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CREATING A WORKABLE LEGAL STANDARD FOR DEFINING AN INDEPENDENT CONTRACTOR

KAREN R. HARNED*, GEORGINE M. KRYDA**, ELIZABETH A. MILITO***

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I. INTRODUCTION

Determining whether a particular worker should be classified as an employee or an independent contractor currently depends heavily upon the specific circumstances of employment. Although current legal approaches are meant to be flexible, the open-endedness of the current tests means that many business owners struggle with fitting their employees into the proper categories. A business that misclassifies employees, whether in good faith or on purpose, will face expensive penalties. In 2007, the state of California alone collected $163 million in back taxes and penalties for independent contractor misclassifications.1 Audits for such

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misclassifications are becoming more frequent, indicating that more and more business owners struggle because of uncertainty in the law. Also, the number of businesses using non-traditional work arrangements is increasing, meaning that this problem is likely becoming more widespread. Other studies indicate that the more innovative a company is, the more likely it is to use non-traditional forms of employment.

This article proposes a workable legal standard for defining an independent contractor—the step-back test, based on business practice and contract law. The next sections of this article summarize current business considerations and legal requirements before turning to the proposed standard. The independent contractor model has been used throughout U.S. history, primarily for its flexibility and cost advantages. In attempting to define the individual’s “degree of control,” current legal requirements often conflate classification with enforcement. These two functions need to be disentangled and focus concentrated on simplifying the appropriate classification of workers.

No one disputes the existence of legal economic incentives for employers to use independent contractors or the potential for abuse from misclassification of bona fide employees as independent contractors. Previous scholarship on independent contractor misclassification has thus focused almost entirely on the problems that misclassified workers face. These concerns are real. But such scholarship has almost entirely overlooked employers’ interests in keeping their businesses and glosses over the core problem that employers face. The core problem is that different government agencies use different factors in their balancing tests, but the business owner bears the consequences for however the owner resolves the dichotomy between employee and independent contractor.

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****The views expressed in this article are entirely those of the authors and do not necessarily reflect the views of NFIB. The authors would like to thank Bill Rys for his helpful review and comments.


2 Id. In California alone, the number of state audits climbed to 5,730 in the fiscal year ending June 30, 2007. Id. This number rose 54% over the course of three years. Id.

3 See, e.g., Press Release, U.S. Census Bureau News, Businesses With No Paid Employees Increase to 19.5 Million (July 30, 2006), http://www.census.gov/newsroom/releases/archives/ economic_census/cb06-115.html. The nation added nearly a million businesses with no paid employees between 2003 and 2004 to reach 19.4 million, a growth rate of nearly 4.7 percent over a one year period. Businesses without a payroll also make up more than 70 percent of the nation’s 27 million plus firms, with annual receipts of $887 billion.

4 See, e.g., Id. The nation added nearly a million businesses with no paid employees between 2003 and 2004 to reach 19.4 million, a growth rate of nearly 4.7% over a one year period. Businesses without a payroll also make up more than 70% of the nation’s 27 million plus firms, with annual receipts of $887 billion. Id.

5 See Nick Kratzer, Employment Organization and Innovation – Flexibility and Security in Virtualized Companies, 17(1) TECH. ANALYSIS & STRATEGIC MGMT. 35, 38 (2005) (describing an investigation conducted in West Germany which showed that companies that successfully carried out process or product innovations displayed substantially higher levels of atypical forms of employment, including contract work, part-time work, freelance work, or temporary employment).

For example, the Government Accountability Office’s July 2006 report recommends that the Department of Labor (“DOL”) share potential employee misclassifications with “appropriate federal and state programs” rather than limiting discussions between the DOL and a business owner to enforcement of the Fair Labor Standards Act (“FLSA”).

The DOL agrees with this recommendation, which would leave the business owner vulnerable to a Pandora’s Box of legal challenges from a host of agencies—each with its own definitions of employee and independent contractor. A straightforward test ex ante would simplify the enforcement task ex post for both the government and the business owner. To that end, this article proposes a single-factor legal test for distinguishing between an employee and an independent contractor by recognizing business considerations as well as legal requirements.

II. BUSINESS CONSIDERATIONS

Employers and individuals are the two parties to both employment and independent contracting arrangements. Scholars traditionally categorize workers in one of two categories, which are based on the employer’s needs and actions:

Traditional or core workers: individuals hired on a permanent full-time or part-time basis with an understanding of continuous employment.

Contingent workers: individuals who lack a contract for long term employment and whose minimum hours may vary at random. Contingent workers include temporary-help firm workers (hired via an explicit short-term contract with an intermediate organization), in-house temporaries (hired directly by the employer “to meet short-term or variable scheduling needs”), and independent contractors (“self-employed workers who are brought into an organization to provide specific skills”).

This article focuses on a subgroup of the latter category, the independent contractor.

According to the Bureau of Labor Statistics (“BLS”), 89.1% of the U.S. workforce was in “traditional employment arrangements” as of February 2005. The number of independent contractors has risen from 6.4% of the workforce in

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9 Id. at 4.
10 Daniel G. Gallagher & Magnus Sverke, Contingent Employment Contracts: Are Existing Employment Theories Still Relevant?, 26(2) ECON. & INDUS. DEMOCRACY 181, 186-87 (2005); see also Kratzer, supra note 5, Fig. 1 (listing categories of contingent workers).
11 Gallagher, supra note 6 at 187 (citing A. E. Polivka & T. Nardone, The Definition of Contingent Work, 112 MONTHLY LAB. REV. 9, 11 (1989)).
12 Id.
13 Id.
14 U.S. DEP’T OF LABOR, BUREAU OF LABOR STATISTICS, CHARTING THE U.S. LABOR MARKET IN 2005, Chart 3-5 (June 2006), USDL 05-1433, http://www.bls.gov/cps/labor2005/chartbook.pdf. The BLS also reports that, “[m]ore than half of the 226 million persons in the civilian non-institutional working-age population in 2005 were employed full time.” Id. at Chart 1-1.
February 2001 to 7.4% (10.3 million people) in February 2005. 15 Although the percentage of the U.S. workforce classified as independent contractors has remained under 10% since BLS first collected these statistics in 1995, there has been a 25.4% increase in the number of independent contractors from February 1999 to February 2005. 16, 17 The definition of independent contractor is relevant at global, national, and individual levels of analysis.

According to a 2008 survey of small business owners, 61% of respondents had hired independent contractors within the past twelve months to perform construction, transportation, or computer work. 18 Within these areas, there are many additional jobs that are likely to be contracted out such as catering, automotive repair, and building maintenance. Thus, the overall impact of independent contractors on the economy becomes clear. 19

Globally, businesses are incorporating non-traditional work arrangements in order to be flexible. 20 Independent contractors form part of the cohort of workers worldwide that seek alternative and flexible work practices. This trend has been tracked by the Organization for Economic Development (“OECD”) in its 1994 Jobs Study and subsequent updates. 21 The OECD’s 1999 Employment Outlook found that businesses “in different countries use flexible working practices to a

16 GAO-06-656, supra note 8 App. III, Tbl. 4 (showing changes in the size of the contingent workforce).
17 Id.
19 Id.
20 Arne L. Kalleberg, Nonstandard Employment Relations: Part-Time, Temporary and Contract Work, 26 ANN. REV. SOC. 341, 356 (2000). Kalleberg cites several reasons. First, global economic changes increased competition and uncertainty among firms and put greater pressure on them to push for greater profits and to be more flexible in contracting with employees. Id. Second, sluggish economic growth, particularly in Europe, made the hiring of more part-time and flexible workers attractive to many firms. Id. Third, the evolution of technologies that made it easier to organize temporary workers contributed to this shift. Id. Fourth, the growth of labor and employment codes designed to protect permanent workers made hiring temporary workers or independent contractors more attractive. Id. Fifth, many older workers and married women — groups that often prefer less traditional working arrangements — are increasingly joining the workforce. Id.

