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Richard R. Carlson  
*University of Memphis*

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# EMPLOYMENT BY DESIGN: EMPLOYEES, INDEPENDENT CONTRACTORS AND THE THEORY OF THE FIRM

Richard R. Carlson\*

## INTRODUCTION

Employment laws protect “employees” and impose duties on their “employers.” In the modern working world, however, “employee” and “employer” status is not always clear. The status of some workers and the firms they serve can be ambiguous, especially when the workers work as individuals not organized as firms. Individual workers might be “employees,” but they might also be self-employed individuals working as “independent contractors.”<sup>1</sup> Even if it is clear that workers are someone’s “employees,” the identity of the employer can be unclear. If one firm pays “employees” to work mainly or exclusively for another firm that pays the first firm for the work, which firm is the “employer” of the employees?

Courts resolve these questions with a multi-factored test descended from nineteenth century “master-servant” law, centered on an alleged employer’s “control” of the work, and supplemented by an accumulation of “economic reality” factors.<sup>2</sup> The multi-factored test has been widely criticized for nearly a century.<sup>3</sup> The Supreme Court criticized the test more than 70 years

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\* Professor of Law, South Texas College of Law.

1. See *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318, 322-25 (1992) (discussing the difficult distinction between “employees” and “independent contractors”).

2. *Id.* at 322-24; see also RESTATEMENT OF EMPLOYMENT LAW §§ 1.01, 1.04 (AM. LAW INST. 2015).

3. For some very early criticism, see Judge Learned Hand’s opinion in *Lehigh Valley Coal Co. v. Yensavage*, 218 F. 547, 552-53 (2d Cir. 1914). For a sampling of much more recent criticism, see Stephen F. Befort, *Revisiting the Black Hole of Workplace Regulation: A Historical and Comparative Perspective of Contingent Work*, 24 BERKELEY J. EMP. & LAB. L. 153, 166 (2003); Craig Becker, *Labor Law Outside the Employment Relation*, 74 TEX. L. REV. 1527, 1538 (1996); Richard R. Carlson, *Why the Law Still Can’t Tell an Employee When It Sees One and How It Ought to Stop Trying*, 22 BERKELEY J. EMP. & LAB. L.

ago and offered a revision based on “economic facts” and “the ends sought to be accomplished by the legislation . . . .”<sup>4</sup> Congress, fearful of overextension of laws to regulate relations between “employers” and their “employees,” repudiated the Court.<sup>5</sup> It amended the laws in question to state emphatically: “The term ‘employee’ . . . shall not include . . . any individual having the status of independent contractor . . . .”<sup>6</sup>

“Employee” remains the usual term of coverage in nearly every employment law, and “independent contractors”—including individual, self-employed workers—are still excluded from the usual definition of “employee.” But to deny that “independent contractors” are “employees” begs the question: How should we distinguish an independent contractor, especially a self-employed worker, from an employee? A self-employed worker lacking an organizational structure or higher management looks like a client’s employee during service for the client, especially if his service lasts for more than a few discrete tasks. Self-employed workers are not the only problem. If a firm employs and dedicates a set of workers to serve one client at a time, the relationship between the workers and the client can resemble an employment relationship. Imagine, for example, an “employer” firm that “leases” its “employees” to a client firm.<sup>7</sup> If the leased workers serve the client firm exclusively and are subject to the client’s requests for work, it appears that the *client* is the employer of the

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295, 297-99 (2001); Keith Cunningham-Parmeter, *From Amazon to Uber: Defining Employment in the Modern Economy*, 96 B.U. L. REV. 1673, 1691 (2016); Marc Linder, *Dependent and Independent Contractors in Recent U.S. Labor Law: An Ambiguous Dichotomy Rooted in Simulated Statutory Purposelessness*, 21 COMP. LAB. L. & POL’Y J. 187, 222, 227 (1999); Robert Sprague, *Worker (Mis)Classification in the Sharing Economy: Trying to Fit Square Pegs Into Round Holes*, 31 A.B.A. J. LAB. & EMP. L. 53, 58-72 (2015); Lara Turcik, *Rethinking the Weighted Factor Approach to the Employee Versus Independent Contractor Distinction in the Work For Hire Context*, 3 U. PA. J. LAB. & EMP. L. 333, 336, 338 (2001).

4. NLRB v. Hearst Publ’ns, Inc., 322 U.S. 111, 127-28 (1944); see also United States v. Silk, 331 U.S. 704, 713 (1947).

5. Labor Management Relations Act of 1947, Pub. L. No. 80-101, sec. 101, § 2(3), 61 Stat. 136, 137-38 (codified as amended at 29 U.S.C. § 152(3)).

6. *Id.*

7. Employee “leasing” is an unfortunate but widely used term to describe a staffing service arrangement in which workers are listed on one firm’s payroll while providing work for a client firm that supervises the work. The legitimate purposes of this arrangement include procurement of insurance and employee benefits, payroll services, and possibly other human resources management. Staffing services that provide this arrangement are also widely known as “professional employer” firms. See RICHARD CARLSON & SCOTT A MOSS, EMPLOYMENT LAW 81-82 (3d ed. 2013).

employees. Sometimes, the question is whether a worker is an “employee” or a self-employed worker. At other times, a worker is clearly an employee but there is a question whether one firm, another firm, or both firms are the worker’s “employer.”

Given lawmakers’ reticence to abandon “employee” coverage, a test of employee status remains essential for determining statutory coverage. There might be no practical or politically feasible alternative to “employee” coverage in existing or future worker protective legislation. However, it might be possible to improve the analysis and process for determining who is an employee, and whether a particular firm is an employer. This article proposes a new approach based mainly on the “make or buy” facet of “the theory of the firm.”<sup>8</sup>

“The theory of the firm” is not a single theory. It is a set of theories mainly inspired by Professor Ronald Coase’s landmark article, *The Nature of the Firm*.<sup>9</sup> Theories about the nature of the firm explain why firms exist, how they organize economic activity and ownership, and where their boundaries lie.<sup>10</sup> Some of these theories address a “make or buy” problem: Why does a firm perform some work itself (“making”) while going to the market to buy other work from other parties (“buying”)? This question could be restated as follows: Why does a firm hire some employees to perform some work while contracting with non-employees to perform other work? If the firm hires employees, it is “making” a needed input. If the firm pays for work or work product by other parties such as self-employed workers, it is “buying” the work.

Authors of “make or buy” theories generally assume we can know whether workers are a firm’s employees or non-employees.<sup>11</sup> These theories are concerned with why a firm does one thing rather than another and not with how to know what a firm

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8. See Robert Gibbons, *Four Formal(izable) Theories of the Firm?*, 58 J. ECON. BEHAV. & ORG. 200, 201 (2005).

9. See generally R. H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937); see also Gibbons, *supra* note 8, at 200-02 (describing the theories that are part of “the theory of the firm”).

10. *Why Do Firms Exist?*, ECONOMIST, Dec. 18, 2010, at 134.

11. Rosanna Nisticò, *Make-or-Buy Theories: Where Do We Stand?* 14 (Università della Calabria Dipartimento di Economia e Statistica, Working Paper No. 02-2008, 2008), [http://www.ecostat.unical.it/RePEc/WorkingPapers/WP02\\_2008.pdf](http://www.ecostat.unical.it/RePEc/WorkingPapers/WP02_2008.pdf) [<https://perma.cc/R5ZB-AFQP>].

has actually done. Employment law, on the other hand, looks at what a firm has done in fact without asking why. The prevailing legal test of “employee” status consists of a list of factors, possibly as many as twenty,<sup>12</sup> depending on which version a factfinder invokes. The core of the test consists of “control” factors descended from a pre-industrial domestic model of “master-servant” law.<sup>13</sup> Over time, courts have added “economic reality” factors to account for the modern workplace, but the test still considers outdated concepts of control as a starting point.<sup>14</sup> Economic realities factors modernize the test,<sup>15</sup> but the resulting multi-factored approach is difficult for the parties—and factfinders—in worker-status disputes because it lacks a clear conception or theory of what “employment” is in the modern world.

This article proposes to connect the legal issue of worker status to the organizational and economic theory of the firm. The attempt to link employment law to the theory of the firm is not entirely unprecedented. Professor Matthew Bodie has used the theory of the firm to explain why “employees” deserve more protection than individual independent contractors, and to propose a “participation” test of employee status.<sup>16</sup> In this article, I propose using the theory of the firm—particularly the “make or buy” aspect of the theory—to facilitate analysis and proof of worker status. Connecting the issue of worker status with the theory of the firm makes a firm’s *reasons* for choosing employees or non-employees important, not merely incidental. Identification of reasons provides a focus for the organization and presentation of evidence, and a test of the credibility of a denial of employment relations.

Part I of this article, “Why Worker Status Matters,” explains the importance of employee status in employment and tax law. Part II, “Early Master-Servant Law and the Rise of the Firm,” summarizes the law of employee status by way of its origins in

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12. The Internal Revenue Service has its own checklist of twenty factors. *See* Rev. Rul. 87-41, 1987-1 C.B. 296.

13. *See* Matthew T. Bodie, *Participation as a Theory of Employment*, 89 NOTRE DAME L. REV. 661, 662 (2013).

14. *See id.* at 675-81.

15. *Id.* at 684-89. Professor Bodie adds “entrepreneurial opportunities” and “entrepreneurial control” factors, which could also be described as the most recent interpretations of “economic realities.” *See id.* at 688-690.

