Bloomberg Law

Professional Perspective

Independent Contractor Misclassification and Compliance Law: 2010-2020

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Ten years ago, the landscape of the law involving independent contractor compliance and misclassification was quite different—although a great deal remains unchanged today. This article summarizes key legislative, judicial, and administrative developments that have shaped this key niche area of the law in the past decade.

Today, the gig economy's reliance on the independent contractor business model grabs a great deal of attention from lawmakers, regulators, and class action lawyers. But turn the clock back 10 years, and the same story was making headlines—not with an entire industry, but rather with a single company that was caught in the crosshairs of some of the same class action lawyers who are now litigating the gig economy's IC misclassification cases.

That first poster child for IC misclassification claims was FedEx Ground, which suffered an initial setback in 2010 when a federal district court concluded that FedEx had violated the Illinois Wage Act by classifying drivers as ICs. FedEx ultimately paid nearly $500 million in settlement costs to resolve dozens of cases brought against it by drivers for its Ground Division.

While a few courts and administrative agencies have concluded that FedEx Ground was in compliance with certain IC laws, the company was found to have violated a number of state IC laws in large part because the very contract it drafted for drivers needlessly included clauses that retained the right to direct and control them. It was enough control for two federal appellate courts to conclude that FedEx Ground had misclassified the drivers as a matter of law.

Companies in the gig economy have not yet suffered IC misclassification setbacks anywhere near what FedEx Ground experienced. But the prolonged course of legal attacks on businesses using ICs illustrates the need for companies in the sharing economy, as well as more traditional industries, to implement an effective strategy using available tools to enhance compliance with state and federal IC laws, as discussed at the end of this article.

A Decade of Legislative Developments

Beginning in 2010, a host of bills were introduced in Congress to crack down on IC misclassification. The Employee Misclassification Prevention Act was introduced in 2010 and again in 2011. That was followed by the Payroll Fraud Prevention Act, which was first introduced in 2011 and reintroduced with virtually identical language in 2013, 2014, and 2015. Despite no likelihood of passage, the bill was reintroduced in 2017 and was the subject of hearings on the "future of work" in fall 2019.

During that 10-year period, although a dozen or so bills regulating ICs were introduced in Congress, not a single bill involving ICs was passed, and none are likely to pass in the current political climate in Washington, D.C.

While Congress has had no legislative accomplishments involving IC matters in the past decade, one of the major developments over the past 10 years has been the rise in state legislation involving independent contractors. Some states have passed laws cracking down on industries where IC misclassification was found to be prevalent, such as the construction industry. For example, restrictive tests for IC status in the construction industry were enacted in New York and Pennsylvania.

Many state laws were passed throughout the U.S. seeking to curtail the use of ICs, penalize willful misclassification, impose greater penalties for misclassification of ICs, and create misclassification task forces. In contrast to these types of legislation, a few states have passed legislation that accommodates legitimate independent contractor relationships or even encourages IC relationships, including in the ride-sharing industry.

The most meaningful law enacted in the past 10 years involving independent contractors is undoubtedly the recent passage in California of Assembly Bill 5 (AB5), effective Jan. 1, 2020. That law sought to codify into a statute the California Supreme Court's decision in the *Dynamex* case, which adopted a so-called "ABC" test that severely limits the use of ICs.

AB5 created IC convulsions throughout California. Transportation companies and their industry associations filed legal challenges to AB5, and three gig economy companies proposed a ballot initiative to overturn the legislation. Meanwhile, some companies are converting ICs to employees, others are terminating relationships with workers previously regarded as ICs, and still more are just going out of business rather than risk enormous legal liability if workers treated as ICs are found to have been misclassified.

Despite the view by many companies that AB5 spells the end of ICs in California, companies using an IC business model may still be able to operate lawfully in California after AB5 becomes effective. . Even though AB5 carves out over 50 industries from the *Dynamex* ABC test in a series of exemptions, many of those exemptions have been characterized as "opaque" and "ambiguous."