Less rigid arrangements for daily, weekly, annual and life-time working hours could meet both enterprise requirements and worker aspirations. They would permit firms better to exploit their productive capacities by matching production more closely to shifts in demand. Workers and their families would also gain from new working-time arrangements tailored to their individual preferences or family circumstances. The type of working-time flexibility sought by firms may not always coincide with the aspirations of workers. The best way to resolve such conflicts is through negotiated solutions at de-centralised [sic] levels. In some countries legislative changes and changes to taxation and social security provisions would also be needed. One important attraction of greater work-time flexibility is its potential to integrate working-time reductions with new patterns of life-long learning. More flexible working-time arrangements would also facilitate greater lifetime participation of women.

Id.
significantly different extent”; however, there was no suggestion “that increased use of flexible working practices necessarily leads to a growing polarisation [sic] between ‘core’ and ‘peripheral’ workers.”

Countries that follow the common law tradition, such as the U.S., encourage organizations to be flexible by permitting employment at-will and by providing a lesser degree of employee protection than is found in Europe. The law of classifying independent contractors evolved slowly from the Anglo-American common law of agency, specifically the master-servant relationship.23 Disparities between countries that follow the common law system and those that have different legal traditions have generated international discussions of employment policy.24

Defining the employment relationship is important at the national level because U.S. employers: (1) incur costlier legal obligations (e.g., contributions toward employee income taxes, Social Security, unemployment and workers’ compensation, overtime, and pensions) and assume greater tort liability when they hire employees rather than using independent contractors;25 and (2) risk substantial penalties for misclassifying an employee as an independent contractor.26 U.S. businesses, like their global counterparts, are experimenting with non-traditional work arrangements in order to maximize flexibility.27 In doing so, U.S. businesses require a clear definition of independent contractor in order to satisfy legal obligations.

Thus, successful use of independent contractors in business blurs the line between outside contractor and inside employee (i.e., peripheral and core individuals), thereby increasing the likelihood of misclassification. Classifying individuals as independent contractors versus employees is antithetical to the employer’s need to have everyone perform as a coordinated unit.28 Technological

23 See Carlson, supra note 6 at 302 (discussing the pre-industrial origins of worker classification, in particular the master-servant relationship).
25 Employers who hire independent contractors for especially dangerous work typically do not have a reduced risk of tort liability. RESTATEMENT (SECOND) OF TORTS § 427 (1965).
26 In the case of a negligent failure to withhold income tax, the employer is subject to a penalty of 1.5% of income paid, plus income compounded daily. If a failure to pay Social Security taxes is classified as “willful,” the employer is subject to the penalty of paying the employer share of Social Security and unemployment taxes, as well as a penalty equal to 5% of the tax for each month of the failure to pay, up to a maximum of 25% of the tax. For failure to pay employment taxes, the employer is subject to the penalty of 0.5% of the tax, for each month of the failure to pay, up to a maximum of 25% of the tax.
27 See, e.g., THE GEORGETOWN UNIV. LAW CTR, FLEXIBLE WORK ARRANGEMENTS: THE FACT SHEET, http://www.law.georgetown.edu/workplaceflexibility2010/definition/general/FWA_FactSheet.pdf (last visited Oct. 9, 2009). The percentage of the workforce that works a flexible schedule increased dramatically from 1985 to 1997 and has since leveled off. Id. In 1985, 12.4% of the working population worked on a flexible schedule, compared to 27.6% in 1979 and 27.5% in 2004. Id. at 2.
advances further encourage flexible, or even “virtual,” employment arrangements. Vague definitions impose costs and risks on individuals as well as business owners. “When employers have misclassified workers as independent contractors, workers may need to go to court to establish their employee status and their eligibility for protection under the laws.” Alternatively, the individual may not recognize him or herself as an independent contractor and fail to pay the full amount of his or her federal tax contributions. “Businesses without a payroll make up more than 70 percent of the nation’s 27 million-plus firms, with annual receipts over $887 billion.” Nevertheless, the BLS’ Current Population Surveys (“CPS”) found that, “[a]n additional 5% to 6% of CPS respondents identified themselves as self-employed but not independent contractors in [1995 and 1997], suggesting that there is not a perfect correspondence between people’s understanding of these two work arrangements.”

The nature of the work arrangement may explain some of the confusion. Currently, independent contractors and temporary workers are both classified as contingent workers, yet expectations by both employers and individuals differ between them.

Public policy does not require treating all categories of contingent workers in the same way. Independent contracting affords personal flexibility. As acknowledged by the BLS, “[f]ewer than 1 in 10 independent contractors said they would prefer a traditional work arrangement.” Individuals who opt for independent contracting – who “tend to be older, highly educated individuals who work in relatively high-paying management, business, and financial operations occupations” – have a strong desire to preserve personal choice in arranging the conditions of their employment. Nevertheless, some workforce protection laws (e.g., sexual harassment, anti-discrimination) transcend the contractual relationship to address societal concerns.

Today, for many workers, “the emphasis is on building up a portfolio of

Construction projects are like football games. There must be instructions, there must be control, and there must be integration in order to properly sequence the work. All subcontractors, regardless of size, have to work in harmony and therefore must work under a clear plan or schedule. A delicate balance must be struck to avoid misclassification of these individuals when they are simply carrying out their duty to build the project.

Id.
29 Id.
30 GAO-06-656, supra note 8 at 21.
31 Press Release, supra note 3.
32 Kalleberg, supra note 20 at 356.
33 GAO-06-656, supra note 8 at 23.
35 CONTINGENT AND ALTERNATIVE EMPLOYMENT ARRANGEMENTS, supra note 15 at 4; see also GAO-06-656, supra note 8, App. III, Tbl. 5 (listing characteristics of contingent workers).
36 Hugh Collins, Independent Contractors and the Challenge of Vertical Disintegration to Employment Protection Laws, 10 OXFORD J. LEGAL STUD. 353, 355 (1990); see also GAO-06-656, supra note 8 at 21-22, fig. 5 (listing key laws designed to protect workers).
experiences that keep the individual attractive in the marketplace. As the marketplace changes, employers and individuals find lower costs and increased satisfaction in using the independent contracting model rather than traditional employment arrangements. In practice, effective organizations cannot maintain an artificial distinction between core employees and peripheral contractors. The lack of a clear definition of independent contractor leaves the individual vulnerable to a lack of employment protections (and traditional benefits such as health insurance and pension plan) and increases the business owner’s risks from misclassification. The common law’s traditional emphasis on employment at-will and preservation of personal choice suggest that courts should look primarily at the contract to determine each party’s expectations regarding the nature of the commitment; however, public policy mandates safeguards. The next section reviews the legal definitions of independent contractors at the federal and state levels before proposing a workable standard for defining independent contractors.