16. *See id.* at 666-68, 704-06.

the domestic model of master-servant law through its further development with the rise of the firm and the modern workplace. Part III, “Legal Tests of Employee Status,” describes prevailing rules for distinguishing “employees” from non-employees, especially “independent contractors.” Part IV, “The Theory of the Firm and the ‘Make or Buy’ Problem,” describes the theory of the firm with particular emphasis on a firm’s decision whether to perform needed work itself by hiring employees or to buy the work from other parties in the market. Part V, “Reforming the Dispute Resolution Process for Worker Classification,” explains how the law and process for determining a worker’s status can be aided by incorporating the theory of the firm.

## I. WHY WORKER STATUS MATTERS

The stakes can be high for workers and the firms they serve if there is an issue whether the workers are “employees” of one firm, employees of another firm, or self-employed workers acting as “independent contractors.” At the very least, worker classification affects the parties’ tax obligations. If the workers are a firm’s “employees,” the firm owes FUTA (unemployment compensation) taxes,<sup>17</sup> bears half the cost of social security and Medicare taxes,<sup>18</sup> and owes a duty to withhold income tax to secure tax payment, resulting in a less painful tax experience for the worker.<sup>19</sup> If another firm is the employer of the employees, the tax burden shifts to that employer-firm.<sup>20</sup> If the workers are self-employed, the workers bear the full cost of social security and Medicare taxes, and a firm paying for or receiving the benefit of their services is relieved of these burdens.<sup>21</sup>

A firm does not necessarily avoid payroll taxes or the burden of withholding by buying work from non-employees. A seller of work or a work product might be expected to include the cost of

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17. 26 U.S.C. § 3306(i) (Supp. III 2016).

18. 26 U.S.C. §§ 3101, 3121(b) (2012).

19. See 26 U.S.C. § 3403 (2012).

20. For an example of a dispute whether one party or another was the “employer” of a group of employees for tax purposes, see *Tochril, Inc. v. Tex. Workforce Comm’n*, No. 06-15-00078-CV, 2016 WL 3382747, at \*5 (Tex. App. 2016) (holding that a staffing agency supplying temporary employees for other parties was the “employer” for tax purposes).

21. Jayesh M. Rathod & Michal Skapski, *Reimagining the Law of Self-Employment: A Comparative Perspective*, 31 HOFSTRA LAB. & EMP. L.J. 159, 175-76 (2013).

payroll taxes in the price it charges a buyer firm. However, a firm might gain some advantage by engaging self-employed workers who lack experience or sophisticated business or accounting skills. Such workers might be attracted by what seems to be a high rate of compensation, failing to appreciate the greater burden they will bear for the full cost of payroll taxes.

Liability for work-related accidents and insurance are additional costs that depend on a firm's relationship with workers. In every state but Texas, a firm must pay for workers' compensation insurance for the work-related injuries and illnesses of "employees," but not for independent contractors.<sup>22</sup> On average, workers' compensation adds between one and two percent to an employer's "wage" costs.<sup>23</sup> But the cost of such insurance depends on experience ratings and can be much higher in industries with a higher-than-average rate of injury and illness.<sup>24</sup> A firm also faces the cost of third-party injuries caused by work. An employee's torts against third parties in the course of employment are imputed to the employer firm without regard to the firm's fault.<sup>25</sup> This rule of *respondeat superior* compounds a firm's liability exposure and insurance costs. On the other hand, if a worker-tortfeasor is not the firm's employee, the firm is liable only if the injured party can prove the firm's negligence contributed to the accident.<sup>26</sup> The enhanced liability of hiring employees is another motivation for a firm to buy work from non-employees, or to classify workers as "independent contractors" whenever there is a plausible argument for doing so.

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22. See MARJORIE L. BALDWIN & CHRISTOPHER F. MCLAREN, NAT'L ACAD. OF SOC. INS., WORKERS' COMPENSATION: BENEFITS, COVERAGE, AND COSTS 4-6 (2016), [https://www.nasi.org/sites/default/files/research/NASI\\_Workers\\_Comp\\_Report\\_2016.pdf](https://www.nasi.org/sites/default/files/research/NASI_Workers_Comp_Report_2016.pdf) [<https://perma.cc/U5DG-9DAK>]. A Texas employer that "opts out" of workers' compensation does not entirely avoid the cost of work-related employee accidents. The employer can still be liable under tort law if an employee can prove an accident was because the employer failed in its duty to provide safe work or a safe workplace or was guilty of some other negligence. See CARLSON & MOSS, *supra* note 7, at 410-18 (analyzing *New York Central Railroad Co. v. White*, 243 U.S. 188 (1917) and the Texas "Opt-Out" Model). Thus, a wise Texas "non-subscriber" (an employer who has opted out of workers' compensation) will purchase work-related accident insurance or become self-insured.

23. See BALDWIN & MCLAREN, *supra* note 22, at 40.

24. See BUREAU OF LABOR STATISTICS, USDL-17-1646, EMPLOYER COSTS FOR EMPLOYEE COMPENSATION— SEPTEMBER 2017, at 9 tbl.5 (2017), <https://www.bls.gov/news.release/pdf/ecec.pdf> [<https://perma.cc/A4RN-KG55>].

25. RESTATEMENT (THIRD) OF AGENCY § 7.07 (AM. LAW INST. 2006).

26. *Id.* § 7.05.

A self-employed worker who is no one's employee bears his or her own accident and insurance costs. The worker has no right to compensation from a client firm with respect to work-related injury or illness except upon proof that the client's negligence caused the injury or illness.<sup>27</sup> Natural risks, including the debilitating long-term effects of work without the fault of any party, are also borne solely by the self-employed worker.<sup>28</sup> Finally, liability and insurance costs for tort claims by third parties are more likely to be assumed by the self-employed worker alone because the worker's torts are not imputed to a client firm. The client firm shares responsibility only upon proof of the firm's own negligence.<sup>29</sup>

Taxes, insurance, and liability are obvious, immediate, and quantifiable costs for parties buying and supplying work. Less obvious and ultimately overlooked are the administrative burdens of taxes and insurance. A firm acting as an employer for workers is more likely to have an administrative staff or payroll service to calculate taxes, withhold and forward taxes, and manage the procurement of insurance. A firm with these administrative resources is better able to spread the cost of administration over several workers and is better able to predict and account for these costs and other expenses in negotiating prices for work transactions.<sup>30</sup> If a self-employed worker is no one's employee, he or she must calculate and pay taxes without the convenience of a firm's administrative resources and keep enough funds in reserve

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27. NAT'L ASS'N OF INS. COMM'RS, AN OVERVIEW OF WORKERS' COMPENSATION INDEPENDENT CONTRACTOR REGULATORY APPROACHES 2-4 (2009), <http://www.naic.org/store/free/OWC-OP.pdf> [<https://perma.cc/3UXN-JT8U>].

28. See Alison Doyle, *Differences Between Employed vs. Self-Employed*, BALANCE (Dec. 13, 2017), <https://www.thebalance.com/differences-between-employed-vs-self-employed-2062139> [<https://perma.cc/GY22-LP5F>].

29. RESTATEMENT (THIRD) OF AGENCY § 7.05.

30. *Worker Benefits—and Their Costs—Vary Widely Across U.S. Industries*, PEW CHARITABLE TRUSTS (July 21, 2016), <http://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2016/07/worker-benefits-and-their-costs-vary-widely-across-us-industries> [<https://perma.cc/6EH5-LK7E>]. Individual workers often underestimate the cost of working, especially in the kinds of work that often lead to misclassification. Pizza delivery drivers, for example, sometimes bear the costs of vehicle maintenance, depreciation, insurance, and fuel. A contract promising a delivery driver a certain rate of compensation—whether as an employee or contractor—can actually leave the driver with significantly lower net earnings, even below the minimum wage. See, e.g., *Zellagui v. MCD Pizza, Inc.*, 59 F. Supp. 3d 712, 716-18 (E.D. Pa. 2014). The driver can recover the difference between the minimum wage and net earnings by a lawsuit under federal or state minimum wage law, provided the driver is an employee and not an independent contractor.



to pay these costs as they come due. These burdens, combined with the demoralizing effect of paying taxes not previously withheld and relatively lax government enforcement of self-employment taxes, may tempt a worker to underreport self-employment income.<sup>31</sup> But underpayment of payment taxes puts a worker at serious personal risk later in life when the worker needs benefits measured by the amount of reported and taxed income.<sup>32</sup> Underpayment of self-employment taxes also reduces government revenue and harms the financial integrity of the social security and Medicare systems.<sup>33</sup>

Under some circumstances, a worker might be better off being self-employed as far as taxes, insurance, and liability are concerned.<sup>34</sup> The actual allocation of costs is subject to bargaining. A worker with business acumen, experience, and bargaining power will demand a price sufficient to recover all the costs of work and yield a profit. However, a worker who enters the market as an individual in search of a “job,” not as a business in search of “customers,” is less likely to possess the skill and experience necessary to account for all costs of work, manage taxes and insurance, and bargain for the right price. What appears to a worker to be well-paying work might yield much less than expected—perhaps even a net loss after all costs are considered. An “employee” whose net earnings are below the minimum wage and

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31. Joseph Sorrentino, *Social Security Doesn't Come to All Who Paid*, INVESTIGATIVE FUND (Mar. 9, 2015), [http://inthesetimes.com/article/17616/social\\_security\\_doesnt\\_come\\_to\\_some\\_farmworkers\\_who\\_earned\\_it](http://inthesetimes.com/article/17616/social_security_doesnt_come_to_some_farmworkers_who_earned_it) [<https://perma.cc/YVY2-EQPM>].

32. See 42 U.S.C. § 414(a)-(b) (2012) (outlining eligibility for benefits based on reported income history).

33. The non-reporting of payment to workers who are not on an employer's employee payroll is an important part of an “underground” economy that, by one estimate, deprives the nation of about half a trillion dollars in tax revenues. See Stephen Fishman, *The Underground Economy of Unreported Income*, NOLO (July 2013), <https://www.nolo.com/legal-encyclopedia/the-underground-economy-unreported-income.html> [<https://perma.cc/ZLF9-P9LY>].

