PROSKAUER ROSE LLP®

Client Alert

A report for clients and friends of the firm

January 2004

Second Circuit Expands Potential Vicarious Joint Employer Liability for Wage and Hour Violations by Subcontractors

The U.S. Court of Appeals for the Second Circuit recently issued a decision that is of potential significance to all businesses that subcontract out some aspect of their work. The court's decision in *Zheng v. Liberty Apparel Co.* (No. 02-7826, 12/30/03), clarifies the standard by which companies may be held liable for the wage and hour violations of their subcontractors as a "joint employer" under the Fair Labor Standards Act ("FLSA") and under analogous provisions of New York law. The new test adopts many additional factors beyond those previously considered by the Second Circuit, and is therefore likely to increase the risk of a finding of joint employer liability. Indeed, given the application of the new *Zheng* test to New York wage and hour law, where the statute of limitations period is six years, the risks facing New York businesses have grown exponentially. Although this decision directly affects businesses in New York, Connecticut, and Vermont, it likely will influence courts in jurisdictions throughout the country.

Under the joint employer doctrine, a company can be held jointly and severally liable for the violations of its subcontractors, even if the contracting business has no direct involvement in, or knowledge of, the wage practices of the subcontractor. The potential exposure can be substantial, as wage and hour cases are increasingly filed as large collective or class actions, with the FLSA providing double damages and attorneys' fees awards to successful plaintiffs. When faced with such liability, smaller subcontractors often fold up or disappear, leaving their corporate customer "holding the bag," typically without business records or knowledge of the facts to defend the case. For example, in a recent case, several major New York City supermarket and drugstore chains paid over $6 million to settle a class action wage case brought by delivery workers employed by subcontractor delivery services.

Historically, the legal standard for determining joint employer status has been uncertain. The FLSA defines "employ" broadly to include "to suffer or permit to work," and the only guidance provided by the Supreme Court with regard to whether a particular entity should be considered the employer of an individual has been a direction that the fact-finder analyze the "economic realities" of the situation and consider the "totality of the circumstances." Most courts focused on whether the contracting company asserted "control" over the subcontractor's employees. Prior Second Circuit decisions had utilized a four-factor control test that analyzed whether the contracting company hired and fired the workers, maintained payroll records, determined the rate of pay and determined work schedules of the subcontractor's employees. That "control" test was similar to the approach utilized to determine joint employer status under other statutes, including Title VII and the National Labor Relations Act, which do not have the same "suffer or permit to work" definition of employment. The *Zheng* decision substantially expands this analysis for claims under the FLSA.

In *Zheng*, the plaintiffs were all employed by a garment factory that sewed apparel as a subcontractor to various clothing manufacturers, including Liberty Apparel ("Liberty"). The workers brought an action for alleged overtime and minimum wage violations under both the FLSA and state law against both the garment factory and Liberty, claiming that most of their work had been performed for Liberty. The garment factory defendants could either not be located or had ceased doing business; thus the case proceeded only against Liberty, which had never directly employed the plaintiffs. The district court, applying the four-factor "control" test, held that Liberty was not the joint employer of the garment factory's workers, and was thus not liable for the wage and hour violations allegedly committed by the garment factory.

The Second Circuit disagreed with the legal analysis applied by the lower court and vacated and remanded the district court's decision. The Court of Appeals reasoned that the control test it had previously espoused was too narrow and could not be reconciled with the FLSA's broad "suffer or permit to work" definition of employment. Judge José Cabranes' opinion, joined by Judges Winter and Leval, substantially deemphasized the importance of "control," concluding that while it may be sufficient to establish joint employment if it exists, the presence of control over the workers is not necessary to establish joint employment. Rather, Judge Cabranes stated that any factor deemed relevant should be considered, and focused on the following six factors that "illuminated" the analysis:

(1) whether the contracting employer's premises and equipment were used for the subcontractor employees' work;

(2) whether the subcontractor had a business that could or did shift as a unit from one contractor to another;

(3) the extent to which the subcontractor's employees performed a discrete line job that was integral to the putative joint employer's process of production;

(4) whether the employees of the subcontractor passed from one subcontractor to another while continuing to perform the same work for the same putative joint employer;

(5) the degree to which the contracting employer or its agents supervised the subcontractor employees' work; and

(6) whether the subcontractors' employees worked exclusively or predominantly for the putative joint employer.

The Court emphasized that its decision was not intended to classify legitimate outsourcing relationships as joint employment. The "economic reality" test, Judge Cabranes noted, "is intended to expose outsourcing relationships that lack a substantial economic purpose, but it is manifestly not intended to bring normal, strategically oriented contracting schemes within the ambit of the FLSA." Concomitantly, the Court recognized that there is no clear way to draw such a distinction. Industry custom and historical practice should be consulted, the court said, for indications that the subcontracting arrangement was a subterfuge to evade FLSA obligations. Close supervision of the subcontractor's employees may be another indicator of an intent to evade the law, but monitoring the subcontractor for the purpose of enforcing contractual warranties of quality and time of delivery, on the other hand, are "perfectly consistent with a typical, legitimate subcontracting arrangement." Additionally, the court concluded that if a "majority" of the subcontractor's employees' work is performed for a single company (as distinguished from "exclusively or predominantly"), that alone is *not* a basis to find joint employment.

The reach of the *Zheng* decision will depend on its application by the lower courts here and elsewhere. In moving away from a strict "control" test, the risk of a joint employment finding is increased. The decision may particularly impact businesses in industries where subcontracting has historically been used to circumvent labor laws, even if in a given situation the outsourcing is not intended to be used in such a manner.

The *Zheng* decision makes it increasingly important for businesses that subcontract out some aspect of their production to consider the extent to which they should monitor their subcontractors and confirm their compliance with applicable wage and hour laws. Although direct involvement in the wage and hour practices of the subcontractor may increase the risk of a finding of control, thus leading to joint employer liability, *Zheng* indicates that the risk may already outweigh the benefit of staying out of the subcontractor's employment matters. The liberalization of joint employer liability will become even more significant if Congress adopts recently proposed legislation that would explicitly recognize the right of illegal immigrant workers to bring claims for wage and hour violations.

NEW YORK LOS ANGELES
WASHINGTON BOCA RATON
NEWARK PARIS

Proskauer's Labor and Employment Department includes over 160 attorneys with significant and diverse labor and employment experience. If you have any questions about the application of wage and hour laws to your business, particularly where joint employment concerns may arise, please contact your Proskauer Rose relationship attorney or:

Harold M. Brody
310.284.5625 – hbrody@proskauer.com

Edward Cerasia II
973.274.3224 – ecerasia@proskauer.com

Lawrence Z. Lorber
202.416.6891 – llorber@proskauer.com

Marc A. Mandelman
212.969.3113 – mmandelman@proskauer.com

Kathleen M. McKenna
212.969.3130 – kmckenna@proskauer.com

Aaron J. Schindel
212.969.3090 – aschindel@proskauer.com

Allan H. Weitzman
561.995.4760 – aweitzman@proskauer.com

Proskauer is an international law firm that handles a full spectrum of legal issues worldwide.