III. LEGAL REQUIREMENTS

As businesses in the U.S. and globally experiment with different types of work arrangements, U.S. law has attempted to define non-traditional work relationships. The primacy of the contract in defining employment relationships goes back to the nineteenth century. Given the common law’s endorsement of private contracting and adherence to employment-at-will, the U.S. legal system has struggled with the distinction between employer and independent contractor rather than starting with an ILO-type presumption of employment.

The U.S. and other legal systems have relied heavily on factor tests to capture the low–versus high–performance ambiguity construct described in the previous section (e.g., prescribed hours of work, work done on employer’s premises, ability to work simultaneously for multiple employers). State and federal governments have thus used several different tests to address the problem, among them the common law right to control and economic reality tests, the Internal Revenue Service (“IRS”) approach, and the ABC Test. But significant

38 See Carlson, supra note 6 at 337.
39 See, e.g., Payne v. Western & Atl. R.R., 81 Tenn. 507, 518-19 (1884) (“[M]en must be left, without interference to buy and sell where they please, and to discharge or retain employees at will for good cause or for no cause, or even for bad cause without thereby being guilty of an unlawful act per se. It is a right which an employee may exercise in the same way, to the same extent, for the same cause or want of cause as the employer.”) (emphasis added).
40 See generally Carlson, supra note 17 (providing a historical overview of classification schemes and an evaluation of current legal tests for classification).
problems have arisen from this piecemeal approach. First, one particular worker might be an employee under a test used by one arm of government and an independent contractor under the test used by another, creating significant confusion and uncertainty for employers.43 Second, reasonable minds can differ over interpreting and weighting the factors, exacerbating employer uncertainty.44 This section of the article examines the major strengths and weaknesses of three of the most common independent contractor classification tests: (1) the common law approaches; (2) the IRS approach; and (3) the ABC Test.

A. Common Law Approaches (Right to Control and Economic Reality Tests)

The common law definition of independent contractor has two approaches, the right to control test and the economic reality test.45 The “right to control” looks at the control the employer has over the employee but not over an independent contractor, focusing on the employer’s right to direct the means of production.46 The common law “right to control” test is used by courts to determine employee status in various types of cases, including employment discrimination and benefits cases, tax cases, and tort (wrongful act) liability cases. This approach to classification stems from the agency law definition of employee,47 and relies on a thorough investigation of the facts of each case. This test generally gives employers more latitude to classify workers as independent contractors than do other legal approaches.48

The economic reality test is based on financial issues, in particular the investment and risk the worker has in the business.49 The economic reality test, in some variation, is used to classify workers under the Fair Labor Standards Act of 1938 (“FLSA”), Equal Pay Act of 1963, Family and Medical Leave Act of 1993 (“FMLA”), and the Employee Polygraph Protection Act of 1988 (“EPPA”).50 The United States DOL uses the “economic reality test” to determine coverage under, and compliance with, the minimum wage and overtime requirements of the FLSA.51 The following are among the factors considered by the DOL: (1) the degree of control exercised by the hiring party over the manner in which the work is performed; (2) the relative investments by the hiring party and the worker in

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43 See Carlson, supra note 6 at 301.
44 Befort, infra note 49, at 167.
46 Id.
47 See Nat’l Labor Relations Bd. v. Hearst Publ’n, 322 U.S. 111, 120-21 (1944) (discussing the development of the definition of independent contractors in agency law from vicarious liability cases involving workers).
49 WOOD, supra note 34 at 12.
51 See id.
materials and equipment; (3) the degree to which the worker’s opportunity for profit and loss is determined by the hiring party or the worker’s own managerial skill; (4) the skill and initiative required in performing the job; (5) the permanency of the relationship; and (6) whether the service is an integral part of the hiring party’s business.\footnote{Wood, supra note 34 at 132.}

The Supreme Court first formulated the economic reality test when, in 1944, the Court held that the meaning of “employee,” as used in the National Labor Relations Act, must, in doubtful situations, be determined broadly by underlying economic facts rather than technically and exclusively by previously established legal classifications.\footnote{Nat’l Labor Relations Bd., 322 U.S. at 129.} Three years later, in United States v. Silk, the Court used financial considerations in classifying workers as employees under the Social Security Act.\footnote{United States v. Silk, 331 U.S. 704, 711-12 (1947).} The Court held that determining whether or not the employees were integral to the employer’s work is crucial for employee classification purposes.\footnote{See id. at 714-16; see also Orley Lobel, The Four Pillars of Work Law, 104 Mich. L. Rev. 1539, 1554 (2006). “In the mid-1990s, the Dunlop Commission on the Future of Worker-Management Relations called for ‘the definition of employee in labor, employment, and tax law [to] be modernized, simplified, and standardized.’” Id. The Commission recommended that, “instead of the multi-factored control test of master-servant common law, courts and regulators should move to economic realities.” Id.}

Concerned that the Court’s economic reality definition would be too vague, encompass every worker, and bankrupt the Social Security system, Congress passed the Gearhart Resolution.\footnote{Gearhart Resolution, 62 Stat. 468 (1949).} In the resolution, Congress articulated its preference for the common law definition, but did not reject the Court’s use of economic factors in making a characterization.\footnote{Wood, supra note 34, at 7. See also Social Security discussion below.} Despite the use of the more far-reaching economic reality test for certain labor protection laws, the controlling standard for most classification purposes remains the common law right to control test.\footnote{Id. at 1.}

“During the 1970s and 1980s, most federal courts of appeal adopted a ‘hybrid’ test for determining employee status under federal discrimination statutes [which] combines elements of the common law and economic realities tests.”\footnote{Befort, supra note 48, at 167.}

Under the hybrid approach, courts examine the economic realities of the work relationship but place emphasis on “the employer’s right to control the ‘means and manner’ of the worker’s performance.”\footnote{Spirides v. Reinhardt, 613 F.2d 826, 831 (D.C. Cir. 1979); see also Equal Employment Opportunity Comm’n v. Zippo Mfg. Co., 713 F.2d 32, 38 (3d Cir. 1983) (applying the hybrid test to Age Discrimination in Employment Act (“ADEA”) claims).} Despite the growing popularity of the hybrid test, the Supreme Court reinvigorated the common law standard in its 1992 decision in Nationwide Mutual Insurance Co. v. Darden, which addressed how Employment Retirement Income Security Act (“ERISA”) defined employee status.\footnote{See generally Nationwide Mutual Ins. Co. v. Darden, 503 U.S. 318, 323-24 (1992).} In that case, the Court declined to use the hybrid test and instead adopted...
a thirteen factor formulation of the common law test. Following the Darden decisions, many courts again began to apply the more traditional common law test even outside the ERISA context. However, the Darden test remains problematic, as employers struggle with applying its thirteen factors consistently. As Stephen Befort noted, any test with thirteen variables is bound to have “considerable play in the joints.”

B. The ABC Test

For purposes of state unemployment taxes, most states use the “ABC Test”, which is very broad and includes most workers. The ABC Test requires the employer to prove three factors to show that the worker is an independent contractor: a) the worker is free from control or direction in the performance of the work; b) the work is done outside the usual course of the firm’s business and is done off the premises of the business; and c) the worker is customarily engaged in an independent trade, occupation, profession, or business.

