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Analyzing the Latest Risks of Worker Misclassification

BY JOEL M. COHN AND RICHARD J. RABIN

FOR A COMPANY seeking to control labor costs or manage its workforce to account for fluctuations in the business cycle, classifying workers as independent contractors can appear an attractive option. Because independent contractors are not “employees,” they generally do not receive employee benefits, are not paid “overtime,” cannot receive unemployment benefits, and, in many states, are ineligible for Workers’ Compensation benefits.

The temptation to avoid these additional expenses and potential liabilities can lead employers to classify workers as independent contractors even when the circumstances do not truly warrant that classification. Even employers with the best intentions can misclassify employees as independent contractors because of the confusing and inconsistent tests for classification. But such misclassification can be costly and the risks are growing. In the last several years numerous federal and state agencies—including the U.S. Department of Labor (DOL), the Internal Revenue Service (IRS), and the New York State Department of Labor (NYSDOL)—have stepped up their enforcement efforts regarding the misclassification of independent contractors.

Federal Scrutiny

In 2010, the DOL and the IRS announced an initiative aimed at identifying employees misclassified as independent contractors.

JOEL M. COHN and RICHARD J. RABIN are partners in the labor and employment practice at Akin Gump Strauss Hauer & Feld in Washington, D.C., and New York, respectively. Associates JOHN T. KOERNER and ANASTASIA M. KERDOCK assisted in the preparation of this article.



The agency has identified several “high-risk industries” for increased independent contractor misclassification investigations, including construction, home health care, transportation, and warehousing.¹ For its part, the IRS aims to audit 6,000 business enterprises each year in order to identify misclassified employees.

The DOL and IRS also have announced a “carrot-and-stick” approach with respect to worker classification issues. The IRS recently unveiled the Voluntary Classification Settlement Program, which allows employers to elect to treat workers as employees in future tax years. In exchange, the IRS will waive all but a small portion of past tax liability, including all penalties and interest that might otherwise be assessed. The program is not open to employers who are currently under

audit by IRS, DOL or any state agency regarding worker classification.

At the same time, the IRS and DOL also have established a joint information-sharing program designed to target employers who do not participate in the Settlement Program. The DOL will provide the IRS with investigation information and “other data that DOL believes may raise Internal Revenue employment tax compliance issues related to misclassification.” IRS will examine and classify employment tax referrals provided by the DOL and then determine compliance with employment tax laws. The IRS also will provide the DOL with aggregate data relating to trends in misclassification on an annual basis. The DOL also has entered into written information-sharing agreements with labor commissioners and agency

leaders from 11 states: Connecticut, Hawaii, Illinois, Maryland, Massachusetts, Minnesota, Missouri, Montana, New York, Utah and Washington.

State Scrutiny

Worker misclassification has been a growing target for state governments as well. In 2007, New York established the Joint Enforcement Task Force on Employee Misclassification, creating a partnership between the NYSDOL, the New York State Workers' Compensation Board, the New York State Workers' Compensation Fraud Inspector General, the New York State Department of Taxation and Finance, the New York State Attorney General's Office, and the Comptroller of the City of New York.^{2,3} The purpose of the Task Force is to increase information sharing between these agencies and to better coordinate their misclassification investigations and enforcement efforts. As of Feb. 1, 2011, the Task Force had conducted 79 "joint enforcement sweeps," identifying \$205 million in unreported wages, more than \$5 million in unemployment taxes due, more than \$7 million in wages due, and approximately \$2.3 million in Workers' Compensation penalties.⁴ In certain cases, JETF investigations also have led to criminal prosecution for falsification of business records and violations of tax law, among other offenses.⁵

Employers in the construction industry have become a special target of state legislation. In 2010, New York passed the New York State Construction Industry Fair Pay Act, which creates a presumption that workers utilized by construction contractors are employees rather than independent contractors.⁶ Studies leading to the passage of the Construction Industry Fair Pay Act purportedly found that as many as one in four New York City construction workers were either misclassified as independent contractors or employed completely off the books.⁷

Private Scrutiny

The misclassification of independent contractors also has become an increasingly popular target for the plaintiffs' bar. Many such challenges have been brought under the overtime and minimum wage laws, including the federal Fair Labor Standards Act (FLSA) and analogous state laws. Plaintiffs have brought class lawsuits challenging the classification of financial advisors,⁸ field nurses,⁹ sales assistants,¹⁰ and a host of other workers. Plaintiffs and the DOL also have brought actions seeking employee benefits for workers classified as independent contractors.

