice of misclassifying employees in order to avoid providing

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11 29 U.S.C. § 201 et seq.

12 *Ruiz*, 2012 U.S. App. LEXIS 2450, at *9 (quoting Nedlloyd Lines B.V. v. Superior Court, 3 Cal. 4th 459, 466 (1992)).

13 48 Cal. 3d 341(1989).

employment protections."[14] The DOL has also signed similar MOU's with 12 states, including California.

Nancy J. Leppink, Deputy Administrator of the DOL's Wage and Hour Division, commented on the recent MOU with California, observing that "[t]his memorandum of understanding helps us send a message: We are standing together with the state of California to end the practice of misclassifying employees. . . . This is an important step toward making sure that the American dream is still available for workers and responsible employers alike."[15] California Labor Commissioner Su also commented on the agreement, stating that "California is proud to enter into this partnership with the U.S. Department of Labor to work together to attack the problems of the underground economy."[16]

In 2011, the DOL collected more than $5 million in back wages for minimum wage and overtime violations under the FLSA as a result of employers misclassifying employees as independent contractors. And, the DOL emphasizes that:

> The misclassification of employees . . . presents a serious problem as these employees often are denied access to critical benefits and protections - such as family and medical leave, overtime compensation, minimum wage pay and Unemployment Insurance - to which they are entitled. In addition, misclassification can create economic pressure for law-abiding business owners, who often struggle to compete with those who are skirting the law.[17]

The MOUs between the DOL and state government agencies arose as part of the DOL's Misclassification Initiative, which the agency launched to prevent, detect and remedy employee misclassification. Colorado, Connecticut, Hawaii, Illinois, Maryland, Massachusetts, Minnesota, Missouri, Montana, Utah and Washington have entered into similar agreements with the DOL.[18] Employers should be concerned about these MOUs because the involved agencies (i.e., the DOL, the IRS and multiple states, including California) will now be coordinating enforcement efforts to investigate and take action against employers who misclassify employees as independent contractors.

Penalties for Misclassification

The final development addressed in this article pertaining to employee misclassification involves penalties for noncompliance with the law. Employers who improperly classify an employee as an independent contractor may be liable for a multitude of wage and hour violations, including failure to pay overtime, failure to provide meal and rest periods, and failure to provide workers' compensation insurance. In addition, the employer may face potential civil tort liability to the worker (or to a third party) injured on the job, and may be liable for unpaid payroll taxes.

As of January 2012, California's SB 459[19] is in effect. This new legislation, which adds section 226.8 to the Labor Code, prohibits an employer from engaging in a "pattern and practice" of "willfully misclassifying" workers as independent contractors. "Willful misclassification" refers to situations in which an employer attempts to "avoid[] employee status for an individual by voluntarily and knowingly misclassifying that individual as an independent contractor."[20]

Pursuant to SB 459, civil penalties for a violation range from $5,000 to $15,000 for each violation, and between $10,000 and $25,000 if there is a pattern and practice of violations. Further, if it is determined that an employer has improperly classified an employee as an independent contractor, the employer may be required to post on its website (or if the employer does not have a website, in a conspicuous area) a notice advising that the employer has committed a misclassification violation, and that if any other worker believes he or she has been misclassified, the worker may contact California's Labor and Workforce Development Agency ("LWDA"). The notice must advise that the employer is being required to post the notice, and that the employer will be changing its workplace policies and procedures to ensure additional violations do not occur.

Best Practices for Employers

The bottom line is that employers need to be vigilant in ensuring compliance with the wage and hour laws related

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[14] DOL, WHD News Release No. 11-1373-NAT, *Labor Secretary, IRS Commissioner Sign Memorandum of Understanding to Improve Agencies' Coordination on Employee Misclassification Compliance and Education* (Sept. 19, 2011), *available at* http://www.dol.gov/opa/media/press/whd/WHD20111373.htm.

[15] *See* WHD News Release, *supra* note 4.

[16] *See* WHD News Release, *supra* note 4.

[17] *See* WHD News Release, *supra* note 4.

[18] More information on employee misclassification is available on the DOL's webpage at http://www.dol.gov/misclassification.

[19] SB 459, codified at Cal. Lab. Code §§ 226.8 and 2753 (effective Jan. 2012).

[20] Cal. Lab. Code § 226.8(i)(4).

to the classification of a worker as either an employee or an independent contractor, especially in light of the *Ruiz* decision, the MOUs between the DOL and the IRS/ California, and the significantly increased penalties for misclassification pursuant to SB 459. As federal and state enforcing agencies join together to crack down on those employers who are violating misclassification laws, and the increased penalties for violation of applicable laws take hold, employers should consider the following:

- ✓ Carefully review workplace policies and procedures on classification of workers as independent contractors;
- ✓ Avoid relying solely on an agreement to establish independent contractor status;
- ✓ Recognize that in California there is a presumption of employee status; and
- ✓ Understand the *Borello* criteria on the issue of control.

Finally, if an employer intends to enter into an independent contractor service agreement with a worker, the employer should first consult with their employment counsel for assistance in determining whether the worker can be properly classified as an independent contractor.

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