34. See *Doe v. Deja Vu Services, Inc.*, No. 2:16-cv-10877, 2017 WL 490157, at \*1-2 (E.D. Mich. Feb. 7, 2017) (approving a class action settlement allowing individual workers to elect to be treated either as employees or independent contractors, presumably because independent contractor status might be to the advantage of some workers, depending on their circumstances).

statutory overtime can sue the employer to recoup the difference.<sup>35</sup> In contrast, a self-employed worker cannot sue a client firm because of an unexpectedly small profit.<sup>36</sup>

Another significant set of rights and duties at stake relates to the security of worker earnings. An employee's right to compensation is not based on the success of an employer-firm's business. A firm is obligated to compensate an employee even if the firm loses money or never clears a profit at all.<sup>37</sup> Thus, a firm is obligated to pay employees a statutory minimum regardless of what the employment contract says.<sup>38</sup> An employer's ability to shift business costs or losses to its employees by deductions is limited and, in some states, strictly prohibited.<sup>39</sup> And an employee's contractual and statutory rights to pay are fortified by a statutory right to payment of earned wages at the base rate at least twice a month.<sup>40</sup>

A self-employed worker, on the other hand, bears the challenges and risks of an erratic and insecure stream of income. Federal and state employment laws do not protect a self-employed worker against possible dips below the statutory minimum compensation.<sup>41</sup> Even if net earnings drop below zero for any week, the worker's client has no obligation to make a minimum payment. In a dispute over responsibility for costs or losses, the worker has no employment-law protection against a firm's unjustified cost-shifting or deduction from a payment due. Moreover, the worker lacks the security of a statutory right to regular and current payment of earned compensation. Subject to the terms of a negotiated contract, the worker's right to all or part of compensation might be delayed until long after the beginning of the worker's performance.

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35. See CARLSON & MOSS, *supra* note 7, at 295-310 (describing case law on employees suing employers and the remedies available to those employees).

36. See Pamela A. Izvanariu, *Matters Settled But Not Resolved: Worker Misclassification in the Rideshare Sector*, 66 DEPAUL L. REV. 133, 137-38 (2016).

37. HORACE GAY WOOD, A TREATISE ON THE LAW OF MASTER AND SERVANT § 97 (2d. ed. 1886).

38. See 29 U.S.C. §§ 206(a), 207(a) (2012) (establishing a minimum wage and requiring the payment of an "overtime" premium). Many so-called "exempt" salaried workers are entitled to a minimum salary. 29 C.F.R. § 541.602(a)(1) (2017).

39. See CARLSON & MOSS, *supra* note 7, at 304-05, 308-09.

40. *Id.* at 328-29.

41. Izvanariu, *supra* note 36, at 137-38.

A worker's access to a group pension plan is also at stake.<sup>42</sup> A firm has an incentive to create a pension plan for employees because the firm's managers reap significant personal tax advantages by deferring compensation in a qualified pension plan.<sup>43</sup> The greater the managers' income and marginal tax rates, the greater the tax advantage. If firm managers create an employee pension plan, they also have an incentive to include a wide circle of lower-ranked employees. A pension plan's qualification for tax advantages depends on a federal rule of "nondiscrimination," which requires a pension plan to include low-paid employees according to a formula for minimum inclusiveness.<sup>44</sup> Workers who are not "employees" can be excluded from a plan without any effect on nondiscrimination compliance. Moreover, an employer has little or no motivation to provide a pension for non-employees.<sup>45</sup> In fact, reducing pension costs might be a motivation to buy work from non-employees rather than hire employees, or to classify workers as "independent contractors" whenever there is a plausible reason to do so.

Again, in some circumstances a self-employed worker might be equally well or better off by charging for retirement costs in the price of the work, and saving for retirement in an individual plan. However, as noted earlier, a worker who enters the market in search of a "job," and not "clients," might lack the sophistication or the bargaining power to achieve this goal. Moreover, creating, maintaining, and managing an individual pension plan requires a level of sophistication and discipline that cannot be taken for granted among self-employed workers. In the rare event that a class of self-employed workers successfully persuades a client firm to establish a group plan, the workers lack the protection of the Employee Retirement Income Security Act, which applies only to plans for "employees."<sup>46</sup> Thus, for example, a self-employed worker is not protected against a pension plan's forfeiture

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42. In this article, the phrase "pension plan" has the same meaning as it does under the Employee Retirement and Income Security Act. See 29 U.S.C. § 1002(2)(A) (2012).

43. See CARLSON & MOSS, *supra* note 7, at 383-86.

44. *Id.* at 384.

45. If a firm did include independent contractors in a benefit plan, that fact could be used against the employer as evidence of misclassification. *Cnty. for Creative Non-Violence v. Reid*, 490 U.S. 730, 751-52 (1989).

46. *Cf. Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318, 320-23, 328 (1992) (reversing Fourth Circuit's vacation of summary judgment and subsequent decisions while

clause even if that clause results in the loss of an entire pension after decades of service.<sup>47</sup>

A pension is only one of several welfare benefits at stake. Firms often provide other welfare benefits to employees, including subsidized medical insurance, disability insurance, life insurance, job training, tuition support, and severance pay.<sup>48</sup> A firm's motivation for providing such benefits is to improve employee morale and loyalty. If a firm establishes a non-pension welfare benefit plan for employees, practical considerations favor broad coverage for all full-time "employees." Granting benefits to some groups of employees and not others can hurt morale and expose the firm to allegations of unfair or illegal discrimination.<sup>49</sup> On the other hand, exclusion of self-employed workers serving the firm is perfectly normal for an "employee" benefit plan, and is not likely to disappoint the truly self-employed or lead to charges of discrimination.<sup>50</sup> As in the case of a pension, an employer has

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adopting a common-law test for qualification as "employee" under ERISA and leaving application to the appellate courts' discretion).

47. *Cf. id.* at 319-20, 322, 328 (leaving a ruling against self-employed worker likely under such facts).

48. *See cf.* Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1002(1) (2012) (defining "employee welfare benefit plan" to include, *inter alia*, plans for medical care, disability, "benefits in the event of . . . death," "apprenticeship or other training programs," and "scholarship funds"); Shelley A. D. Sandoval, Comment, *Ready to Re-Launch: Fixing the Pitch for the Social Enterprise*, 37 N. ILL. U. L. REV. 340, 362 (2017) (explaining Starbucks's full-tuition support program for employees attending Arizona State University); Peter K. Stris, *ERISA Remedies, Welfare Benefits, and Bad Faith: Losing Sight of the Cathedral*, 26 HOFSTRA LAB. & EMP. L.J. 387, 390-91, 391 n.21 (2009).

49. A welfare plan or policy that discriminates between classes of "employees" might save the employer money in the short run, but drafting rules of inclusion and exclusion can be challenging, and the long term effect of exclusionary rules can be toxic to employee morale, loyalty and interpersonal relations. Exclusionary rules can also create problems for workforce management if any employee's transfer or reassignment can result in the loss of a valued benefit. A loss or exclusion from benefits can also generate a claim that the exclusion is for an illegal discriminatory reason, such as to "interfere" with an older or disabled employee's right to a benefit. Thus, inclusiveness is often wise even if not legally compulsory. CARLSON & MOSS, *supra* note 7, at 386-87, 394-96.

50. Exclusion of workers designated "independent contractors" is simple because the standard employee benefits plan applies only to "employees." Exclusion requires no special language of the sort that, on its face, might raise suspicions or complaints of discrimination. However, the lawfulness of the exclusion may depend on whether the excluded workers are in fact employees and not independent contractors. *See Vizcaino v. Microsoft Corp.*, 120 F.3d 1006, 1009-12 (9th Cir. 1997) (en banc) (holding that workers were "employees" under common law and under the terms of their employment agreements despite contracts' erroneous recital that workers were "independent contractors").

little or no motivation to bear the cost of including self-employed workers in its “employee” welfare plans.<sup>51</sup>

Not all employee benefits are granted and received through “employee benefit plans.” Firms usually offer full time employees paid leave for certain purposes, treating employees as still at work even when they are away from work on qualified “leave.” Paid leave includes vacation pay, holiday pay, sick pay, and short-term disability pay, and allows rest and attention to personal needs without a loss or interruption of regular income.<sup>52</sup> Paid leave constitutes on average about seven percent of employee compensation and is one more motivation to buy work from non-employees or classify ambiguous workers as non-employees.<sup>53</sup> A firm’s denial of paid leave to self-employed workers is unsurprising because such workers are not on the firm’s “payroll.” Nevertheless, self-employed workers are just as likely to have occasional personal needs for “leave” from work. They might fund their eventual need for leave from work by charging more and saving in advance, but their ability to do so cannot be taken for granted. Less sophisticated workers may not appreciate that a seemingly generous rate of compensation is much less generous when the self-funded cost of leave is included.

Tax, insurance, and welfare benefits are the most immediate and certain status-dependent issues parties face in a working relationship, but not necessarily the most substantial issues. Other issues can become much more important depending on the behavior and disputes of the parties. Discrimination by a firm against a class of workers is one possibility. A batch of federal and state statutes protect “employees” against discrimination on the basis of race, color, national origin, sex, religion, age, disability and other protected characteristics or protected conduct.<sup>54</sup>

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51. See *supra* note 45 and accompanying text.

