Wage and Hour Litigation

Employee Status

By Jason J. Thompson

FAST FACTS

At first blush, a person's status as an employee might seem to be a simple question. But under the Fair Labor Standards Act (FLSA), "employment" is defined with "striking breadth."

Employment contracts or elections do not decide whether a worker is an employee under the FLSA; the economic-realities test controls.

The FLSA contemplates that *more* than one employer may be responsible for violations under the act.

The Fair Labor Standards Act

The Fair Labor Standards Act (FLSA) establishes several important employee benefits, including minimum-wage, overtime-pay, recordkeeping, and youth-employment standards affecting employees in the private sector and in federal, state, and local governments.[1] Covered nonexempt workers are entitled to a minimum wage of not less than $7.25 an hour. Overtime pay at a rate not less than 1½ times the regular rate of pay is required after 40 hours of work in a workweek.

Employment Status

To enjoy the benefits afforded under the FLSA, however, a worker must in fact be a nonexempt employee.[2] At first blush, establishing one's status as an employee might seem to be simple. But under the FLSA, "employment" is defined with "striking breadth."[3] An entity is said to "employ" a person if it "suffers or permits" the person to work.[4] The "suffer or permit to work" standard derives from state child-labor laws and has been called the broadest definition of "employee" that has ever been included in one act. Consequently, many work situations that might appear to be non-employee based, such as those involving subcontractors, are in fact employment situations covered by the FLSA.

The Economic-Realities Test

Most jurisdictions use the "economic realities" test to determine whether an individual is an "employee" under the FLSA. Under the economic-realities test, employee status turns on whether the individual is, as a matter of economic reality, in business for himself or herself. In *Donovan v Brandel,* the United States Court of Appeals for the Sixth Circuit recognized that the definition of employment under the FLSA is "determined" by evaluating whether the employee, "[a]s a matter of economic reality [is] dependent upon the business to which the employee render[s] service."[5] Whether an employee's "economic reality" is "dependent" on the employer's business is determined by evaluating six factors. No single factor is more important than another: courts consider the entire circumstances of the working relationship. The six factors include:

(1) The permanency of the relationship between the parties

(2) The degree of skill required for rendering the services

(3) The worker's investment in equipment or materials for the task

(4) The worker's opportunity for profit or loss, depending on his or her skill

(5) The degree of the alleged employer's right to control the manner in which the work is performed

(6) Whether the service rendered is an integral part of the alleged employer's business[6]

The economic-realities test is different from other regularly used tests for determining employee status, such as those based on tax law or common-law principles (applying the factors found in chapter seven of the Restatement 2d, Agency, §220).[7] Many federal circuits and the United States Supreme Court have rejected the use of all other common and practical tests for determining the employment status of a worker when the FLSA is involved and require trial courts to apply the economic-realities test. This is because the test for employment status under the FLSA is *far different* from those governing the tax code or traditional common-law principles. In *Nationwide Mut Ins Co v Darden,* the United States Supreme Court evaluated this precise issue and held that the FLSA's definition of employee, "whose striking breadth we have previously noted, stretches the meaning of 'employee' to cover some parties who might not qualify as such under a strict application of traditional agency law principles."[8] Many business owners—and their advisors—may be surprised to learn that the tests they routinely use to determine employee status in other aspects of operating their businesses are inapplicable when determining FLSA coverage.

Two Common Misclassification Scenarios

Many FLSA cases are litigated over whether the plaintiff is an "employee," and thus entitled to FLSA protections, or an independent contractor, and thus not afforded FLSA benefits. Portraying regular workers as independent contractors allows companies to circumvent minimum-wage, overtime, tax, and antidiscrimination laws. Workers classified as contractors do not receive unemployment insurance if laid off or workers' compensation if injured, and they rarely receive the health insurance or other fringe benefits regular employees do. Workers often misclassified include cable TV installers, loan underwriters, construction workers, and home-health aides. Misclassification tactics include (1) employment contracts in which the workers purportedly "elect" to work as independent contractors and (2) obtaining workers through use of "subcontractors" or labor supply companies.

