Insights, News & Events

# INDEPENDENT CONTRACTOR MISCLASSIFICATION: THE HIDDEN TRAP OF OUTSOURCING

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It's a beguiling option. Companies that classify workers as independent contractors receive a number of benefits, including elimination of payroll taxes, workers' compensation insurance, and unemployment insurance withholdings. Additionally, independent contractors are not entitled to overtime, double-time pay, or meal and rest breaks. The appeal of classifying workers as independent contractors can't be questioned.

But be wary when applying the independent contractor classification to your workforce. Such action, if misguided, may have severe consequences. The relevant provisions of the California Labor Code can be cumbersome and technical, as courts are continually redefining and interpreting what these provisions mean in application to everyday business operations.

For instance, as recently determined by the California Court of Appeal, failure to properly classify workers as employees may now be extremely costly, not only for the employer that initially misclassifies the employees, but also for other companies in contractual service relationships with the employer. This case means that it's not as easy to "pass the buck" through independent contracting.

**Peeling Away Layers Of The Onion**
In the June 2015 decision of *Noe v. Superior Court of Los Angeles*, a number of vendors brought a class-action lawsuit against Anschutz Entertainment Group (AEG) and two other companies in its subcontracting chain (which provide food services to AEG's various venues in the southern California

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## Service Focus

Wage and Hour

region). Specifically, AEG contracted directly with Levy Premium Foods (Levy), which, in turn, contracted with Canvas Corporation (Canvas).

The vendors argued that they were being misclassified as independent contractors by all three companies as "joint employers." Furthermore, the vendors argued that AEG – at the top of the chain of contractors – should also be held liable for the alleged wage and hour violations and civil penalties.

The lawsuit focused primarily on Section 226.8 of the Labor Code, which prohibits the "willful misclassification" of independent contractors. AEG and Levy contended that they could not be liable as joint employers because they only had "limited oversight" and control over the vendors, with Canvas being "solely responsible for hiring and paying the plaintiffs ... and ensuring they were properly compensated." They further contended that liability could only result if they actually made the decision to employ the vendors as independent contractors. Since Canvas was the party which hired the laborers and compensated them, they argued, Canvas should be responsible.

On the other hand, the evidence showed that Levy's human resource representative had expressed concern that laborer-vendors were being paid by Canvas as independent contractors, and that Levy had classified its own laborer-vendors as employees. The vendors contended, in any event, that AEG and Levy had a duty as contracting parties to ensure that all of the vendor-laborers were properly classified.

**The Court's Decision Casts A Wide Net**

The Court of Appeal rejected AEG and Levy's arguments and ruled that liability for misclassification is not solely limited to employers that make the initial decision to misclassify employees as independent contractors. It also ruled that a co-employer could not be found liable based solely on the acts of another co-employer.

Instead, the Court pointed out that the law makes it illegal to "engage," "participate," or "knowingly acquiesce" in a co-employer's decision to "willfully misclassify their joint employees." In this broader connotation of "engage," a party can be held liable for civil penalties so long as the party has knowledge that employees were being misclassified as independent contractors by a co-employer.

According to the Labor Code, these civil penalties can range from $5,000 to $25,000 per individual. For the defendants in *Noe*, this meant $10 million to $50 million in potential liability. Notwithstanding the possibility of significant liability, AEG and Levy did raise a successful jurisdictional argument. They contended, and the court agreed, that there is no private right of action for plaintiffs to collect these civil penalties. However, employers may still be held liable by government agencies or individuals acting on behalf of the state to enforce such penalties.

**How the Ruling Affects Employers**

Companies contracting with other companies for services and workers may no longer be able to argue that they should avoid liability for misclassification under the contention that they were not the party to initially misclassify the aggrieved employees. Instead, if the companies are deemed to be employers, mere knowledge of misclassification creates potential liability. Knowledge can be imputed in many ways, as shown by the *Noe* case.

This is especially troubling given the growing trend of companies outsourcing work or obtaining a labor force through third-party staffing agencies. Because California courts are continually interpreting the Labor Code, and usually doing so liberally in favor of protecting employees, employers should ensure that they and their subcontractors are properly classifying their workers. Although the independent contractor classification may be enticing, the long-term consequences of misclassifying employees as independent contractors is increasingly worrisome and brutal in its potential financial impact.

**Protecting Against Liability**

California presumes that all workers are employees, so the burden is on a company to prove that it shares an independent contractor relationship with its workers. Failure to properly classify employees may result in a number of costly consequences, especially given the recent trend of state and federal agencies aggressively pursuing the issue.

For instance, a single claim for unemployment benefits to the California Employment Development Department (EDD), brought by an individual misclassified as an independent contractor, may oftentimes trigger an audit of all workers to ensure that they are not being misclassified as independent contractors. As a result, in addition to penalties and damages stemming from wage and hour violations,

employers may also be subject to enormous tax assessments and other financial liabilities.

How can you safeguard your company to ensure that you won't incur such liability? Unfortunately, there is no single, simple solution. Our advice? Prevent these potentially disastrous consequences, by seeking legal counsel and conducting an independent analysis of individuals performing work under contract. Although there are a number of slightly different tests utilized by state courts, federal courts, the IRS, and the U.S. Labor Department, there are three key elements that you should always consider:

1. **Control is Key**
   First, each analysis utilized by the varying courts and agencies examines the level of control that the employer has over the individual worker. The more control the employer has over the way individuals do their jobs, the more likely it is that the individuals are employees.

2. **Look To All The Factors**
   Second, every analysis implements a number of factors to determine if an individual is an employee or a genuine independent contractor. Although not readily apparent in all factors, the factors generally assess the level of control between the employer and the individual.

   For example, one typical factor is whether an employee provides the needed tools or assumes risk of financial loss. If not, this factor suggests that by eliminating the blow of a financial investment, the nature of the engagement of this individual is one of employment, not the individual running his own business investment.

   Moreover, each factor is rarely dispositive in and of itself; therefore, you must weigh a number of factors. Err on the side of caution if you want to be sure.

3. **Labels Mean Little**
   Third, merely labeling a worker as an independent contractor does not on its own establish a legitimate independent contractor relationship. Essentially, courts will look beyond the words written on a piece of paper or the title of independent contractor often clumsily bestowed upon an actual employee.

   Nevertheless, a well-constructed independent contractor agreement is a crucial step in establishing and ensuring

that a proper contractor relationship exists among companies and their workforce. Additionally, in many cases, the independent contractor agreement is used to interpret the intent of the parties and to inform a court's understanding of the job duties and amount of control between the company and its workers.

**Conclusion**

Cases like *Noe v. Superior Court of Los Angeles* demonstrate that the landscape of the law pertaining to independent contractor classification is constantly shifting; defenses that were once thought to be safe-havens for companies in avoiding liability are slowly eroding. Ultimately, it is important for companies to assess the roles of the individuals performing work under contract.

No doubt about it, there is still a viable role for independent contractors, and there often is a bright line between independent contractor and employee (such as the air conditioning repair technician making a visit to an accounting firm). But in the closer cases, especially when outsourcing an essential function of one's business undertaking, failure to carefully consider whether workers are employees or independent contractors may result in significant liability for both the employer and the company contracting services from the employer.

With adequate precautions, businesses can avoid falling into the misclassification trap. If you'd like our help in assessing your risk, give us a call.

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