52. BUREAU OF LABOR STATISTICS, USDL-17-1013, EMPLOYEE BENEFITS IN THE UNITED STATES—MARCH 2017, at 16 tbl.6 (2017), [https://www.bls.gov/news.release/archives/ebs2\\_07212017.pdf](https://www.bls.gov/news.release/archives/ebs2_07212017.pdf) [<https://perma.cc/P9UE-5JS9>] (listing percentage of employees enjoying most types of paid leave).

53. See BUREAU OF LABOR STATISTICS, *supra* note 24, at 9 tbl.5.

54. See, e.g., Title VII of the Civil Rights Act, 42 U.S.C. §§ 2000e(f), 2000e-2, 2000e-3 (2012); Age Discrimination in Employment Act, 29 U.S.C. §§ 623, 630(f) (2012 & Supp. IV 2017); Americans with Disabilities Act of 1990, 42 U.S.C. §§ 12111(4), 12112 (2012). Self-employed workers and other independent contractors are not wholly without protection against discrimination. They are protected against race discrimination in making and performing contracts under 42 U.S.C. § 1981. However, Section 1981 lacks the administrative

Some employment discrimination laws also require an employer to “accommodate[e]” an employee’s disability,<sup>55</sup> religious practices<sup>56</sup> or pregnancy.<sup>57</sup> An employer’s duty to accommodate a disability or pregnancy can be particularly significant when it requires measures so costly that an employer would be unlikely to grant the same accommodation to an otherwise valued nonemployee worker.<sup>58</sup> An employer’s duty to accommodate does not end with “discrimination” laws. Employee right-to-leave laws require an employer to accommodate an employee’s need for leave from work in situations not covered by discrimination law. For example, a non-disabled employee who needs time off to care for a seriously ill family member has a right to unpaid leave and job restoration under federal law.<sup>59</sup> Self-employed workers lack this statutory right and depend on a client firm’s voluntary accommodation.

Finally, when a firm unilaterally terminates a working relationship, employee status can become more important than ever. Discrimination laws protect an employee, but not a self-employed worker, from discriminatory termination. An involuntarily terminated “employee” may be entitled to unemployment compensation depending on the cause of termination,<sup>60</sup> and a termination

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investigation, mediation, and enforcement provisions of the laws specifically against employment discrimination. *See, e.g.*, 42 U.S.C. § 2000e-5 (2012) (enforcement provision for Title VII).

55. 42 U.S.C. § 12112(b)(5).

56. 42 U.S.C. § 2000e(j) (2012).

57. There is no federal statute that expressly requires an employer to accommodate an employee’s pregnancy, but the Supreme Court has held that a provision of Title VII, 42 U.S.C. § 2000e(k), implies this duty in some circumstances. *Young v. United Parcel Serv., Inc.*, 135 S. Ct. 1338, 1343-44 (2015). Moreover, “pregnancy” might be regarded as a “disability” under certain circumstances. *See* EQUAL EMP’T OPPORTUNITY COMM’N, NOTICE NO. 915.003, ENFORCEMENT GUIDANCE: PREGNANCY DISCRIMINATION AND RELATED ISSUES 39 (2015), [https://www.eeoc.gov/laws/guidance/upload/pregnancy\\_guidance.pdf](https://www.eeoc.gov/laws/guidance/upload/pregnancy_guidance.pdf) [<https://perma.cc/JH9E-ZHFY>] (“[A]lthough pregnancy itself is not an impairment within the meaning of the ADA, and thus is never on its own a disability, some pregnant workers may have impairments related to their pregnancies that qualify as disabilities under the ADA, as amended.” (footnotes omitted)).

58. The Americans with Disabilities Act in particular requires a range of accommodations that can be very expensive for an employer. *See* 42 U.S.C. § 12111(9), (10) (2015) (defining “reasonable accommodation” and “undue hardship”).

59. *See* Family and Medical Leave Act, 29 U.S.C. §§ 2612(a)(1)(C), 2612(c), 2614(a), 2651(a) (2012).

60. *See* CARLSON & MOSS, *supra* note 7, at 815-27 (explaining rationales of disqualification from unemployment compensation, including misconduct and resignation, and collecting cases).

without cause might be charged against the employer firm's experience rating for tax purposes.<sup>61</sup> By contrast, a self-employed worker in between jobs is not "unemployed." Thus, a self-employed worker has a greater need to save in advance for periods when job revenue ceases or declines below basic living needs. If many workers lose work all at once because of a firm's significant reduction in work activity, the stakes are doubled. The firm might owe advance notice or severance pay in lieu of notice to employees affected by a reduction in force of requisite size.<sup>62</sup> Self-employed workers affected by a client firm's reduction in work have no statutory right to advance notice or severance pay, regardless of the size of the reduction and regardless of the extent to which they might rely on the firm's business.

A worker's rights, the firm's duties, and the allocation of costs between the parties depend on whether that worker serves the firm as an employee or as a self-employed worker, but that is not the end of the story. Even if that worker is clearly an employee, the extent of his or her rights and the firm's duties depends on the status of *other* workers serving the same firm. The status of other workers matters because some employment statutes exempt small firms, and a firm's size depends on a count of a firm's employees.<sup>63</sup> Title VII, for example, exempts employers with fewer than fifteen "employees."<sup>64</sup> If a firm employs 14 employees and 100 self-employed workers, the firm cannot be liable under Title VII for harassing female employees or refusing to hire Muslims,<sup>65</sup> and it cannot be liable under the Americans with Disabilities Act for denying reasonable accommodation or terminating employees who become diabetic.<sup>66</sup> If the firm employs 19 employees and 100 self-employed workers, it cannot be liable under the Age Discrimination in Employment Act for refusing to interview applicants older than forty.<sup>67</sup>

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61. *Id.* at 816.

62. *See* Worker Adjustment and Retraining Notification Act, 29 U.S.C. §§ 2101-2109 (2012).

63. *See* Richard Carlson, *The Small Firm Exemption and the Single Employer Doctrine in Employment Discrimination Law*, 80 ST. JOHN'S L. REV. 1197, 1197 & nn.3-4 (2006) (citing headcount limits under Title VII and ADEA).

64. 42 U.S.C. § 2000e(b) (2012).

65. *Id.*

66. 42 U.S.C. § 12111(5) (2012).

67. 29 U.S.C. § 630(b) (2012).

A firm with too many employees to qualify for a small firm exemption can still avoid some statutory employer duties at its small *facilities*.<sup>68</sup> Again, a count of “employees” determines whether a particular facility is small enough to be exempt from an employment law obligation.<sup>69</sup> A Family and Medical Leave Act (FMLA) exemption relieves a firm of its duty to grant statutory leave to an employee if the employee works at a facility with fewer than 50 employees, not counting self-employed workers.<sup>70</sup> Thus, even if an employer employs 1,000 employees, it owes no FMLA duties to any employee at a facility with 49 employees and 51 non-employee workers.

Other small facility exemptions based on “employee” counts lie in the mechanics of certain employment laws. A firm can avoid statutory duties of advance layoff notice or severance pay<sup>71</sup> if the affected employees work at a site with no more than 49 employees, even if any number of self-employed workers or other non-employees also work at the same site.<sup>72</sup> The Americans with Disabilities Act led to another small firm exemption. It limits a firm’s duty to “accommodat[e]” an employee’s disability by making the size of the employee’s worksite a factor in determining whether a proposed accommodation will be an “undue hardship.”<sup>73</sup> Moreover, a count of the employer firm’s employees at the relevant site is part of the test for measuring the hardship caused by a proposed accommodation.<sup>74</sup>

There is one more reason worker status can remain an issue even for a worker who is indisputably an employee. There might be an issue in determining whether the employee is employed by one firm or another. At first glance, this issue might seem to be of little consequence to employee rights, because if the em-

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68. See 29 U.S.C. §§ 2611(2)(b) (2012).

69. *Id.*

70. *Id.*

71. See 29 U.S.C. § 2101(b)(1) (2012).

72. The WARN Act imposes notice or severance pay duties only with respect to the closing of a “single site” or a “mass layoff” at a single site causing the termination of at least 50 “employees.” 29 U.S.C. § 2101(a)(2)-(3).

73. 42 U.S.C. § 12111(9)-(10).

74. See EQUAL EMP’T OPPORTUNITY COMM’N, NOTICE NO. 915.002, ENFORCEMENT GUIDANCE: REASONABLE ACCOMMODATION AND UNDUE HARDSHIP UNDER THE AMERICANS WITH DISABILITIES ACT 4, 23-24 (2002), <https://www.eeoc.gov/policy/docs/accommodation.html#undue> [<https://perma.cc/A5CH-GF52>].



ployee's own firm owes no employer duties, the other will. However, this is not always the case. A workforce can be subdivided among two or more firms so that one or more gains a small firm or small facility exemption.<sup>75</sup> Moreover, employee rights are worthless unless they are enforceable by the collection of a judgment. A nominal employer of a group of employees might have so few assets that it can easily flee or claim insolvency if the government or employees seek to enforce the law.<sup>76</sup> Effective vindication of the employees' rights might depend on whether another firm is the real or "joint" employer[.]<sup>77</sup>

From a firm's perspective, there are enough reasons to hire at least some employees (to "make" rather than "buy") that the firm will hire at least some workers as employees and will not deny their employee status.<sup>78</sup> It is hard to imagine a firm with no employees, unless the firm itself is a self-employed individual. However, a firm might try to have it both ways. It might claim workers are self-employed workers—"independent contractors"—or employees of some other firm if there is any plausible basis for the claim. The status of some individual workers is naturally ambiguous because there is no clear demarcation between employed and self-employed,<sup>79</sup> but a firm can also create ambiguity by the way it organizes the work.<sup>80</sup> Of course, it is not up to firm to make a self-serving declaration about the status of ambiguous workers. If the workers or a regulatory agency claims a misclassification, it is for the ultimate factfinder—a judge or a jury—to decide whether the workers are employees of the target firm.

