LOS ANGELES & SAN FRANCISCO

Daily Journal

www.dailyjournal.com

FRIDAY, FEBRUARY 2, 2024

PERSPECTIVE

Worker classification: New rules shouldn't change settlement calculus

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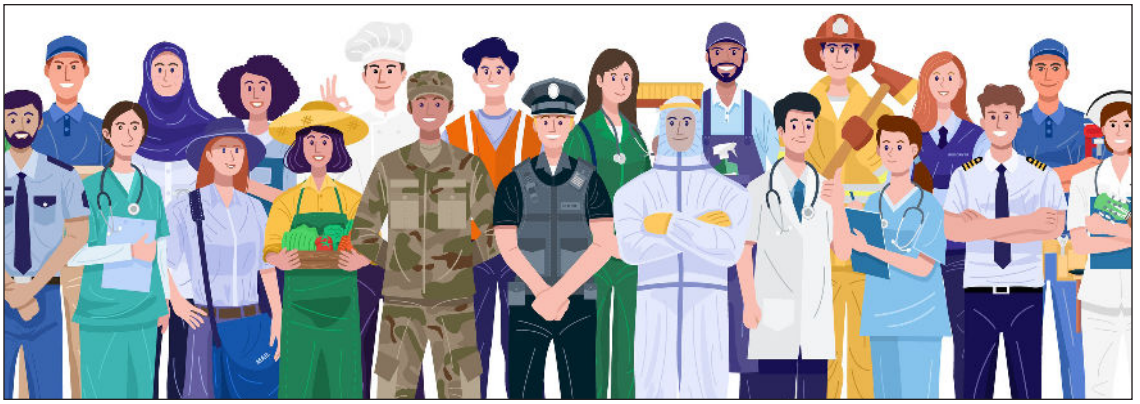

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On Jan. 9, the U.S. Department of Labor announced a new rule, effective March 11, that could impact how California businesses classify their workers. The rule will use a multifactor "economic reality" test to define which workers should be classified as employees rather than independent contractors under the Fair Labor Standards Act (FLSA).

The final rule will rescind the prior administration's 2021 independent contractor rule, which used a "core factors" approach, giving heaviest weight to "the nature and degree of the individual's control over the work" and "the individual's opportunity for profit or loss." It restores the prior "economic realities" test, which looks at the "totality of the circumstances."

Six factors will be assessed equally, with none weighing more heavily than the others. These factors are opportunity for profit or loss; investments by the worker and the potential employer; the degree of permanence of the work relationship; the nature and degree of control over the work; the extent to which the work performed is an integral part of the potential employer's business; and the skill and initiative required to perform the work. Together these factors are evaluated to determine if the work is economically dependent on the potential employer.

The changes are sure to have a significant impact on businesses across the country, especially those that classify large numbers of their workers as independent contractors. These businesses may find that they are required to reimburse their employees for back pay minimum wages and overtime and to set up detailed records of future compensation and hours worked for previously misclassified workers. They could be obligated to set up payroll withholdings to cover taxes, Social Security, Medicare and unemployment benefits. Other employee benefits programs could also extend to these former independent contractors.

For California employers, pain may be felt, but it should be far less severe. Recall that the state's businesses have been operating for a few years now under the *Dynamex* decision, as well as its aftermath, AB5. Except for certain categories of workers, employers have been using an ABC test to determine the proper classification for their workers. Yes, Prop 22 established a carve-out for app-based gig workers, but the reality is that the rules changed a while back for most California companies.

Under the ABC test, a worker must be classified as an employee if all three of these factors apply: (A) the worker is free from the control and direction of the hiring entity in connection with the performance of the work; (B) the worker performs work that is outside the usual course of the hiring entity's business; and (C) the worker is customarily engaged in an independently established trade, occupation, or business of the same nature as that involved in the work performed. Hence, absent the Prop 22 carve-out, rideshare and delivery drivers would almost certainly fail all three prongs of the test.

Although somewhat different, the DOL rules follow a similar logic. The first factor - opportunity for profit or loss depending on managerial skill -

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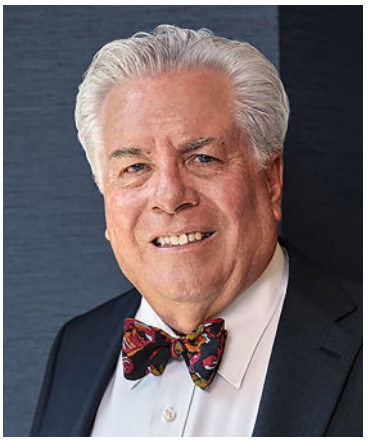

looks primarily at whether workers are able to earn profits or suffer losses through their own independent efforts and decision making. In explaining how to conduct the analysis, the DOL cites factors such as whether workers can negotiate their own compensation; whether they can accept or decline work; whether they advertise their business or take other steps to expand it; and whether they make decisions about hiring workers, purchasing materials, or renting space.

The analysis for the five other factors closely hews to the "economic realities" test that underlies California's current ABC classification law. If anything, the six-factor test could provide additional nuance and ammunition for plaintiffs intent on proving that they have been incorrectly classified. When added on top of the existing ABC criteria, the new FLSA rules could make it very difficult for businesses to succeed against such challenges.

What does this mean in the context of a mediation and settlement negotiation? In my experience as an employment law mediator, I have seen a sharp increase in the number and frequency of misclassification claims. Years ago, we rarely dealt with the issue but today misclassification has become an automatic part of almost every employment dispute that I mediate.

It is commonly asserted in actions brought by apartment managers against building owners, but misclassification is regularly included in cases brought by workers at all levels and skill sets when they have been treated as independent contractors. Even when the primary claim involves discrimination, retaliation, or unsafe work conditions, misclassification will be included in the complaint. And that claim will inevitably become the "tail wagging the dog." The primary claim may lack support or otherwise be questionable, but the misclassification claim endows the entire action with both gravitas and staying power. It cannot be easily or summarily dismissed.

Unlike other claims asserted, a misclassification claim will entitle the prevailing plaintiff to attorneys fees. If all else fails, those fees will still be recoverable, and they are generally not covered by the employer's business insurance. An employer could find itself rejecting its carrier's push to close a case for the simple reason that settlement will leave it holding the bag on a huge fee award.

I think it is incumbent on counsel for employers to properly assess the risk of a successful claim for misclassification at the outset of litigation and to neutralize that claim by paying those damages at the start of the litigation, rather than waiting until the time of mediation - which may be years after the claim arose. That would significantly insulate the client from the leverage of these claims.

There are rumblings about pushback against the new DOL classification scheme, with business groups threatening to seek action from Congress. But given the current level of dysfunction in Washington, it's unlikely that anything will change in the foreseeable future. This leaves businesses to review their worker classification decisions, make adjustments as appropriate, and be prepared to defend those decisions in mediation negotiations or before a court.