The ABC Test has several attractive features. First, it is simpler than the IRS or the common law test; it is easier for employers to apply three factors than it is to apply thirteen or twenty. Second, it creates a presumption of employment, making it more difficult for unscrupulous employers to misclassify employees as independent contractors to avoid legal obligations.

The ABC Test also has some negative features. First, some workers who are employees under a state ABC Test may be independent contractors under federal statutes. This disparity creates confusion for employers and workers alike. Second, by creating the presumption of employment, the ABC Test makes it harder for employers to create unconventional employment relationships with workers. If faced with the possibility of hiring either an individual protected by the entire panoply of employment laws or not hiring anyone at all, some employers might simply choose the latter. In such situations, adopting the seemingly worker

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62 Id.
63 Befort, supra note 48, at 167 (citing Lambertsen v. Utah Dep’t of Corrections, 79 F.3d 1024, 1028 (10th Cir. 1996) “favoring common law test for Title VII claim, but finding that because the common law and hybrid tests are so similar, the lower court did not commit reversible error by applying the latter standard”); compare Frankel v. Bally, Inc., 987 F.2d 86, 90 (2d Cir. 1993) (adopting the common law test for ADEA claims).
64 Id.
65 Id.
66 See INDEPENDENT CONTRACTOR STATUS, supra note 42 at 9.
67 Id. at 9-10.
69 Id.
70 Id.
71 See, e.g., Maria O’Brien Hylton, The Case Against Regulating the Market for Contingent Employment, 52 Wash. & Lee L. Rev. 849, 858 (1995) (“Alternatively, an employer facing increased labor costs associated with hiring contingent workers may do what Professor Kalleberg would like to see done - reduce the number of contingent employees. There is no guarantee, however, that the employer would substitute core workers for contingent workers under these circumstances. If the employer did elect to consolidate the work of several contingent employees into one core worker, one
friendly ABC Test may actually harm employees.

C. The IRS Test

At the federal level, the IRS identified twenty factors in its Revenue Ruling 87-41\textsuperscript{72} to distinguish between employee and independent contractor based upon the common law.\textsuperscript{73} It now categorizes these factors as evidence of behavioral control, financial control, and type of relationship.\textsuperscript{74} The IRS provides a three page document, Form SS-8, for an \textit{ex ante} determination of the worker’s status\textsuperscript{75} and limited relief for the reasonable and consistent misclassification of certain employees.\textsuperscript{76}

Three problems arise with the IRS approach. First, as with the \textit{Darden} test, the compliance costs of completing Form SS-8 are burdensome and limit employer flexibility. The IRS estimates the average amount of time for completing and filing Form SS-8 to be just under twenty four hours.\textsuperscript{77} Second, although the IRS scheme identifies relevant factors of the employment, contractual, or agency relationship, the subjective factors are susceptible to competing, yet justifiable, interpretations. This point will be illustrated in the cases discussed below. Third, IRS rules technically apply only to issues of federal employment taxes and income tax withholding. Other federal statutes and agencies use other approaches. For example, the FMLA of 1993 uses the number of hours worked as a criterion for defining “eligible employee.”\textsuperscript{78} The U.S. DOL enforces minimum wage and overtime requirements, among other laws, using the definition of “employee” found in the FLSA.\textsuperscript{79} Under the FLSA, with exceptions for people who volunteer or work for public agencies or in some agricultural roles, “the term ‘employee’ means any individual employed by an employer.”\textsuperscript{790} Without a consistent definition of “employee,” it is impossible to have a consistent definition of “independent contractor.”

State statutes and agencies compound the inconsistencies found at the federal level. Whereas federal legislation is relatively newer than state legislation and starts with a broad definition of employee in the FLSA, employment law traditionally fell under each state’s purview and emphasized private contracting. It must still inquire as to whether this is a desirable outcome. A conclusion that this is a superior outcome requires one to accept that the current full-time employment of one core employee and the simultaneous unemployment of several formerly contingent employees are more attractive than the contingent employment of all of them. Given how little we can say about the subjective desirability of contingent employment, such a conclusion does not appear warranted.”). \textit{Id.}

\textsuperscript{72} See \textsc{Internal Revenue Serv.}, \textsc{Rev. Rul.} 87-41 (Jan. 1987), at 11-18.
\textsuperscript{74} See \textit{supra} note 41.
\textsuperscript{75} \textit{Supra} note 41.
\textsuperscript{76} \textsc{Internal Revenue Serv.}, \textit{supra} note 58 at 5-6; \textit{see also} 26 U.S.C. § 3509 (2000).
\textsuperscript{77} \textit{Id.} at 5.
\textsuperscript{79} 29 U.S.C. §§ 201-219 (1938).
\textsuperscript{80} 29 U.S.C. § 203(c) (2000).
From colonial times through the expanding republic of the nineteenth century, state courts embraced the entirety doctrine with regard to employment contracts.\textsuperscript{81} The entirety doctrine required individuals to perform all contractual terms in full or forfeit all compensation.\textsuperscript{82} Around the mid-nineteenth century, courts started to acknowledge that the entirety doctrine could unjustly enrich employers who, for example, fired employees one day short of the contract’s termination date.\textsuperscript{83} Although recognizing legitimate grounds for breach of an employment contract, state courts favored performance over compensation.\textsuperscript{84}

These two streams – the federal public policy objective of broad employee protection that originated in the New Deal era and the states’ longstanding encouragement of employment-at-will and enforcement of private contracts – inform the current conundrum over defining employees and independent contractors. These conflicting traditions make it unlikely that the U.S. could adopt the ILO suggested presumption in favor of employment wholesale without acknowledging independent contractors’ personal work preferences and employers’ flexible work arrangements.

The U.S. federal and state levels do share an interest in encouraging employers to innovate, which, in turn, blurs the demarcation between traditional employee and independent contractor. The former distinction between core and peripheral employees is fading fast and regulations do not adequately capture the new configurations. Before turning to the single factor test that this article proposes, it is worthwhile to examine two legal cases against existing standards and vis-à-vis the proposed single standard. The following two lawsuits illustrate the applications and shortcomings of existing factor tests, the variability among state laws, and the difficulties posed by current definitions of employee versus independent contractor.

\textbf{D. Two Case Illustrations}

\textit{Federal Express}

Federal Express Ground Package System, Inc. ("FedEx Ground") and its division, FedEx Home Delivery ("FHD") have been involved in a spate of legal contests regarding the company’s classification of its drivers as independent contractors.\textsuperscript{85} The company has faced class action as well as individual claims before the IRS, regional divisions of the National Labor Relations Board ("NLRB"), the California Unemployment Insurance Appeals Board, the Los

\textsuperscript{81} \textsc{Robert J. Steinfeld, Coercion, Contract, and Free Labor in the Nineteenth Century} 290-314 (2001).
\textsuperscript{82} \textit{Id}.
\textsuperscript{83} \textit{Id}.
\textsuperscript{84} \textit{Id}.
Angeles Superior Court, and other forums. Each agency or court has first had to answer the question whether pick-up and delivery (“P&D”) drivers were employees or independent contractors before addressing the specific claims regarding payment of unemployment taxes, the establishment of union representation, eligibility for unemployment benefits, or responsibility for operating expenses. Recently (summer 2009), the federal district court for the northern district of Indiana ruled on motions to certify class actions in the consolidated multi-district litigation, In re Fed Ex Ground Package System, Inc., Employment Practices Litigation.