The absence of legislation at the federal level has undoubtedly created an impetus for state lawmakers to pass new IC laws. As a result, there is now a quilt of varied state laws with vastly different tests for IC status. Differences in state IC laws has made it extremely challenging for companies operating on a nationwide basis to maintain a high level of compliance with IC laws. However, companies can use certain tools, as noted below, to enhance their compliance with this wide-ranging array of state and federal IC laws.

Multimillion-Dollar Settlements Now Commonplace

The first seven-figure settlement in the area of IC misclassification involved FedEx Ground, which agreed to pay $3 million in a July 2010 settlement with the attorney general of Massachusetts to resolve claims that it misclassified Ground Division drivers. Shortly thereafter, FedEx settled similar claims with Montana's attorney general for $2.3 million.

The first multi-million-dollar settlement of a class action lawsuit alleging IC misclassification involved 3P Delivery Inc., which settled with drivers from Oregon and Washington in Oct. 2010 for $2.25 million.

The earliest gig economy settlement of an IC misclassification case took place in Jan. 2013, when kgb USA, a text message and internet information provider, settled a lawsuit brought by the U.S. Department of Labor for $1.3 million.

Later in 2013, the first of many IC misclassification settlements in the adult entertainment area was reached between exotic dancers and Penthouse Executive Club, which agreed to pay the dancers and their lawyers $8 million. Since that time, adult entertainment clubs have been targeted for IC misclassification lawsuits and have entered into dozens of seven-figure settlements with dancers.

The first eight-figure IC misclassification settlement in the past decade was reached in Jan. 2014 by Copley Press, publisher of the San Diego Tribune, which agreed to pay $11 million to settle claims by a class of 1,200 paper carriers.

The first reported IC misclassification settlement in the retail economy was with Lowe's in May 2014, when it settled with home improvement contractors for $6.5 million. Other retailers have been sued, such as Macy's, J.C. Penney, Sears, and Home Depot, leading to a number of multi-million-dollar IC misclassification settlements involving the retail industry.

Logistics and delivery companies have been targeted repeatedly as class action defendants in IC misclassification cases, and the amounts of settlements in those cases are often very substantial. For example, XPO Logistics settled one of many IC misclassification cases against it for $16.5 million.

By mid-decade, the first nine-figure settlement in an IC misclassification case was reached, when FedEx settled a class action with Ground Division drivers in California for $228 million. This settlement followed on the heels of a blockbuster decision by the U.S. Court of Appeals for the Ninth Circuit, which held that FedEx had misclassified those drivers in California as a matter of law. That decision was one of the first decisions by an appeals court on the merits of an IC misclassification claim.

Nine-figure settlements were not limited to FedEx and Uber: Swift Transportation announced in March 2019 that it reached a $100 million settlement with 20,000 owner-operators.

The gig economy has become the main target of plaintiffs' class action lawyers in IC misclassification cases during the second half of the past decade. In early 2016, two ride-sharing companies announced that they had reached large settlements with drivers in California and Massachusetts: $12.5 million in the case of Lyft and between $84 million and $100 million in the case of Uber Technologies. The federal courts overseeing those settlements rejected both as being legally inadequate. This prompted Lyft to recalibrate its settlement parameters and settle its California class action in June 2016 for $27 million.

Uber, though, chose to reevaluate its defense strategy and adopt an even more vigorous litigation approach, together with a greater reliance on arbitration agreements with class action waivers. Eventually, Uber chose to resolve most of its IC misclassification cases in the first and second quarters of 2019 (just before it issued its initial public offering), settling for approximately $175 million its California and Massachusetts class actions as well as 60,000 individual arbitrations The ride-sharing industry today remains a focus of IC misclassification class action lawyers.