In many employee rights lawsuits, there is no issue about what happened, only whether a worker or group of workers were

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75. See, e.g., *Papa v. Katy Industries, Inc.*, 166 F.3d 937, 941-42 (7th Cir. 1999) (holding that an employer is not allowed to invoke the small facility exemption when the corporate veil has been pierced), *cert. denied*, 528 U.S. 1019 (1999); see generally Carlson, *supra* note 63.

76. See, e.g., *Zheng v. Liberty Apparel Co.*, 355 F.3d 61, 66-70 (2d Cir. 2003) (finding that garment contractors and a garment manufacturer were joint employers within the meaning of FLSA).

77. *Id.* at 79.

78. See *infra* Part IV.B.

79. See Carlson, *supra* note 3, at 337-38.

80. See, e.g., *Vizcaino v. Microsoft Corp.*, 120 F.3d 1006, 1011-13 (9th Cir. 1997) (“[Microsoft’s] intentions were in perfect accord in that respect, and the independent contractor label was a mere error.”).

employees of the target firm, employees of another firm, or self-employed “independent contractors.”<sup>81</sup> The issue is resolved by multi-factored tests centered on an alleged employer’s control of the work, supplemented by “economic realities factors.”<sup>82</sup> This approach is difficult and costly, especially for the party challenging a firm’s characterization of its workers. Some form of a multi-factored test may be an inescapable necessity as long as law-makers persist in tying work rights and duties to “employee” status. However, it is possible to make the test easier for parties challenging a firm’s worker classification, and to make the issue clearer for the fact finder. The next section explains the origin of the current “control” centered test, the flaws of the test, and the need for a revised test that accounts for the way firms obtain and manage work in the modern world.

## II. EARLY MASTER-SERVANT LAW AND THE RISE OF THE FIRM

To be an “employee” is to hold a certain status. A worker has a substantial batch of rights as an employee, but not as an independent contractor. If the worker is an employee, and the parties satisfy the other conditions of coverage under a particular statute, employee status rights attach so securely that, in many instances, the rights are non-waivable and not subject to negotiation or contract.<sup>83</sup>

Yet employment is also a contractual relation, formed by contract and subject to significant variation according to the contract within a range allowed by employment law. The contractual aspects of employment can make determination of a worker’s status difficult when the contract does not align with the standard model of employee status. In this regard, employee status differs from other important examples of status like marriage or shareholder. In contrast with marriage, there is no ceremony, registration or other definitive act that makes “employee” status certain. In contrast with a shareholder of a firm, an employee’s role is not

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81. *See id.* at 1009-10.

82. *See, e.g., id.*

83. *See, e.g.,* Alexander v. Gardner-Denver Co., 415 U.S. 36, 51 (1974) (“[W]e think it clear that there can be no prospective waiver of an employee’s rights under Title VII.”); Barentine v. Ark.-Best Freight Sys., 450 U.S. 728, 745 (1981) (finding that employee rights under Fair Labor Standards Act cannot be waived).

based on a transfer of property rights. There is no single, clear and essential feature that distinguishes an “employee” from other individual service providers such as independent contractors. The principal act that creates an appearance of employee status, performance of service in return for pay,<sup>84</sup> can also be an individual contractor’s service in return for a customer’s payment.

Without an essential distinguishing feature, employee status depends on “factors” relating mainly to the degree of a potential employer firm’s control and a worker’s dependence on that firm.<sup>85</sup> But neither control nor dependence is quantifiable as a practical matter, and employers and workers can mold their relations and exercise contractual and non-contractual levers of control in ways that span concepts of “employee” and “independent contractor.” Some employees work without much direction by their employers, and some independent contractors tolerate a great deal of customer control. Classifying such variegated relations by a multi-factored test is like identifying marriage by cohabitation, fidelity, devotion, affection, and mutual support, instead of by a wedding.

Modern tests of employee status can be traced to an era when worker rights and duties really were a matter of fixed status law, similar to marriage or parentage today.<sup>86</sup> At one time, the body of law applying to worker rights and duties was titled “master and servant” law<sup>87</sup> and frequently presented as a subpart of “domestic relations law.”<sup>88</sup> In the once substantial agrarian and domestic

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84. For some purposes in the common law, especially *respondeat superior*, a volunteer who donates services without expectation of compensation might be regarded as a servant or employee. See JAMES SCHOUER, A TREATISE ON THE LAW OF THE DOMESTIC RELATIONS § 461, at 756 (5th ed. 1895); WOOD, *supra* note 37, § 97. However, in modern employment law “volunteers” are generally regarded as non-employees. See CARLSON & MOSS, *supra* note 7, at 43-44.

85. See CARLSON & MOSS, *supra* note 7, at 43.

86. 1 C.B. LABATT, COMMENTARIES ON THE LAW OF MASTER AND SERVANT § 3, at 12-13 (1913).

87. See generally WOOD, *supra* note 37.

88. E.g., SCHOUER, *supra* note 84, § 489. The occasional inclusion of “Master and Servant” law in the larger subject of Domestic Relations continued well into the twentieth century. See Janet Halley, *What is Family Law?: A Genealogy, Part II*, 23 YALE J.L. & HUMAN. 189, 202-07 (2011). Before modern employment regulation, one of the single largest problem areas of master servant law involved child labor, rights of parents with respect to child labor, employment relations between family members, and other intersections between employment and family life. See WOOD, *supra* note 37, § 8.

service sector, relations between masters and servants were governed as much by a social code as by contract law, and variation in relations was limited by the character of the assets for productive activity.<sup>89</sup> In the agrarian world the predominant assets were land, livestock, and relatively simple tools associated with use of land or livestock, which were controlled by individuals or families. If a landowner owned enough of these assets to require more labor than he could supply by himself, the owner's labor needs were primarily for unskilled or semi-skilled work by individuals with relatively little investment in "human capital," and in the case of slavery even a worker's human capital was owned by a master. The skills a worker offered were mainly the result of natural physical ability and ongoing experience, not formal education. In fact, most individuals supplying labor lacked any formal education, and most were illiterate.<sup>90</sup> A master had limited needs for managerial or administrative work beyond what he and his own family could supply. Even if a master's assets were substantial enough to require additional supervisors and overseers, he was unlikely to employ more than one additional layer of management.<sup>91</sup>

A landowner's control over the work was simple and direct, reinforced by a combination of social norms, sole ownership of the physical assets, and the workers' lack of substantial human capital or, in the case of slaves, no human capital at all.<sup>92</sup> In this setting, the rules of master and servant status applied naturally when an individual landowner accepted the service of an individual worker or purchased a slave.<sup>93</sup> Status rules upheld the master's control over a servant's work and some non-work activities.<sup>94</sup> The law of servant status was included in the paternalistic law of domestic relations at least in part because servants, like

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89. See SCHOULER, *supra* note 84, § 454, at 742-43.

90. CARLSON & MOSS, *supra* note 7, at 5.

91. *Id.* at 2.

92. *Id.*

93. WOOD, *supra* note 37, § 1, at 2 n.3; see SCHOULER, *supra* note 84, § 458, at 750-51. In general, the law of master and servant was the starting point for rules applicable to slaves, although the status of slaves was fundamentally different from the status of other servants. See, e.g., *Snee v. Trice*, 2 S.C.L. (2 Bay) 345, 347-50 (1802); see also Jenny Bourne Wahl, *Legal Constraints on Slave Masters: The Problem of Social Cost*, 41 AM. J. LEGAL HIST. 1, 19-20 (1997).

94. SCHOULER, *supra* note 84, § 462, at 759-60; WOOD, *supra* note 37, §§ 93-94, 110.

wives and children, lived on the master's premises, obtained daily necessities from the master's household or manor, and depended on the master for supervision and discipline.<sup>95</sup> The master's control was pervasive.

Social convention, ownership of assets, and economic domination led to the same master-servant model in craft and transportation settings before the rise of the modern firm. In craft settings, the key physical assets were owned by an individual master or aspiring master. Human capital, including knowledge and skill in a craft such as blacksmithing or weaving, was important but learning was on the job as an "apprentice[]" servant.<sup>96</sup> Thus, a master craftsman's servants were often minors and student workers, residing with the craftsman and dependent on the craftsman for instruction, direction, access to assets, lodging, and daily needs.<sup>97</sup> The status of servant applied naturally to an apprentice and provided the same legal presumption of the master's control.<sup>98</sup>

The master-servant model also prevailed in the merchant and marine industries, where a ship was often the principle physical asset, a residence and a workplace.<sup>99</sup> The patriarchal command of a captain was as important to social order and security as it was to productive work.<sup>100</sup> The status of seamen and their superiors, while not officially governed by master and servant law or domestic relations law, was subject to an even more paternalistic admiralty law, and admiralty law gave the captain the power of a sovereign over subjects on board the ship.<sup>101</sup>

In each of these settings, a servant's status was clear by his service and submission to a landowner, craftsman, captain, or master in any of the limited number of roles available in the pre-industrial economy. British treatise writers described a stratified

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95. SCHOULER, *supra* note 84, §§ 458, 467-468.

96. *Id.* § 455, at 744; WOOD, *supra* note 37, § 39.

97. *See, e.g.*, Eastman v. Chapman, 1 Day 30, 31 (Conn. 1802); *see also* SCHOULER, *supra* note 84, § 457; WOOD, *supra* note 37, § 49.

98. James v. Le Roy, 6 Johns. 274, 274, 276 (N.Y. Sup. Ct. 1810); *see also* SCHOULER, *supra* note 84, § 455; *see generally* WOOD, *supra* note 37.