Each agency or court referred to its own precedents in examining the individual’s relationship to FedEx Ground. The degree of control each plaintiff had over how work was done featured prominently in the analyses. Common factors of the analyses included: the individual’s tenure with the company; required use of the FedEx logo on vans, wearing of FedEx-approved uniforms, and use of FedEx scanners; rights of FedEx to inspect the individual’s equipment and to approve of drivers or workers hired by the individual; specifications regarding schedules, reports, and routes; and freedom to terminate the contract. Each of the decisions referenced above found that the individuals were employees of FedEx Ground.

FedEx Ground’s difficulties lay in the structure of its business operations and in the drivers’ contracts it inherited from its predecessor, Roadway Package Systems (RPS). The Estrada court found a distinction between drivers who had single routes (employees) and those with multiple routes (independent contractors). From the company’s perspective, “of importance to the court is the clear evidence that [single route drivers] are totally integrated into the [FedEx Ground] operation... if ‘lightning’ were to strike and there were suddenly no [single route drivers], [FedEx Ground] would lose its principal means of pick up and delivery.” From a single route driver’s perspective,

...there is little or no opportunity for profit or loss as a [single route driver], but... there are tremendous opportunities in this regard for [multiple route drivers]... Unlike the [single route driver], who in effect is just a package pick up and delivery person, a [multiple route driver] has the opportunity to hire drivers and slowly but

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86 Id.
87 Letter from Gail Lontine, SS-8 Program Coordinator, IRS SB/SE Compliance, BIRSC, SS-8 Unit, Case # 37653, (July 12, 2006) (advising Ms. Sharon Pagels that the IRS considered her to be an employee of FedEx Ground).
89 Case No. 1617957, supra note 85 (finding Jerrett W. Henderson was an employee of FHD).
90 No. BC 210130, supra note 85. The court subsequently awarded $5.3 million in damages to single route drivers who had borne operating expenses. U.S. Newswire Corp., AP ONLINE, June 3, 2006.
92 No. BC 210130, supra note 85.
93 Id.
surely create a little financial empire under the aegis of [FedEx Ground].

Indeed, the ability to tap into FedEx’s global client network formed the heart of the company’s business plan when it took over RPS in 1998. In 1984, RPS initiated the practice of having each P&D driver at its Fairfield, New Jersey terminal sign a “Pick-Up [sic] and Delivery Contractor Operating Agreement.” RPS revised the form in 1994. At the time of the 2004 NLRB decision, FedEx Ground had “agreements with approximately 8,600 P&D drivers [handling local deliveries] and 1,300 linehaul drivers [covering inter-hub or long distance routes]” system-wide. The agreement’s background statement indicated the contractual intentions of the parties:

FedEx Ground wants to provide for package pick-up [sic] and delivery services through a network of independent contractors, and, subject to the number of packages tendered to FedEx Ground for shipment, will seek to manage its business so that it can provide sufficient volume of packages to Contractor to make full use of Contractor’s equipment. Contractor wants the advantage of operating within a system that will provide access to national accounts and the benefits of added revenues associated with shipments picked up and delivered by other contractors throughout the FedEx Ground system. In order to get that advantage, Contractor is willing to commit to provide daily pick-up [sic] and delivery service, and to conduct his/her business so that it can be identified as being a part of the FedEx Ground system. Both FedEx Ground and Contractor intend that Contractor will provide these services strictly as an independent contractor and not as an employee of FedEx Ground for any purpose. Therefore, this Agreement will set forth the mutual business objectives of the two parties intended to be served by this Agreement – which are the results the Contractor agrees to seek to achieve – but the manner and means of reaching these results are within the discretion of the Contractor, and no officer or employee of FedEx Ground shall have the authority to impose any term or condition on Contractor or on Contractor’s continued operation which is contrary to this understanding.

FedEx Ground went beyond these contractual intentions, though, to institute a compensation and bonus system for its P&D drivers. The five components of the system included: (1) a non-negotiable amount paid per stop and per package handled; (2) a non-negotiable daily payment for making a delivery truck and driver available to FedEx Ground; (3) monetary inducements to encourage drivers to work in less densely populated areas; (4) a “Flex Fee” program for drivers who were willing to take on additional packages; and (5) a Quarterly Performance Settlement under which P&D drivers with more than one year of service can receive additional payment if they have performed their contract obligations . . . . The quarterly payment can be taken in cash or put into an HR10

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94 Id. at 17-18.
95 Case 22-RC-12508, supra note 85 at 10.
96 Id. at 9.
97 Id. at 6.
98 Id. at 9-10.
99 Id. at 34-37.
Beyond the basic compensation for P&D drivers, FedEx Ground offered: (1) “supplemental payments to drivers who use[d] ‘approved’ helpers[;]” (2) bonuses to drivers who achieved individual customer service and safety goals and who contributed to their terminal’s service goals; (3) a “Business Support Package” (e.g., vehicle washing, scanner leasing, and uniform cleaning); (4) a “Time-Off Program” in lieu of paid holidays or vacations; (5) interest-free loans for the first thirteen weeks of a new P&D driver’s contract; (6) access to spare vehicles, uniform rental, and vehicle maintenance; and (7) rewards for drivers who referred new drivers to FedEx Ground. Linehaul drivers were eligible for similar incentives.

Rather than stepping back after specifying its requirements in the contract, FedEx Ground added financial inducements and oversight mechanisms to encourage loyalty and compliance. In a case similar to the Estrada case, JKH Enterprises also had individuals sign agreements stating that they were independent contractors. JKH Enterprises exercised less oversight of its delivery drivers than did FedEx Ground. Relying on precedent, the California court applied the fourteen Borello factors and upheld the hearing officer’s finding that the individuals were JKH Enterprises employees. The court ruled: “[E]ven though there is an absence of control over the details, an employee-employer relationship will be found if the [principal] retains pervasive control over the operation as a whole, the worker’s duties are an integral part of the operation, and the nature of the work makes detailed control unnecessary.”

Thus, a contract’s wording alone is insufficient to distinguish between an

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100 Id. at 37-42.
102 Id. at 569.
103 These factors substantially include:
(1) whether there is a right to fire at will without cause; (2) whether the one performing services is engaged in a distinct occupation or business; (3) the kind of occupation, with reference to whether, in the locality, the work is usually done under the direction of the principal or by a specialist with-out [sic] supervision; (4) the skill required in the particular occupation; (5) whether the principal or the worker supplies the instrumentalities, tools, and the place of work for the person doing the work; (6) the length of time for which the services are to be performed; (7) the method of payment, whether by the time or by the job; (8) whether or not the work is a part of the regular business of the principal; (9) whether or not the parties believe they are creating an employer-employee relationship; (10) whether the classification of independent contractor is bona fide and not a subterfuge to avoid employee status; (11) the hiree’s degree of investment other than personal service in his or her own business and whether the hiree holds himself or herself out to be in business with an independent business license; (12) whether the hiree has employees; (13) the hiree’s opportunity for profit or loss depending on his or her managerial skill; and (14) whether the service rendered is an integral part of the alleged employer’s business.
104 Id. at 1064 n.14 (citing S.G. Borello & Sons, Inc. v. Dep’t of Ind. Relations, 769 P.2d 399 (Cal. 1989)).
105 JKH Enterprises, 48 Cal. Rptr. 3d at 1054.
employee and an independent contractor. Courts look at the nature of a business’ operations. Both employees and contractors may be essential to a firm’s operations, but each should be accorded different treatment under the law. Not every state uses the IRS’ twenty factors or Borello’s fourteen factors. For example, in the next case, Fleece on Earth, Vermont’s Department of Labor uses only a three factor test, but both parties differ over how to characterize the degree of control exercised by the business owner.106