Other gig economy companies have been sued regularly in the second half of this decade for IC misclassification. Those companies include such household names as Amazon, Postmates, Instacart, DoorDash, GrubHub, Homejoy, and Handy, some of which have settled cases for sizeable seven-figure amounts.

There has been virtually no industry using ICs that is immune from an IC misclassification lawsuit, and the list would go on for pages. Just taking one letter from the alphabet, "C," IC misclassification lawsuits have been brought by cable television installers, cheerleaders, chiropractors, cell phone sales agents, convenience store franchisees, and cleaning contractors and custodians.

A Few Successful Defenses

Some companies have successfully defended against IC misclassification cases. American Family and Northwest Mutual have withstood court challenges to their IC business model for insurance agents.

While some oil and gas companies have settled IC misclassification cases for considerable amounts, at least one has withstood that type of legal challenge by directional drilling consultants.

In the second half of the past decade, courts and administrative agencies have found high school referees to be properly classified as ICs, as well as certain black car drivers, distributors for a baked goods company, barbers, psychological counselors, surgeons, bloggers, freight drivers, and yoga instructors. However, none of these decisions means that similar service providers for other companies will likewise be found to be ICs. Indeed, other courts have found many of the above service providers to be employees.

The list of those companies that have succeeded in establishing IC status are a lot shorter than the list of those who have settled IC misclassification cases or been found to have misclassified employees as ICs, because the legal fees alone to defend these types of lawsuits can approach the cost of settling or litigating them to judgment.

Three Influential Court Cases

The decision that has caused an earthquake in California independent contractor circles was *Dynamex,* issued by the California Supreme Court on April 30, 2018. Overnight, it changed close to three decades of settled law in California that had been based on the 1989 California Supreme Court decision in the *Borello* case, which had set forth a non-exhaustive list of factors that the courts should consider in determining if a worker was an IC or employee. In *Dynamex*, the California Supreme Court created a so-called ABC test where all three prongs must be met to establish IC status.

Many companies—from mom-and-pop shops to the largest gig economy companies—had invested in and built their businesses in reliance on *Borello,* only to have the highest court in the state change the test for IC status in a manner that severely restricts the use of ICs. As noted above, the *Dynamex* decision prompted the California legislature to pass AB5, which was signed by the governor and is effective Jan. 1, 2020. While AB5 was designed to "codify" *Dynamex* into the California Labor Code, it exempted more than 50 industries from the ABC test and allows them to continue to qualify for IC status under *Borello*.

Rather than simplify the law, which the California Supreme Court sought to do by enacting a three-part test, litigation resulting from *Dynamex* and AB5 will likely complicate the legal landscape in California and consume a great deal of attention in the next year or two—and maybe a number of years thereafter.

The second noteworthy decision in the past decade was issued in May 2018 by the U.S. Supreme Court in the *Epic Systems Corp*. case. That opinion upheld mandatory arbitration agreements, including those with class action waivers, imposed on workers by companies. *Epic Systems* has dramatically changed the landscape of IC misclassification class actions, prompting motions to compel arbitration and reducing considerably the cost of settlements in these types of cases.

While *Epic Systems* may have permitted mandatory arbitration agreements with class action waivers, many courts have struck down such agreements because they were not well-drafted or were found to be unconscionable under applicable state laws. Companies seeking to effectively draft such arbitration agreements with class waivers can deploy various tactics in the IC agreements.

The third judicial decision of note in the past two years was the U.S. Supreme Court's opinion in *New Prime Inc*., holding that Section 1 of the Federal Arbitration Act exempts interstate transportation workers from mandatory arbitration agreements. That Jan. 2019 decision had prompted Swift Transportation, as mentioned above, to settle its class action IC misclassification lawsuit by owner-operators for $100 million, once it became clear that the FAA could not be used to compel individual arbitrations of the IC misclassification claims.

Plaintiffs' class action lawyers are now trying to expand the *New Prime* decision to cover couriers making local deliveries of food, groceries, and retail goods. That argument will likely be litigated for years before being resolved, possibly by the U.S. Supreme Court.