99. *See generally* CHARLES ABBOTT, A TREATISE OF THE LAW RELATIVE TO MERCHANT SHIPS AND SEAMEN (John Henry Abbott ed., 5th ed. 1827).

100. *Id.* at 136, 143.

101. Gibbs v. Two Friends, 10 F. Cas. 302, 302-04 (Pa. Adm. Ct. 1781) (No. 5,386) ("The relation between the owners and master of a vessel hath, to many purposes, been considered as that of master and servant . . ."); 1 LABATT, *supra* note 86, §§ 243, 273.

classification of types of servants persisting well into the industrial revolution.<sup>102</sup> American treatise writers adopted a holistic view. For legal purposes, “servants” constituted one class, although highly variegated and subject to a combination of express contract terms and community or occupational customs.<sup>103</sup> Even in the U.S., however, servants were identifiable by social patterns, roles and customs. A worker who accepted one of these customary roles was a servant, and he was subject to the master’s control because he was a servant.<sup>104</sup>

The rise of the modern firm disrupted social roles and hierarchy. Firms combined the financial assets of many investor-owners to serve rapidly expanding markets,<sup>105</sup> acquire expensive new tools from the industrial revolution, spread risks of entrepreneurial activity, and transform craft shops into factories. A firm was a “person” and “master” only in an abstract legal sense. It could employ a workforce of hundreds or thousands with a constantly changing composition of individuals in multiple workplaces or roving worksites. Workers were no longer residential members of a common household, manor, plantation, or ship. The essence of their relation with the firm was reduced to an exchange of money for work.<sup>106</sup>

A firm organizing the work of hundreds or thousands of workers in an enterprise far exceeded the means of a traditional craft shop. This resulted in a fundamental change: How could an

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102. See 1 WILLIAM BLACKSTONE, COMMENTARIES \*410-15; Wood, *supra* note 37, § 2.

103. SCHOULER, *supra* note 84, §§ 454-456; WOOD, *supra* note 37, §§ 1-4, § 94, at 188.

104. WOOD, *supra* note 37, §§ 1-3, § 83, at 166. American writers acknowledged the social implications of the labels “master” and “servant” but often encouraged rejection of this terminology. See, e.g., SCHOULER, *supra* note 84, §§ 454-455 (“[I]t is gratifying to reflect that the servant is frequently the social equal, or even the superior, of his master.”). But the term “employee” was not a widely used substitute term for “servant” until the enactment of modern employment laws applying to “employees” and their employers. Before modern employment law, writers and lawmakers used an assortment of terms, such as “workmen[.]” to describe persons known today as “employees.” See, e.g., *id.* § 456; see also Carlson, *supra* note 3, at 306-10.

105. John Buttrick, *The Inside Contract System*, 12 J. ECON. HIST. 205, 205-06 (1952).

106. One sign of the depersonalization of master-servant relations was the obsolescence of an old rule that a master could not assign his rights to a servant’s service. See WOOD, *supra* note 37, §§ 44, 91, 116. Of course, in the modern world corporate employers routinely assign rights to employee service in the course of a transfer of ownership.

abstract and impersonal entity organize and transmit power to direct, coordinate, and synchronize activities of a large and complex workforce? The early American workforce was not accustomed to coordinated and synchronized work in large organizations. To a modern observer, workers at many nineteenth century craft shops might seem surprisingly disorganized, unsupervised, undisciplined, often shirking, working separately and according to their own pace and schedule, and without central management or coordination of the work.<sup>107</sup> The organization, coordination, and supervision that modern workers take for granted today was present, if at all, only in a rudimentary form until the culmination of the industrial revolution.

“Scientific management” and corporate bureaucracy were two solutions for firms seeking greater efficiency. Scientific management, as its name implies, is the idea that work management is a science, and that work methods should be investigated and subjected to experimentation for the purpose of making work as efficient as possible at the lowest cost possible.<sup>108</sup> In the last half of the industrial revolution, firms used scientific management to convert workshops of autonomous individuals into synchronized machines. Techniques developed by scientific management were implemented by corporate bureaucracy. A managerial hierarchy established firm governance over workers by “fiat” or “managed coordination,”<sup>109</sup> expressed and transmitted by corporate policy, and enforced by “supervisors” wielding disciplinary power.<sup>110</sup>

The transition from a master’s paternalistic “control” over a servant to a firm’s bureaucratic management and control was neither simple nor smooth. It was not immediately obvious, even by the middle of the industrial revolution, that an employee-based firm hierarchy would become the predominant model. There were competing models for the organization of work from the beginning of the industrial revolution, and some of those models

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107. See KATHERINE V.W. STONE, FROM WIDGETS TO DIGITS: EMPLOYMENT REGULATION FOR THE CHANGING WORKPLACE 15-17 (2004).

108. See FREDERICK WINSLOW TAYLOR, SHOP MANAGEMENT 58 (1912).

109. HAROLD DEMSETZ, THE ECONOMICS OF THE BUSINESS FIRM: SEVEN CRITICAL COMMENTARIES 2 (1995); see also Buttrick, *supra* note 105, at 207-08, 213; Gibbons, *supra* note 8, at 203-04; Bengt Holmstrom, *The Firm as a Subeconomy*, 15 J. LAW, ECON., & ORG. 74, 77 (1999).

110. CARLSON & MOSS, *supra* note 7, at 2.

bear striking resemblance to the “sharing economy” arrangements of today.<sup>111</sup> In larger craft shops or small-scale factories, one early step toward large-scale organization of work was the rise of the “journeyman” class. Journeymen were too skilled to be apprentices but too lacking in resources or opportunity to be masters of their own shops.<sup>112</sup> Journeymen labored in the shops of masters, receiving work orders, paying rent for the use of assets, earning fixed rates, and working under various degrees of autonomy or submission to a master’s control.<sup>113</sup> Some journeymen employed and paid their own team of workers.<sup>114</sup> Another widely followed arrangement, “putting out[,]” involved organizing large numbers of workers at physically dispersed locations, mainly homes or small workshops, with the central organizer delivering materials to workers for assembly and collecting the work for delivery to the next stage.<sup>115</sup>

Organizing and coordinating substantial and complex enterprises required managerial hierarchy, but not necessarily a hierarchy of “employees” in a single firm. Some large craft shops that resembled employee hierarchies at first glance were in fact a collection of independent masters or “inside contractors,” employing their own workers at essential phases of a manufacturing process and coordinated masters who acted more like property owners than supervisors.<sup>116</sup> Some factories resembled modern construction sites, managed at the top by a general contractor with work performed mainly by subcontractors and subordinates of subcontractors, each with their own system of organization.<sup>117</sup> The production workers were sometimes supervised and paid exclusively by inside contractors, and sometimes the production workers’ pay was supplemented by a daily wage from the general contractor or manufacturer.<sup>118</sup>

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111. *See id.*

112. *See* Walter Nelles, *The First American Labor Case*, 41 YALE L.J. 165, 166-68 (1931) (describing relations between master and journeymen cordwainers (shoemakers) in Philadelphia during the early days of the American industrial revolution).

113. *See* COASE, *supra* note 9, at 386, 403-05; STONE, *supra* note 107, at 14-18.

114. STONE, *supra* note 107, at 15.

115. Buttrick, *supra* note 105, at 205-06.

116. *Id.* at 205; *see also* STONE, *supra* note 107, at 15-18.

117. *See* STONE, *supra* note 107, at 15-18; Buttrick, *supra* note 105, at 216.

118. STONE, *supra* note 107, at 15-18; Buttrick, *supra* note 105, at 216.



Were the production workers in these cases servants, renters, “inside” contractors, “outside” contractors, or employees of contractors? Their status was often a matter of private dispute between the parties insofar as rights of supervision, control, and coordination.<sup>119</sup> In the absence of modern employment law, the issue of status was not a legal issue as much as a matter of social standing and personal pride. Journeymen and other skilled workers often viewed themselves as social, occupational, or professional equals of the masters or owners of the workplaces.<sup>120</sup> Workers and their intermediate masters often resisted demands for synchronized work schedules, reliable attendance, rules of conduct, uniform standards of production, or cooperation with other workers.<sup>121</sup> The ultimate success of modern firms was partially due to the erosion of autonomy of the various actors in the production process by the establishment of a strong managerial bureaucracy, the coordination of work activities, and the standardization of the procedure and specifications of work.<sup>122</sup>

Hierarchy and standardization of the work enabled further revolutions that continue to this very day and tend to perpetuate a stratification of the work force. Two of the most important revolutions were specialization and “deskilling.”<sup>123</sup> Before the industrial revolution, a skilled craftsman learned an entire production process and completed each piece of work from beginning to end.<sup>124</sup> Even a master’s assistants or journeymen often worked with sufficient skill and knowledge to make the master’s close supervision or “control” unnecessary and frequently unwelcome.<sup>125</sup> A worker’s acquired skill empowered the worker in negotiations or other personal dealings with a party seeking to organize work, especially if the organizer was not personally familiar with the skill and skilled workers were in limited supply.<sup>126</sup> With the industrial revolution, however, manufacturing

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119. See STONE, *supra* note 107, at 15.

120. *Id.* at 15-16 (“In such a setting, these men – and they were all men – were able to retain their conception of themselves as self-employed craftsmen.”).

121. *Id.* at 14.

122. Buttrick, *supra* note 105, at 213.

123. CARLSON & MOSS, *supra* note 7, at 5; (on deskilling); see also Raghuram G. Rajan & Luigi Zingales, *Power in a Theory of the Firm*, 113 Q.J. ECON. 387, 388-91 (1998) (on specialization).

124. STONE, *supra* note 107, at 15, 19.

125. *Id.* at 15.