Fleece on Earth

Fleece on Earth is a Vermont retailer of hand-knitted and hand-sewn children’s clothing and gifts.107 Bonny Dutton, Fleece on Earth’s owner, started the enterprise because she loves to design.108 “[U]nfortunately that’s the smallest part of the business at this point in time because of all the other duties [she has] as a retailer.”109 Individual knitters and sewers working out of their homes produce the goods in the stage between the goods’ design and distribution.110 In January 2005, the Unemployment Insurance Division of the Department of Employment & Training assessed Fleece on Earth $295.04 in interest and penalties for contributions on behalf of seven knitters and sewers whom Fleece on Earth had considered to be independent contractors.111 Fleece on Earth appealed, but an Administrative Law Judge (“ALJ”) upheld the assessment.112 The Vermont Employment Security Board (“ESB”) upheld the ALJ’s decision, but reversed some of the ALJ’s conclusions.113 The case was appealed to the Vermont Supreme Court, who affirmed the rulings below in a split decision.114

Vermont’s ABC Test for identifying independent contractors is the focal point of the case.115 After the State establishes that individuals perform services for wages,116 the business owner must demonstrate that the individuals are independent contractors via a three-prong test:117 first (“A”), the individual must “be free from control or direction over performance of the service;”118 second (“B”), the individual’s service must be outside of the usual course or places of the

106 Fleece on Earth v. Dep’t of Employment & Training, 923 A.2d 594 (Vt. 2007).
107 Id. at 596.
109 Id.
110 Id.
113 Id.
114 Fleece on Earth, 923 A.2d at 602.
116 Id. at § 1301(12).
117 Id. at § 1301(6)(B).
118 Id. at § 1301(6)(B)(i).
business doing the contracting;\(^{119}\) and third (“C”), the individual must be “customarily engaged in an independently established trade, occupation, profession, or business.”\(^{120}\) Failure to prevail on any prong renders the individual an employee.\(^{121}\)

Taking the prongs in reverse order, for test C, specific contentions have revolved around missing information for two of the seven individuals who knitted or sewed for Fleece on Earth.\(^{122}\) The State claims that:

[Fleece on Earth] did not present sufficient evidence showing that either [two of the seven individuals] had independently established sewing or knitting businesses.

[Fleece on Earth] did not show that either worker had an established, stable, ongoing business providing knitting or sewing services for others at the same time they provided those services to [Fleece on Earth].\(^{123}\)

Fleece on Earth argues that the State’s (and the ALJ’s) position: 1) has no foundation in the statute’s text, and 2) implies that an individual cannot hold two roles simultaneously.\(^{124}\) Supporting multiple clients also suggests a minimal size of operation that could discourage individuals from innovating and exclude contractors who prefer to work exclusively for one client.\(^{125}\) The organization of Fleece on Earth’s business and of the individuals’ work leads to B and A.

For B, the ALJ found that both Fleece on Earth and the individuals supplied handcrafted garments, i.e., engaged in the same course of business.\(^{126}\) But contrary to the ALJ,\(^{127}\) the ESB held that Fleece on Earth passed B because “services performed in an individual’s home are not to be considered to have been performed within the usual places of business of the employer.”\(^{128}\) These general observations about the respective functions of Fleece on Earth and the individuals ignore both the perceptions that Bonny and the knitters/sewers had about their roles and the nature of the production process. That process and the control over it are at the heart of A.

Both the ALJ and ESB held that Fleece on Earth failed A because Bonny: 1) retained the right to exert actual control over the knitters and sewers; 2) provided yarn for knitting, material for sewing, and patterns for every item; and 3) paid only upon inspection of the final goods – thereby implying that knitters and sewers lacked discretion to deviate from the designated materials and patterns.\(^{129}\)

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\(^{119}\) Id. at § 1301(6)(B)(ii).

\(^{120}\) Id. at § 1301(6)(B)(iii).

\(^{121}\) Fleece on Earth, 923 A.2d at 597.

\(^{122}\) See ESB Decision, supra note 112 at 4-5.

\(^{123}\) See Appellee’s Brief, supra note 111 at 28.

\(^{124}\) Id. at 16.

\(^{125}\) Id.

\(^{126}\) ALJ Transcript, supra note 108 at 5.

\(^{127}\) Id.

\(^{128}\) ESB, supra note 111 at 4.

\(^{129}\) ALJ Transcript, supra note 108 at 5, and ESB Decision, supra note 112 at 6. The ESB emphasized the nationwide consistency of decision with respect to knitters, sewers, and other home workers. On appeal, though, the State introduces a distinction between other states’ jurisdictions that follow a “strict common law” definition of employee (based on either master and servant or principal
on Earth challenges the ALJ and ESB holdings on A by emphasizing Fleece on Earth’s lack of control over the individuals’ performance versus the ALJ’s and ESB’s focus on Fleece on Earth’s control over the resulting products.\textsuperscript{130} Fleece on Earth cites factors such as the individuals’ ownership of the production equipment and the individuals’ complete discretion over hours worked, techniques used, assistants employed, scheduling, and sequencing.\textsuperscript{131}

A could also be viewed from the perspective of a value-added chain, separating different steps of the production process. Bonny’s testimony before the ALJ, describes how she views her roles as designer and seller with the individuals forming the intermediate production stage:

Bonny: “I probably add four new items to my line each year. I am not a sewing or knitting contractor . . . . [N]o one comes to my business looking to have anything sewn or knitted.”

Q: “So they come to you to buy clothes? . . . And the clothes are put together based on your designs by these folks?”

Bonny: “Yes.”\textsuperscript{132}

Thus, customers view Bonny and Fleece on Earth as a source for finished clothing based on Bonny’s designs. The clothing is assembled based on the designs by individuals who then invoice Bonny at the agreed upon price for the finished items.\textsuperscript{133} Bonny herself does not engage in actual production.\textsuperscript{134} Indeed, when asked what her business would be if she did not have the individual knitters and sewers, Bonny responded that she guessed she would continue to be a retailer-seller, possibly buying from other established children’s clothing lines.\textsuperscript{135} At no point does Bonny aver that she would herself engage in production.

The disjunctive nature of Bonny’s business plan and organization – with her handling the beginning and end functions of design and distribution – hearkens back to the inside contract system that characterized U.S. manufacturing before World War I and stands in marked contrast to the types of cases relied on by the State in its appellee brief. The inside contract system was configured as follows:

The gap between raw material and finished product was filled not by paid employees . . . but by contractors, to whom the production job was delegated. They [the contractors] hired their own employees, supervised the work process, and

and agency theory) and states that follow the “‘control or direction’ element of the ABC test.” Appellee’s Brief, supra note 111 at 13-14. Specifically, the State argues that the Vermont Supreme Court has not followed a “strict common law approach.” \textit{Id.} at 13. The examples that the State cites include adjunct college faculty, auto repossessers, and house cleaners, \textit{Id.} at 14-15, and sound similar to the California holding in JKH Enterprises, HORNE, supra note 50, wherein lack of detailed control did not preclude individuals from being classified as employees.