Administrative and Regulatory Developments

Perhaps the biggest change in the landscape of IC misclassification law over the past 10 years has been in the administrative and regulatory arena. At the federal level, a change in administrations caused dramatic differences at the National Labor Relations Board and the U.S. Department of Labor in their approaches to determining IC status.

At the NLRB, there were three major developments affecting IC status during the Barack Obama administration. In Sept. 2014, the NLRB issued a ruling that FedEx Ground Division drivers were not ICs but rather employees subject to being represented by a union. The Board disagreed with the U.S. Court of Appeals for the District of Columbia Circuit that the opportunity offered to drivers to acquire and operate multiple routes was a key factor demonstrating their IC status. The NLRB instead held that "actual, not theoretical, entrepreneurial opportunity" is the "animating principle" of IC status.

A second major decision affecting IC status was the NLRB's Aug. 2015 decision in *Brown-Ferris Industries* that joint employer status is to be determined by the contractual right to control the workers, not on whether that right was actually exercised. While the case did not directly involve IC status, it appeared that the NLRB would apply the "right to control" principle in cases involving the IC status of workers that were seeking representation under the NLRA.

In Aug. 2016, the NLRB's general counsel released an Advice Memorandum where he seemed poised to find that IC misclassification, standing alone, was itself an unfair labor practice because it purportedly deprived workers of the protections of the National Labor Relations Act by classifying them as non-employees.

Those efforts by the NLRB to limit the use of ICs were overturned after the Donald Trump administration appointed new members of the NLRB, who reexamined the rationale of those initiatives.

In Jan. 2019, the NLRB overruled the 2014 FedEx decision and the earlier FedEx decision on which it was based. The Board concluded in *SuperShuttle DFW, Inc.* that shuttle drivers that owned and operated franchises were independent contractors and not employees eligible for representation under the NLRA. In overruling the earlier FedEx cases, the current NLRB set forth a "non-exhaustive" list of eight common-law factors, noting that none of the eight were determinative and all should be evaluated "through the prism of entrepreneurial opportunity."

In May 2019, the general counsel of the NLRB issued an Advice Memorandum that drivers providing transportation services to customers of Uber Technologies are ICs and therefore outside the purview of the NLRA. In concluding that Uber drivers were independent contractors, the memorandum stated that the drivers had virtually complete control of their cars, work schedules, and log-in locations, as well as freedom to work for competitors of Uber, all indicating significant entrepreneurial opportunity for the drivers.

The memorandum pointed out that there was some control exercised by Uber, such as its limitation on the drivers' ability to select trips and its establishment of fares, but when weighed against the other factors in favor of entrepreneurial freedom, the drivers were independent contractors under the NLRA.

Finally, in Aug. 2019, the NLRB issued a decision finding that the act of misclassifying workers, standing alone, was not an unfair labor practice. NLRB held that "when an employer decides to classify its workers as independent contractors, it forms a legal opinion regarding the status of those workers and its communication of that legal opinion to its workers is privileged by Section 8(c) of the Act."

At the U.S. Department of Labor, the biggest development occurred in June 2015, when the administrator of the Wage and Hour Division of the Labor Department issued an Administrator's Interpretation addressing the misclassification of employees as ICs under the Fair Labor Standards Act. The 15-page interpretation sets forth the factors to be examined by the Labor Department in enforcing its wage and hour laws against companies that classify workers as independent contractors.

The official interpretation focused almost entirely on economic dependence, to the exclusion of most of the other factors that the administrator said should be considered. The interpretation sent a message to businesses and workers that the Labor Department would be cracking down further on IC misclassification. Many practitioners regarded the administrator's interpretation as a roadmap for plaintiffs' class action lawyers bringing IC misclassification cases under the FLSA.