126. *Id.* at 33; see also *infra* text accompanying notes 134-42 and notes 137-38.

firms discovered that complex work can be divided into specialized sub-skills, with different workers assigned to different skills in the production process.<sup>127</sup> Specialization sometimes goes far enough to become “deskilling,” in which complex work is broken down into very simple and unskilled units, with each unit assigned to a relatively low paid and submissive unskilled worker.

Specialization and deskilling accelerated the firm’s managerial empowerment and standardization of work procedure and output. By breaking complex work into simple discrete units, firms were able to implement “scientific management.” The firm could adopt and enforce changes in any detail of the work, and objectively measure each worker’s output. Deskilling production work even allowed firms to deskill some supervisory work.<sup>128</sup> The supervisor of an assembly line did not require knowledge of the entire process and did not supervise the entire process. He needed only to take attendance, assure timely arrival, schedule breaks, and motivate concentrated and fast paced work by threat of disciplinary action. The supervisor’s role was not necessarily to instruct workers in the performance of work but to enforce rules and exhort workers to work faster under threat of disciplinary action.

The rise of firms and competition between firms made workforce size and organization of work a constant issue. Firms can gain competitive advantages by expanding vertically into different but interdependent phases of the same industry, or horizontally into entirely different industries or new technologies. To gain efficiencies of scale or reduce the waste of overgrowth, firms can merge, split, form parent firms, or subsidiary firms. As a firm expands, reorganizes, and adds or sheds different functions, it faces the “make or buy” question that lies at the heart of modern theories of the firm: Should the firm expand to perform desired work itself by hiring employees, or should the firm purchase work from parties outside the firm’s hierarchy of employees, such as independent contractors or separate firms?

Early firms experimented with the “make or buy” question long before the question became a topic of economic theory. John Buttrick’s study of the Winchester Repeating Arms Company’s

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127. STONE, *supra* note 107, at 5.

128. *Id.* at 34-35; DEMSETZ, *supra* note 109, at 18.

operations during the late nineteenth century suggests that an employee-based hierarchy might have been inevitable for most complex work in the long run, but that the merits of this form of organization were not immediately obvious.<sup>129</sup> Initially, Winchester relied substantially on “inside contracting,” paying the contractors (skilled craftsmen) to perform essential phases of the production of firearms inside Winchester’s facility.<sup>130</sup> Initially, Winchester acted less as an employer and more as a general contractor and landlord of the workplace. Inside contractors supervised their own workers in distinct phases of the manufacturing process. To an outside observer, the contractors might have appeared to be Winchester’s own managers or supervisors and part of Winchester’s hierarchy of employees. However, Winchester paid the contractors a fixed amount for each unit of production, as if Winchester was simply purchasing a specific output.<sup>131</sup> Contractors selected, hired, trained, and managed their own production workers, and paid these production workers in amounts according to the contractors’ discretion.<sup>132</sup> A contractor’s net earnings took the form of a profit: The difference between the price Winchester paid the contractor and the contractor’s costs—especially labor costs.<sup>133</sup>

At first, both Winchester and the contractors found this arrangement advantageous. Each side could focus on what it did best. The contractors were metal crafters specialized in different phases of making firearms, and in the best position to manage their part of the work,<sup>134</sup> but they lacked business and financial skills, and they needed capital.<sup>135</sup> Winchester’s managers lacked technical skills for making firearms,<sup>136</sup> but they had the know-

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129. Buttrick, *supra* note 105, at 205-07.

130. *See id.* at 205, 207.

131. *Id.* at 208.

132. *Id.* at 209-10.

133. *Id.* at 216.

134. Buttrick, *supra* note 105, at 207, 210. Even at this stage of the industrial revolution, the owners and top managers of manufacturing firms often lacked technical knowledge or skill with respect to the goods their firms produced. *See id.* at 213-14.

135. *See id.* at 207.

136. At the outset, the upper management of Winchester lacked specialized or technical knowledge or experience in the production of firearms. It was not until the end of the nineteenth century when the firm’s founder, Oliver Winchester, appointed a president with such knowledge. This change was likely important for the later transition to an employee-based hierarchy for the firm’s production. *Id.* at 213-14.

how to raise capital, obtain resources, oversee the production process, organize delivery services, and market the final product.<sup>137</sup> Inside contracting also appealed to Winchester because it allowed the firm to shift part of the risk of the enterprise to the contractors. If the work went badly and units of production were not completed, Winchester had no obligation to pay the contractors. The production workers' right to pay was the inside contractor's problem whether Winchester paid the contractor or not.<sup>138</sup>

The balance of power at the outset was generally but not entirely in Winchester's favor. Contractors retained considerable independence and autonomy,<sup>139</sup> which often frustrated Winchester. However, Winchester still had significant levers for controlling the contractors and gaining the terms it wanted in negotiations. Winchester was a monopsony: The contractors had few or no other local "buyers" for their work.<sup>140</sup> This fact enabled Winchester to exercise enough control over the enterprise for many years without bringing the contractors within its hierarchy of employees. Winchester also exercised its control in one very employer-like way. It appointed its own plant superintendent to oversee and coordinate the work of the contractors.<sup>141</sup> Winchester's control was augmented by control over the premises. When the contractors' independence in setting their own hours began to interfere with synchronization of production, the superintendent found a way to enforce timely arrival of contractors and their employees without disciplinary action. He simply locked the gate after the deadline.<sup>142</sup>

Over time, however, Winchester discovered that the inside contracting arrangement left it without as much control as it needed for long term success in an increasingly competitive world. Most of the innovation and improvement in work methods depended on the contractors and their workers. "Employees"

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137. *Id.* at 207.

138. *Id.*

139. Buttrick, *supra* note 105, at 207.

140. *See id.* at 210.

141. *Id.* at 214.

142. *Id.*

would have had a duty to share improved practices with Winchester,<sup>143</sup> but the insider contractors and their workers had no such duty and little inclination or reason to share knowledge with Winchester. Sharing information sometimes revealed cost-saving measures that enabled Winchester to demand a lower piece rate. The contractors' own workers were also disinclined to share their knowledge with Winchester. They owed their loyalty<sup>144</sup> and jobs to the contractors, and the contractors, not Winchester, decided the workers' pay rates.<sup>145</sup>

The contractors' exclusive possession of production techniques exposed Winchester to the risk that its enterprise would suffer if it was abandoned by a contractor. Even worse, a contractor might share production knowledge and expertise with a competitor. The more the contractors perfected their work techniques, the more distant Winchester was from technical mastery of the work, the greater the contractors' power to resist managerial control, and the greater their leverage in negotiations.<sup>146</sup>

The inside contracting arrangement also prevented Winchester from exercising the control it sought over contractor and production worker earnings. Control of earnings was important to Winchester partly because its executives believed earnings should match their vision of the "social hierarchy" of the workplace, and partly because of morale problems among the contractors' employees.<sup>147</sup> However, Winchester lacked the means to determine the contractors' net earnings because the contractors owed no duty to account to Winchester.<sup>148</sup> Winchester's efforts to investigate costs were viewed with suspicion by the contractors, who feared that this information would be used against them in negotiations.<sup>149</sup> Winchester was similarly frustrated in its effort to

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143. CARLSON & MOSS, *supra* note 7, at 847-53 (analyzing the shop right doctrine); SCHOULER, *supra* note 84, § 488, at 786 (concerning ownership of inventions developed in the scope of employment).

144. As employees of the contractors, the production worker owed a duty not to disclose their employers' trade secrets. WOOD, *supra* note 37, § 131.

145. Buttrick, *supra* note 105, at 210-11.

146. *Id.* at 210 ("The monopsony position of the company was thus threatened by the monopoly power possessed by contractors.").

147. *Id.* at 210-11. The manufacturer's executives and managers evidently feared being surpassed in wealth and prestige by the master mechanic contractors. *Id.* at 215-17.

148. *Id.* at 209-11. Employees, on the other hand, would have owed general duties of loyalty and accounting to Winchester as the employer. See SCHOULER, *supra* note 84, § 477.

149. See Buttrick, *supra* note 105, at 213.

achieve uniform standards of pay for the contractors' employees. Rates of pay became especially important to Winchester when business conditions tightened and the contractors protected their personal earnings by reducing their employees' pay.<sup>150</sup> Declining pay and widening disparities in pay between units of workers led to conflict.<sup>151</sup> Winchester could do little to address these problems because the contractors, not Winchester, decided what to pay the contractors' employees.<sup>152</sup>

All of these factors contributed to Winchester's decision at the beginning of the twentieth century to abandon the inside contracting system and to move toward a hierarchy of employees.<sup>153</sup> A new generation of Winchester managers took interest in scientific management,<sup>154</sup> and the appointment of technically skilled managers placed the firm in a better position to weather the loss of skilled contractors.<sup>155</sup> The precipitative event may have been the fear of unionization. Some contractors had enriched themselves by suppressing wages to such an extent that Winchester began to fear the threat of union organizational activity among the production workers.<sup>156</sup>

Winchester's first major step toward assertion of "employer" control was its direct involvement in the selection of all new workers for any of its inside contractors.<sup>157</sup> The manufacturer's insertion of its authority between the contractors and their workers eliminated one of the basic pillars of the inside contracting system: The production workers' loyalty and submission to the contractors.<sup>158</sup> Soon thereafter, Winchester presented the contractors with two options: Accept positions as "employee" managers, or depart from the enterprise. Some contractors accepted the offer, and some departed.<sup>159</sup>

This narrative of Winchester's transition from inside contracting to a hierarchy of employees suggests some of the reasons

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150. *Id.* at 217-18.

151. *See id.*

152. *Id.* at 210, 217.