\textsuperscript{130} Appellee’s Brief, supra note 111 at 4, 11.


\textsuperscript{132} ALJ Transcript, supra note 108, at 18.

\textsuperscript{133} \textit{Id.} at 18, 22.

\textsuperscript{134} \textit{Id.}

\textsuperscript{135} \textit{Id.} at 29-30.
received a piece rate from the company for completed goods. The company’s largest single expense was the amount paid to the contractors for finished goods.

Reduced costs brought about by the advent of the assembly line and Frederick Taylor’s principles of “scientific management” offer one explanation for the demise of inside contracting by large enterprises in the early twentieth century. Nevertheless, “outside” contracting with independent service providers remained a viable alternative for businesses of all sizes.

With inside contracting in the late nineteenth century, “skilled workers in industries such as iron production controlled the management of the production process, contracting with the firm’s owners only for the total tonnage of iron to be produced and the tonnage rate.” The business configuration for the early iron works and for Fleece on Earth is the same in that each owner contracted for the essential intermediate stage of production and paid on a per unit rate. A newspaper account of a 1914 case suggests that courts upheld the primacy of such contracts:

The Appellate Division dismissed yesterday the appeal of Henry Brody and Hyman Punt, makers of skirts at Passaic, from a $1,500 judgment in favor of Benjamin Schlossberg, a sub-contractor. Schlossberg was an inside contractor who produced the skirts in the Brody & Punt factory under a piece work system while they were in business in New York. When they went to Passaic they asked him to reduce his prices per skirt, because labor was cheaper in Passaic, but he insisted on his former contract price and they put him out.

As modern U.S. manufacturing evolved and workers’ rights expanded after World War I, employment laws increasingly wrestled with the question of which party should bear responsibility for the individual’s economic security. In Fleece on Earth’s appeal, the State cites Andrews v. Commodore Knitting Mills for the holding that New York’s unemployment compensation laws covered home knitters using their own equipment, but not employer-supplied raw materials. However, Commodore supplemented its factory production with outsourcing (rather than being wholly dependent upon it) and sent raw materials as well as samples of the finished products to the homeworkers. Fleece on Earth had no factory and sent only designs for knitting and pre-cut material for sewing to the homeworkers. By suggesting a source of yarn supply, Fleece on Earth had done nothing more than pre-inspect the yarn that it recommended, but did not require, its home knitters to use. Most importantly, the production techniques remained solely within the discretion of Fleece on Earth’s home knitters and sewers.

Unlike FedEx Ground, which contracted with individuals and then continued to introduce additional inducements and control mechanisms, Fleece on Earth

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137 Id. at 219.
141 Andrews, 13 N.Y.S.2d at 577-78.
contracted with individuals and stepped back until it was time for inspection per the initial agreement. Although Fleece on Earth contracted for an essential segment of its operations, Fleece on Earth had no way to compel the knitters and sewers to perform, other than to withhold payment. The knitters and sewers retained freedom of choice over how and when to offer their services and to offer those services exclusively to Fleece on Earth or to multiple buyers. Had Fleece on Earth breached its agreement, the knitters and sewers could have taken Fleece on Earth to court. This distinction between a business owner that continues its oversight function versus one that steps back is at the heart of the proposal for a workable standard to define independent contractors.

IV. PROPOSAL

FedEx Ground and Fleece on Earth both relied on individuals contracting with the respective firms to provide essential services. Adjudications in both cases were based upon the nature and the conditions of the work being done. Having a contract identifying individuals as independent contractors was insufficient to thwart rulings that the firms had misclassified individuals. Early inside contracts upheld by courts specified price and quantity required by the employer. Thus, a clear definition of independent contractor entails not only the title of “independent contractor” but contains some indication of planning by the business owner.

Several industries, such as construction and delivery services, have persistent misclassifications. For example, the Construction Policy Research Center, part of the Labor and Worklife Program of Harvard’s Schools of Law and Public Health, has issued two reports. Both reports estimate that one in seven construction employers in Maine and Massachusetts misclassified workers as independent contractors over the years 1999-2002 and 2001-2003, respectively. The Harvard studies prompted calls for a study by the Government Accountability Office. The Government Accountability Office has focused on increasing independent contractor compliance with IRS requirements. Enforcement, though, is a separate issue from that of the initial classification. Indeed, the Government

142 Fleece on Earth, 923 A.2d at 596.
143 Id.
144 Id.
Accountability Office’s endorsement of clearer reporting requirements for employers – both to the IRS and to the employee/independent contractor – would be strengthened by a clear definition of employee versus independent contractor. To that end, this article proposes a single-factor “step-back” test.

A. The Step-Back Test

We propose that each state and those federal government agencies, including the IRS, that are required to distinguish between employees and independent contractors adopt a single-factor “step-back” test. The proposed step-back test would ask, “[d]oes the employer exert any control over the arrangement apart from (1) providing an initial list of specific expectations for the outcome (product to be provided or task to be performed) and (2) inspecting and accepting the goods or services provided?” In the case of FedEx Ground, the answer would be “yes” because the employer (1) continued to oversee the actual provision of the delivery services and (2) offered additional inducements for performance, such as rewards for meeting periodic service goals – goals that would be determined unilaterally by FedEx Ground. In the case of Fleece on Earth, the answer would be “no” because the employer (1) presented a list of requirements for the final product and stepped back until the inspection and (2) made no further intrusions into the “production process” until inspection and the decision to accept the goods.

Two related questions concern (1) company recommendations regarding materials and supplies to be used and (2) modifications to or anticipated periodic review of the contract. Under the step-back test, FedEx Ground would be able to offer its Business Support Package and Fleece on Earth would be able to recommend brands or sellers of yarn. FedEx Ground’s negotiating clout with truck washes and service providers and Fleece on Earth’s knowledge of yarn quality are assets of those respective businesses. However, FedEx Ground took a big step toward treating individuals as employees when the firm offered a variety of bonuses for meeting company determined targets and supplemental payments for hiring approved drivers. These measures were tantamount to continuous monitoring because the individual’s choice of action would depend upon the firm’s anticipated response rather than the individual’s judgment regarding whether the action would achieve the stated objective. At Fleece on Earth, on the other hand, knitters were free to accept or reject the terms of the arrangement and to complete the work at their own pace.

What about changes of circumstances, repetitive tasks, or long-term projects where a business justifiably would want to receive periodic updates and retain the ability to make mid-course adjustments? Changed circumstances, impracticability, and impossibility are all established areas of contract law. The step-back test focuses on the nature of the contract. Thus, a business could use independent contractors for repetitive tasks or for long-term projects as long as the contract

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147 Case 22-RC-12508 Supra note 98, at 34-42.
148 Fleece on Earth, 923 A.2d at 596.
149 Case 22-RC-12508, supra note 95 at 34-37.
150 Fleece on Earth, 923 A.2d at 596.
specified discrete phases. For example, a firm hiring a computer consultant to streamline financial reporting “as needed” is too vague, implies a lack of freedom on the part of the consultant, and approximates an on-call employee. The firm would need to delineate its objectives by department, type of report, or other criteria and then step back until it is time to evaluate the independent contractor’s work.

