MANAGEMENT
Liability Focus

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Independent Contractor Misclassification and Management Liability

Many businesses rely on independent contractors to manage labor costs and adapt to fluctuating workloads, as these professionals offer flexibility that traditional employees do not. But when a company treats a worker as a contractor who legally qualifies as an employee, it opens itself to liability across tax, wage and hour, and insurance lines. This exposure extends beyond HR; it can raise governance concerns and affect both employment practices liability (EPLI) and directors and officers liability (D&O) coverage. This article examines how worker misclassification occurs, discusses potential implications and offers tips to reduce the exposure.

Why Misclassification Happens

Worker classification depends on the working relationship rather than the title the parties use or the language in a contract. Independent contractors generally have their own businesses and retain greater autonomy in how they perform their work. Employees, by contrast, work under the direction of a business and uphold its regular operations.

Problems arise when a contractor relationship looks more like employment in practice than on paper. A worker who follows a set schedule, uses company equipment, receives ongoing assignments and performs work that is integral to key operations may be more likely to be treated as an employee under applicable legal standards, regardless of what the contract says.

How Classification Tests Differ

Worker classification is governed by multiple federal and state laws, and the applicable legal test depends on the law being enforced. Federal wage and hour laws generally apply a multifactor analysis that considers the overall economic relationship between the worker and the business, including the worker's economic independence and the degree of control exercised by the company.

Many states apply different or more restrictive standards. Under the ABC test, used in California and several other states, a worker is presumed to be an employee unless the business proves the worker operates free from its control, performs work outside the business's usual course and runs an independently established trade. Some states also provide statutory exceptions or apply different standards for certain industries or occupations.

Because these standards vary, a worker may qualify as an independent contractor under one law but be considered an employee under another. Businesses operating in multiple states should evaluate contractor classifications under each applicable jurisdiction rather than relying on a single companywide standard.

Financial and Legal Consequences

A misclassification carries financial and legal ramifications. In particular, businesses may owe back wages, unpaid overtime, employee benefits and payroll taxes, alongside interest and penalties. Some states also impose per-violation penalties that can multiply across workers and pay periods, with certain laws allowing workers to pursue claims on behalf of the state.

Personal liability may also be a concern. Some state wage laws extend liability to individual officers or other company leaders. In addition, a widespread or recurring pattern of misclassification may raise governance concerns if leadership fails to identify, investigate or correct known issues. In some circumstances, plaintiffs or regulators may point to that history as evidence that management knew or should have known of the risk.

Coverage Implications

EPLI may be implicated by a misclassification claim, but coverage is not automatic. Many EPLI policies exclude wage and hour claims, unpaid wages, employee benefits, and other compensation an employer was legally required to pay. Whether coverage applies depends on the policy language, the allegations asserted and the relief being sought.

D&O insurance may also become relevant if a claim alleges that directors or officers failed to oversee or respond appropriately to a systemic misclassification issue. Whether a D&O policy responds depends on the policy wording, the parties involved, the nature of the allegations and any applicable exclusions. As a result, the same underlying facts can produce different coverage outcomes depending on which policy is involved and which parties are named in the claim.

Misclassification can also complicate workers' compensation issues. If an injured contractor is later determined to have been an employee, the business may face workers' compensation disputes, additional premium assessments, penalties or other liabilities, depending on state law and the circumstances of the claim.

Reducing the Exposure

Businesses can take these practical steps to reduce the risk of misclassification before a claim arises:

- **Audit regularly.** Review contractor classifications under the applicable federal and state standards rather than relying on a single test.
- **Document independence.** Maintain records supporting contractor status based on the actual working relationship, not just the written agreement.
- **Coordinate across departments.** Involve HR, legal and risk management professionals in periodic reviews of contractor arrangements.
- **Review policy language.** Understand how EPLI and D&O policies address wage and hour claims, employment-related allegations, and claims involving individual executives.

Key Takeaways

Independent contractor misclassification can create significant tax, wage and hour, employee benefits, workers' compensation, and management liability exposures. The tests that determine classification differ by law and by state. Businesses that treat classification as a one-time decision rather than an ongoing review may carry that risk forward without realizing it.

Contact us today for additional management liability guidance.