Elections

Determining whether a worker is actually an "employee" covered by the FLSA is not something the employer and worker can simply decide between themselves.[9] Thus, the determination is not made on the basis of the employment contract between the employer and employee, the subjective intentions of the parties, any so-called "elections," or any labels placed on the workers. The United States Supreme Court has squarely rejected such arguments, noting that "putting on an 'independent contractor' label does not take the worker from the protection of the Act."[10]

The rule protects workers from overbearing employers who have the unequal bargaining power to impose a phony "election" on their workers under the threat of termination. As the Sixth Circuit explained in *Imars v Contractors Mfg Servs, Inc,*[11] the FLSA is designed to defeat rather than implement contractual arrangements:

> We agree that it makes very good sense to reject contractual intention as a dispositive consideration in our analysis. The reason is simple: *"The FLSA is designed to defeat rather than implement contractual arrangements."* [Sec'y of Labor v. Lauritzen, 835 F.2d 1529, 1544-455 (7th Cir. 1987) (Easterbrook J., concurring)]; see also Real v. Driscoll Strawberry Assoc., 603 F.2d 748, 755 (9th Cir. 1979) ("Economic realities, not contractual labels, determine employment status for the remedial purposes of the FLSA."). *The FLSA represents the New Deal's rejection of Lochner v. New York, 198 U.S. 45, 25 S.Ct. 539, 49 L.Ed. 937 (1905), and its doctrine of freedom of contract.* Even if employees freely want to work for below the minimum wage, or work in statutorily banned work conditions, or work long hours without extra compensation—even if their choices are moral and economically efficient—*the FLSA does not allow this.* This is true even when the bargaining is done at arm's length. [Emphasis added.]

In another example, the Fifth Circuit, evaluating the status of exotic dancers, held: "We reject the defendants' creative argument that the dancers are mere tenants who rent stages, lights, dressing rooms, and music from Circle C."[12] Similarly, in *Harrell v Diamond A Entertainment, Inc,* the court noted: "Arrangements factually similar to the one in this case [i.e., an independent-contractor relationship] have been tested by federal courts in Texas, Indiana and Colorado. *Without exception,* these courts have found an employment relationship and required the nightclub to pay its dancers a minimum wage."[13]

The reason only the economic-realities test is used for determining FLSA employee status, and not job titles or worker elections, was explained well in *Taylor Blvd Theater v United States.*[14] The United States District Court for the Western District of Kentucky *rejected* the defendant's argument that it should follow common employee tests and expressly acknowledged that under a given set of facts, the FLSA may result in a finding of employee status where another common test would not:

> Rather than using the common law test, the FLSA requires courts to examine the "economic reality" of the employment relationship to determine whether it is one of economic dependence or whether, in fact, the worker is an independent businessperson. *Since the two tests could produce vastly different conclusions in practice, and it is possible to be classified as an "employee" under one and not the other, the FLSA cases would not be helpful in the context of a federal tax law question.*[15]

Subcontractors

In another situation, companies use the subcontractor system to avoid FLSA obligations. Rather than actually hire employees, companies obtain laborers through temporary labor providers, which in turn do not provide FLSA benefits to the workers. The workers lose out at both ends—neither the company nor the subcontractor provides FLSA benefits. Companies using this strategy will quickly point to the labor-provider contract and argue that they never intended to "employ" the workers and only obtained temporary workers under a valid contract. They argue that the subcontractor is the employer. But defendants invoking this strategy face two problems. First, as explained earlier, contracts and

elections are not the test for whether a worker is an employee under the FLSA: the economic-realities test is. Second, the FLSA allows for more than one employer. Thus, establishing that the subcontractor is an employer does not itself end the defendant's liability for FLSA benefits.

29 USC 203(d) broadly defines "employer" to mean "any person acting directly or indirectly in the interest of an employer in relation to an employee." The United States Supreme Court has construed the term expansively to fulfill the remedial goals of the act and held that the FLSA contemplates that more than one employer may be responsible for violations under the act.[16] Likewise, the Sixth Circuit has held that "'[t]he remedial purposes of the FLSA require courts to define 'employer' more broadly than the term would be interpreted in traditional common law applications.'"[17] In *Donovan v Agnew,* the First Circuit explained: "The overwhelming weight of authority is that a corporate officer with operational control of a corporation's covered enterprise is an employer along with the corporation, jointly and severally liable under the FLSA for unpaid wages."[18] In *Donovan,* the court held that "corporate officers with a significant ownership interest who had operational control of significant aspects of the corporation's day to day functions, including compensation of employees, and who personally made decisions to continue operations despite financial adversity during the period of non-payment" were employers under the FLSA.[19]