The firm, the individual, and an independent reviewer should be able to visualize a decision tree where the individual and firm interact at each node (i.e., evaluate task completion and agree upon the next objective), but the individual alone moves along the project path. Thus, Bonny Dutton sees her knitters at the time of contract formation and when the products are ready for inspection. If Fleece on Earth knitters fail to perform, they do not get paid. If Fleece on Earth knitters do deliver products and are paid, then both Fleece on Earth and the knitter know that the knitter has earned taxable income. Hence, the proposed step-back test complements the Government Accountability Office’s recommendations for clarifying the individual’s status ex ante. A remaining issue, though, concerns retroactive investigations of and fines for past misclassifications.

B. No Retroactivity

Although businesses have an obvious inclination toward preferring the lower costs and liability associated with independent contractors (versus employees), all businesses have a strong desire for a clear legal standard. Another concern is the retroactive application of whichever standard is adopted. Based on surveys of its 600,000+ membership, the National Federation of Independent Business (“NFIB”) testified before Congress about the costs that retroactive investigations and rulings by the IRS pose on small business owners.

The definitional and retroactivity issues were the top recommendations for Congress made by the 1995 White House Conference on Small Business. The issues were still salient in the Small Business Administration’s (“SBA’s”) 2000 final report on implementation of the 1995 recommendations.

Although employers have a legal economic incentive for not classifying individuals as employees, businesses and the courts recognize the need for a bright-line rule. “[FedEx Ground] needs a ‘bright line’ in order to conduct its

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151 This idea is consistent with the definition of “independent contractor” as, “one who is entrusted to undertake a specific project but who is left free to do the assigned work and to choose the method for accomplishing it.” BLACK’S LAW DICTIONARY (8th ed. 2004).

152 Submitted Statement of the National Federation of Independent Business before the Subcommittee on Oversight Ways and Means Committee, U.S. House of Representatives (June 4, 1996); Statement for the Record by National Federation of Independent Business before the Subcommittee on Taxation and IRS Oversight, Senate Finance Committee (June 5, 1997).


business as to the status of its workers.” The step-back test offers such a line and one that could be applied without imposing an undue retroactive burden on business or on individuals.

C. Alternatives and Potential Objections

The step-back test would meet the needs of workers and business owners alike better than proposed alternatives.

Senate Bill 2044, proposed by then-Senator Barack Obama (IL), offers one such alternative. Obama’s bill would alter the IRS’ current approach to independent classification in three key ways. First, S. 2044 requires employers to treat workers misclassified as independent contractors as employees for employment tax purposes. Second, it repeals a ban on Treasury regulations or revenue rulings on employee/independent contractor classification issues. Third, it eliminates the defense of “industry practice” as a justification for misclassifying workers as independent contractors.

S. 2044 might reduce uncertainty about particular workers’ statuses; however, it reduces uncertainty by restructuring the rules so that nearly all workers are treated as employees. Such a result is undesirable for several reasons. First, giving current independent contractors the full panoply of employee rights does not come without cost. Some employers, rather than bear these additional costs, might simply choose not to hire as many workers as before. This would hardly be a desirable outcome for employees, workers, or consumers who benefit from innovative business practices. Second, some available data indicates that the overwhelming majority of independent contractors are happy with their current employment conditions.

Advocates of S. 2044 and measures like it often contend that the current system too easily allows employers to evade federal and state anti-discrimination laws. Some recent scholarship, however, has outlined promising alternative legal remedies to these problems. Courts that implement these suggestions may

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155 No. BC 210130, supra note 85.
156 S. 2044, 110th Cong. (2007).
157 Id. at § 2(a).
158 Id. at § 2(b).
159 Id. at § 2(c).
160 See, e.g., Hylton, supra note 72 at 858.
161 See, e.g., CONTINGENT AND ALTERNATIVE EMPLOYMENT ARRANGEMENTS, supra note 35. Eighty two percent of independent contractors prefer their current working arrangement to traditional arrangements. Id. Just 10% say that they would prefer a traditional arrangement over their current circumstances. Id.
162 See, e.g., Clyde W. Summers, Contingent Employment in the United States, 18 COMP. LAB. L.J. 503, 518 (1997) (“Employers and their lawyers use all their ingenuity to create forms of detached employment which will free users of all employer responsibility.”).
offer wronged independent contractors some relief, while still allowing other employers and independent contractors to reap the benefits of non-traditional employment relationships.

V. CONCLUSION

Businesses worldwide are experimenting with flexible work arrangements. Successful use of independent contractors blurs the distinction between permanent core and contingent peripheral workers because business owners seek to have all participants functioning as an integrated unit. The ILO proposal for a presumption in favor of employee status (versus independent contractor) is one way to combat disguised employment relationships, but it still relies on relevant indicators that must be balanced and does nothing to alleviate the business owner’s liability for a well-reasoned misclassification.

The IRS’ 20-factor test, among others, is costly in terms of compliance and litigation. Not only can reasonable minds offer competing and valid justifications for each factor, but different agencies at the federal and state levels use different factors. The quest for a clear legal standard has been a prominent issue for businesses for over twenty years. The Government Accountability Office’s July 2006 recommendation to notify every federal and state agency of a misclassification under the FLSA fails to address the problem of dueling factors.

In the U.S., the philosophies of the broad, employment protection policies of the New Deal at the federal level conflict with the narrow, focused emphases on employment-at-will and freedom-to-contract traditionally found at the state level. Organizations such as the National Employment Law Project (“NELP”) caution against “laws that pertain to ‘simplify’ the myriad definitions of ‘employee’ or ‘independent contractor’ under state labor and employment laws.” Conversely, NELP’s assertion that “factors ... are manipulable [sic] by employers,” factors hurt both employers and individuals. The FedEx Ground and Fleece on Earth cases illustrate the problems with factor tests. The proposed step-back test offers a clear legal standard.

The step-back test would label an individual as an employee if the employer exercised any control over the individual’s actions between the formation of the contract and evaluation of interim or final results. The employer would be free to set detailed specifications and to share knowledge with individuals, but would have to step back from attempting to influence the individual’s decisions regarding how

(146) REV. RUL. 87-41, supra note 72, at 11-18; see also EMPLOYER’S SUPPLEMENTAL TAX GUIDE, supra note 73, at 6-7.
(147) GAO-06-656, supra note 8, at 4, 35-36.
(149) Id.
the task or project would be accomplished. Incentives for early completion by independent contractors would be allowed if included in the initial agreement. Side payments, such as perpetual eligibility for bonuses or incentives, would be indicative of control and classify the individual as an employee.

This is not a question of one business model being good or bad, but of providing businesses, individuals, and agencies with a clear standard for distinguishing between employees and independent contractors. Employees tend to be costlier for firms and to subject firms to greater legal liability than do independent contractors, but the ease and cost of misclassification are also expensive – particularly when the penalties are assessed retroactively. The step-back test provides an easily administered standard that preserves the freedom of businesses to organize their operations as they see fit and of individuals to choose their conditions of employment.