After a new Secretary of Labor was nominated by President Trump and confirmed by the Senate, changes at the Labor Department were swift. The Department of Labor announced that it was withdrawing the former administrator's interpretation on the issue of IC status under the FLSA.

In April 2019, the Labor Department issued an Opinion Letter on the issue of independent contractor status of an on-demand virtual marketplace company that refers end-market consumers to service providers who offer delivery, transportation, shopping, moving, cleaning, plumbing, painting, and household services. The Labor Department examined six factors pertinent to IC status under the FLSA and concluded that all six favored IC status. While the letter considered the same factors as did the earlier administrator's interpretation, it interpreted them in a dramatically different manner.

Just before the letter was issued, the Labor Department issued a proposed new regulation on the issue of joint employer status. The proposed regulation made it abundantly clear that joint employer status and IC status are two wholly different legal matters. The test for IC status under the FLSA is commonly referred to as the "economic realities" test and it focuses on factors that bear on the workers' economic dependence on the purported employer. It clarifies that economic dependence has no relevance to joint employer status. In one of the key pronouncements of the proposed rule, the Labor Department states that "joint employer status under the Act" is not determined by the employee's "economic dependence."

How to Enhance IC Compliance

One matter that has remained constant during the past decade is the need for companies using ICs to take thoughtful and well-designed steps to enhance their compliance with IC laws. There are four reasons.

First, while the current administration may not be as aggressive about enforcing the federal wage and hour laws as the past administration, there has been no perceived unwillingness by the Labor Department to pursue companies that have intentionally or recklessly misclassified employees as ICs. Nor has there been any perceived falloff of audits by the IRS of companies that use a business model reliant on the use of ICs.

Second, many state regulatory agencies have continued to conduct audits and investigations of companies that treat workers as ICs instead of employees, forcing businesses to continue to defend an endless number of audits seeking unemployment insurance taxes or workers' compensation premiums.

Third, class action lawsuits have not abated, despite the Supreme Court's decision in *Epic Systems* that countenanced the use of mandatory arbitration agreements including those with class action waivers. While the value of settlements may have decreased due to *Epic*, these types of lawsuits continue to proliferate and are likely to hound companies with an IC dependent business model.

Fourth, the enactment of AB5 in California has caused IC misclassification to enter the national conversation, especially due to the disruption of legitimate IC relationships in that state, the closing of businesses that had been reliant on ICs, and the interest of legislators in other states to adopt a version of AB5 despite its drawbacks. This is likely to prompt even more IC misclassification lawsuits in the coming decade.

All of this leads to one overriding takeaway for businesses that are reliant on ICs: the best defense is to elevate the level of compliance with IC laws in each state in which a company operates, including California. AB5 is not a deathtrap for all ICs and companies that make use of them. There are ways to comply with AB5 without converting ICs to employees or terminating relationships with all ICs.

Many companies are advised to deploy processes that restructure, re-document, and re-implement IC relationships in a manner that enhances compliance with IC laws in a customized and sustainable manner, consistent with a company's business model. As part of that process, it is often wise to have an effective arbitration agreement with class action waiver. Such agreements can be drafted in a state-of-the-art manner that best avoids arguments by plaintiffs' class action lawyers who seek to invalidate those types of valuable agreements.

While there is no way of knowing if another *Dynamex* or AB5 is coming down the road in the next decade, it is fair to assume that the use of ICs by businesses will not diminish. Studies by the Government Accountability Office and the Bureau of Labor Statistics have found that those who identify as ICs have greater work satisfaction than those who have traditional jobs as employees, as confirmed by a recent Gallup poll.

Companies wishing to make the best use of those in the workforce who wish to maintain their status as ICs and freelancers must dot their i's and cross their t's to avoid having their own agreements used against them. The lessons learned from the last decade of IC misclassification lawsuits strongly suggest that a process that elevates a company's IC compliance is likely to negate or minimize needless costs of defending and settling IC misclassification cases.