Some Recent Effects of Misclassification Highlighted

The *New York Times* recently reported how federal and state governments have taken notice of the misclassification problem and the corresponding loss in tax revenue. For example, President Obama's proposed 2010 budget assumed that increased prosecution actions will yield at least $7 billion over 10 years. In New York, a February 1, 2010, state report found more than 31,000 instances of misclassification since 2007, resulting in an estimated $11 million in unpaid unemployment taxes and $14.5 million in unpaid wages. California's Jerry Brown, while still the state attorney general, sought $4.3 million from a construction firm he accused of misclassifying employees and in 2009 won a $13 million judgment against two companies that had misclassified 300 janitors. And in November 2009, the Illinois Department of Labor imposed $328,500 in penalties on a home improvement company for misclassifying 18 workers, saying it had pressed the workers to incorporate as separate business entities.[20]

Avoid Inadvertently Misclassifying Workers

The status of a worker as an employee is not as simple a question to answer as one might expect. Simply applying labels or titles to workers such as "subcontractor" or "tenant" will not work. Offering workers the "election" to be treated as an independent contractor fails the test too. Each situation must be honestly evaluated using the economic-realities test. For example, companies that rely on outside or temporary workers but still want to retain a significant amount of control over the work environment, manner of performance, and workers need to carefully analyze the economic realties of the workers' situations for FLSA purposes. It can come as a costly surprise to learn that FLSA benefits are owed to a large pool of workers. Courts will enforce that obligation against companies that are valid standalone corporations, parent corporations, and even officers within the nominal employer company. Great care is warranted—the FLSA provides for liquidated damages and attorney fees,[21] and class actions are often certified, only raising the stakes. ■

Jason J. Thompson is chair of the Sommers Schwartz complex litigation department and concentrates in state and national class actions and multidistrict litigation in federal courts. He is board certified in civil trial litigation by the National Board of Trial Advocacy and has been selected as a Michigan Super Lawyer. His class action practice includes a wide variety of areas, including wage and hour violations.

FOOTNOTES

1. 29 USC 204 *et seq.* For an overview of the FLSA, see United States Department of Labor, Wage and Hour Division, *Compliance Assistance—Fair Labor Standards Act (FLSA)* <http://www.dol.gov/WHD/flsa/index.htm>. All websites cited in this article were accessed January 18, 2011.
2. 29 USC 213. For an overview of the specific types of workers exempted, see United States Department of Labor, Wage and Hour Division, *Handy Reference Guide to the Fair Labor Standards Act* <http://www.dol.gov/whd/regs/compliance/hrg.htm>.
3. *Nationwide Mut Ins Co v Darden,* 503 US 318, 325; 112 S Ct 1344; 117 L Ed 2d 581 (1992), citing *Rutherford Food Corp v McComb,* 331 US 722, 728; 67 S Ct 1473,1475; 91 L Ed 1772 (1947).
4. 29 USC 203(g).
5. *Donovan v Brandel,* 736 F2d 1114, 1116 (CA 6, 1984), citing *Dunlop v Carriage Carpet Co,* 548 F2d 139, 145 (CA 6, 1984).
6. *Imars v Contractors Mfg Servs, Inc,* 165 F3d 27 (CA 6, 1998) (table), available at 1998 WL 598778, *3.
7. *Nationwide Mut,* 503 US at 325–326.
8. *Id.*
9. *Rutherford Food Corp v McComb,* 331 US 722, 729; 67 S Ct 1473; 91 L Ed 1772 (1947) ("Where the work done, in its essence, follows the usual path of an employee, putting on an 'independent contractor' label does not take the worker from the protection of the Act.").
10. *Id.,* citing *Walling v American Needlecrafts,* 139 F2d 60 (CA 6, 1943).
11. *Imars,* 1998 WL 598778, at *5.
12. *Reich v Circle C Investments Ltd,* 998 F2d 324, 329 (CA 5, 1993).
13. *Harrell v Diamond A Entertainment, Inc,* 992 F Supp 1343, 1347–1348 (MD Fla, 1997) (citations omitted) (emphasis added).
14. *Taylor Blvd Theater v United States,* unpublished opinion of the United States District Court for the Western District of Kentucky, issued May 13, 1998 (No. Civ A 3:97-CV-63-H), available at 1998 WL 375291.
15. *Id.* at *4 n 4 (emphasis added).
16. *Falk v Brennan,* 414 US 190, 195; 94 S Ct 427; 38 L Ed 2d 406 (1973).
17. *Dole v Elliot Travel & Tours, Inc,* 942 F2d 962, 965 (CA 6, 1991) (citation omitted).
18. *Donovan v Agnew,* 712 F2d 1509, 1511 (CA 1, 1983).
19. *Id.* at 1514.
20. Greenhouse, *U.S. Cracks Down on "Contractors" as a Tax Dodge,* NY Times, February 18, 2010, p A1, available at <http://www.nytimes.com/2010/02/18/business/18workers.html>.
21. 29 USC 216.