For companies utilizing a large number of independent-contractors, the scope of potential liability for these claims can be significant. For example, FedEx has been engaged in a decade-long challenge to its independent contractor model, with more than 27,000 drivers alleging that they were misclassified under the FLSA and the wage and hour laws of 40 states. While FedEx has been able to get some of these state-law claims dismissed, the court refused to dismiss the plaintiffs' claims under the FLSA and under a number of other state laws.¹¹

In addition to claiming violations of the wage and hours laws, plaintiffs also have brought such challenges as tort claims, breach-of-contract claims, and claims of unfair trade

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practices. In *Harris v. Vector Marketing Co.*, for instance, plaintiffs coupled their FLSA claims with an argument that defendant engaged in unfair competition by misclassifying workers as independent contractors and depriving them of overtime wages and benefits.¹² Vector ultimately settled the action for \$13,000,000.¹³

Plaintiffs even have alleged misclassification claims as violations of the Racketeer Influenced and Corrupt Organizations Act (RICO). In *Karagozian v. Costy US LLC*, for example, the plaintiff alleged that the defendant had committed a RICO violation by mailing fraudulent tax forms listing him as an independent contractor.¹⁴ The district court dismissed the claim, finding that the plaintiff had failed to demonstrate a link between his damages and the "mail fraud" being alleged.¹⁵

Unions also have targeted employers for misclassifying workers as independent contractors. In *OS Transportation LLC*, for example, the company told its workers that it was futile to join a union because they were independent contractors and not "employees" as defined under the National Labor Relations Act.¹⁶ The Teamsters Union challenged this conduct, arguing that the workers were employees and that the company's statement formed an unfair labor practice.¹⁷ The NLRB agreed with the union that the workers were misclassified, and that the

statement was intended to discourage employees from the exercise of their rights.¹⁸

Conclusion

The classification of workers as independent contractors has drawn increasing scrutiny from the DOL, the IRS, state agencies and legislatures, and the plaintiffs' bar. The plaintiffs' bar and organized labor also continue to find innovative ways to bring claims on behalf of workers classified as independent contractors. To avoid litigation and potential liability, companies should carefully review their utilization of independent contractors and the governing legal standards for such classification. Companies also should consider taking proactive steps to limit the potential liability in connection with a finding that their workers are misclassified.

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1. See U.S. Dept. of Labor, "Strategic Plan: Fiscal Years 2011-2016," at 31-32, available at http://www.dol.gov/_sec/stratplan/StrategicPlan.pdf.

2. See New York State Department of Labor, "Annual Report of the Joint Enforcement Task Force on Employee Misclassification to Honorable Andrew M. Cuomo, Governor State of New York," Feb. 1, 2011, available at [http://www.labor.ny.gov/ui/PDFs/2011%202011%20Misclassification%20Report%20to%20the%20Governor%20\(4\)%20\(2\).pdf](http://www.labor.ny.gov/ui/PDFs/2011%202011%20Misclassification%20Report%20to%20the%20Governor%20(4)%20(2).pdf).

3. New York is not alone in its recent efforts to increase scrutiny of independent contractor misclassifications. In Oct. 2011, California enacted an extremely stringent statute, SB 459, which allows for a fine up to \$25,000 for each worker willfully misclassified as an independent contractor.

4. See *id.* at 6.

5. See *id.*

6. See N.Y. Lab. Law §§861-861F. Maine, New Jersey, and Pennsylvania have also passed laws to address the misclassification of construction employees within the past two years. See Me. Rev. Stat. tit. 39-A, §105-A; N.J. Stat. Ann. §§12:65-1.1-12:65-1.7; 34:20-1-34:20-11; 43 Pa. Stat. Ann. §§933.1-933.17.

7. N.Y. Lab. Law §861-A.

8. See *Taylor v. Waddell & Reed Inc.*, 2012 U.S. Dist. LEXIS 212 (S.D. Cal. Jan. 3, 2012) (granting defendant's motion for summary judgment in misclassification claim brought under the FLSA on behalf of financial advisors; defendant represented by Akin & Gump).

9. See *Gayle v. Harry's Nurses Registry Inc.*, 2010 U.S. Dist. LEXIS 137498 (E.D.N.Y. Dec. 23, 2010) (granting summary judgment to field nurse misclassified as independent contractor).

10. See, e.g., *Martignago v. Merrill Lynch & Co.*, 2012 U.S. Dist. LEXIS 4365 (S.D.N.Y. Jan. 13, 2012) (rejecting motion to transfer misclassification lawsuit brought on behalf of "client associates," who provided sales and administrative support to financial advisors).

11. See *In re FedEx Ground Pkg. Sys. Inc.*, 2010 U.S. Dist. LEXIS 134959 (N.D. Ind. Feb. 11, 2011).

12. 753 F. Supp. 2d 996 (N.D. Cal. 2010).

13. See *Harris v. Vector Mgmt. Corp.*, 2011 U.S. Dist. LEXIS 48878 (April 29, 2011).

14. 2011 U.S. Dist. LEXIS 13974 (S.D.N.Y. Feb. 10, 2011).

15. *Id.*

16. 2011 NLRB LEXIS 431 (Aug. 15, 2011).

17. *Id.*

18. *Id.*