153. *Id.* at 217-18.

154. Buttrick, *supra* note 105, at 219.

155. *See id.* at 213-14.

156. *Id.* at 217-18.

157. *Id.* at 218.

158. *Id.* at 218-19.

159. Buttrick, *supra* note 105, at 219-20.

a firm might buy work from other parties and perform other work itself with its own employees. Winchester gained economies of scale for itself and the contractors by acquiring ownership or rights to a single worksite for complex work that required some degree of centralized coordination. Acquiring the worksite did not require the employment of craft and production employees for making components. Employing skilled craftsmen was no more necessary for Winchester than it is today for any manufacturer that needs components requiring a specialized skill. The fact that the inside contractors (crafters and suppliers of components) performed their operations under the same roof was a matter of convenience. The contractors could have opened their own shops across the street, just as many suppliers locate closely to their important buyers, but it was more efficient for Winchester to act as a landlord providing one space for all the interrelated operations. The advantage of performing the operations under one roof would have been even more important in the nineteenth century than today given the less efficient state of nineteenth century communications and transportation. The parties also achieved some economies of scale by allowing Winchester to obtain materials, especially metals, common to the operations of all the contractors.

Winchester might have tried to acquire the technical knowledge for making the components by hiring skilled craftsmen as employees, if it was economical to do so. However, hiring or not hiring skilled craft employees was not necessarily a decision left entirely to Winchester. The skilled craftsmen of that era were well known to resist becoming anyone's "servant." Like "professionals" of later eras, they prized their independence and resisted becoming anyone's "employee."<sup>160</sup> The labor market for such workers as "employees" might have been difficult when Winchester began its operations. Moreover, not hiring craft "employees" saved Winchester the trouble and cost of managing work as to which its existing managers had no familiarity. At the outset, at least, the cost of luring highly qualified craftsmen to work as "employees," and the additional cost of hiring knowledgeable managers to oversee their work, might not have been economical.

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160. See Jeffrey Helgeson, *American Labor and Working-Class History, 1900-1945*, THE OXFORD RESEARCH ENCYCLOPEDIA OF AMERICAN HISTORY (2016), <http://americanhistory.oxfordre.com/view/10.1093/acrefore/9780199329175.001.0001/acrefore-9780199329175-e-330> [https://perma.cc/N4PH-47Q2].

The inside contracting arrangement failed in the long run for two reasons. First, the contractors controlled an asset—craft skill—critical to Winchester’s business, and Winchester’s lack of this skill limited its ability to improve a significant part of the work process.<sup>161</sup> The contractors, on the other hand, were not eager to innovate. The contractors feared that Winchester would reap all the benefits of any cost-saving innovations, and they used their greater knowledge of technique to resist Winchester in bargaining over prices. For one reason or another, it was not possible for Winchester to invite other competing contractors to bid on the same work, perhaps because of a difficulty in finding other craft workers ready to make parts according to Winchester’s specifications.<sup>162</sup> Even if Winchester could have found the means to encourage the contractors to innovate, it might have feared that any innovations would spill over to competitors, leaving Winchester without a competitive advantage.

These problems grew in significance as the industry became more competitive. Evidently, competition eventually made innovation essential for the survival of both Winchester and the contractors.<sup>163</sup> Moreover, at least some of the contractors proved to be poor managers of employees. While the immediate impact of poor labor relations would have been the contractors’ problem, Winchester foresaw that the contractors’ labor problems were ultimately Winchester’s problems too. Thus, Winchester acquired the asset—craft skill—by converting some contractors to “employee” status and replacing departing contractors with new skilled employee craftsmen.

There is one piece missing from this narrative. How do we know Winchester was buying work from non-employee “inside contractors” before the transition but later hired the contractors as employees and performed the work itself? And how do we know the production workers were first employees of the contractors but then became employees of Winchester? There was no change in the fundamental character of the work, and the work was still performed under the same roof by many of the same persons.

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161. Buttrick, *supra* note 105, at 210-20.

162. Skilled craft associations or unions frequently exercised tight control over compensation and working conditions for craftsmen during this period. STONE, *supra* note 107, at 18-19.

163. *See id.* at 22-26.



Winchester employed a superintendent to oversee the craft work before and presumably after the transformation, and the parties remained mutually dependent but with a new balance of power.<sup>164</sup> The parties made contracts for the craftsmen's services before the transformation, and they made contracts for the craftsmen's services after the transformation. However, Winchester and the craftsmen evidently interpreted their past arrangement as "inside contracting" and their new arrangement as "employment."<sup>165</sup> They were likely sincere in this interpretation because they clearly were not evading employment law. There was no significant employment law at the time. In any event, they were shifting to, not away from, employment.

Buttrick, the narrator, assumed the parties' interpretation of their relationship was correct. Like other economists and organizational theorists, he was interested in *why* parties choose one arrangement and not the other. On the other hand, lawyers, courts and regulators must determine *what* happened in fact. Were the skilled craftsmen "independent contractors" in fact on one day but "employees" in fact on the next, for purposes of employment law? If so, what are the facts that made the parties' assumptions true? The importance of these questions is even more important today than it was when Winchester incorporated the craftsmen within its vertically integrated hierarchy of employees. As the previous section set forth, significant rights and duties depend on a correct characterization of what happened. The following section describes the evolution of the legal tests for determining the correct characterization of workers as employees or independent contractors.

### III. LEGAL TESTS OF EMPLOYEE STATUS

The industrial revolution disrupted traditional working relations. "Masters" were replaced by firms, and "servants" were replaced by "employees," independent contractors, and subcontractor firms. Instead of the agrarian era's limited range of worker roles, the industrial revolution created a nearly unlimited expanse of types of work and working arrangements. Firms needing work could choose between hiring employees to perform the work, or

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164. Buttrick, *supra* note 105, at 214-15.

165. *See id.* at 221.

buying the work from non-employees. At first, the legal aspects of the issue were not particularly important. There were few “employment” statutes of consequence until well into the twentieth century. Horace Wood wrote voluminously about the American common law of “master and servant” beginning in 1877 with scarcely a hint about the problem of distinguishing a servant or employee from an independent contractor.<sup>166</sup>

The issue of status was important as a legal matter initially because of the doctrine of respondeat superior, which made a master strictly liable for torts that a servant committed within the scope of employment.<sup>167</sup> A master was liable regardless of whether the master *actually exercised* control over the work that caused the accident and without proof of any neglect in controlling the work.<sup>168</sup> The rationale for strict liability was that the master had the right to control the work. This rule of strict liability applied only with respect to a master’s servants, not his independent contractors. The buyer of an independent contractor’s service was liable for the contractor’s torts only if the buyer’s own negligence contributed to an accident, or if the buyer exercised *actual* control over work and thereby shared responsibility for the conduct of the work.

When the character of a worker’s relation with a potential employer became important for tort law purposes, social conventions of the master-servant era were of little use. The typical worker and client no longer fell into the standard, predictable roles and relations of the master-servant era. A “master” was less likely to be an easily identifiable person, especially when the alleged master was a commercial enterprise and organized as a firm. Work became an increasing contractual relation, subject to negotiation, and less a matter of predictable status. Under these circumstances, “control,” which was the basis for respondeat superior, could not be presumed according to social convention. Actual control was a fact that required proof.

Proof of an alleged master’s or employer’s “control” proceeded in one or more of three ways in a tort case. First, if a

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166. See generally WOOD, *supra* note 37. Wood published two editions of his book, in 1877 and in 1886. Citations are to Wood’s 1886 edition. His first edition was in 1877.

167. There was very little regulation of employment relations other than child labor laws until the early decades of the twentieth century. See SCHOUER, *supra* note 84, § 456, at 747.

168. *Id.* § 490, at 790; WOOD, *supra* note 37, § 1, at 2 n.1.

master-servant relation was not ambiguous, and overall circumstances made the alleged master's status clear enough, proof of his exercise of control over the specific work or task that caused the accident was unnecessary. A master's right to control all work was inherent in the master-servant relation, making it unnecessary to prove control of any specific work task.<sup>169</sup> Second, if the working relationship was ambiguous because the alleged servant was an individual with some degree of autonomy but subject to some control, an alleged master's assertion of control over any matter in the relationship was at least some evidence of a master-servant relation. Third, if evidence of an alleged master's control was conflicting or not clearly based on a right of contract (as where a contractor fulfills a customer's request as a matter of goodwill), the alleged master might still be liable as a "principal" under the rule that a principal is liable for an agent's tort to the extent the principal *actually exercised* control over the *particular* task that caused the accident.<sup>170</sup> Proof of control was so important in early disputes over status that it is not surprising that courts sometimes suggested that control of the work *is* the test of master-servant status.

But as work became more complex and varied, and as firms reinvented working relationships in ways that suited their particular needs, "control" of the work became an increasingly difficult test of status. As a contractual matter, control can be allocated between two parties in many different ways.<sup>171</sup> Remember that when Winchester employed "inside contractors," it accepted the craftsmen's management of their craft work but it also exercised some control *as a landlord* by locking the gate after Winchester's deadline for arriving at work. After the craftsmen became "employees," Winchester still probably did not closely supervise their work because the craftsmen knew as much or more than Winchester about craft work. Moreover, determining the contractual allocation, as opposed to the goodwill allocation, can be difficult if there is no comprehensive written contract and contract terms are implied by custom and practice.

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169. See SCHOULER, *supra* note 84, § 490, at 790-91.

170. See *id.* § 489, at 787.

171. *Id.* at 787-88.

Control can also be shared among more than one potential master or employer, creating multiple alleged “employer” problems.<sup>172</sup> For example, even if Winchester’s contractors were not employees, the production workers were certainly someone’s employees. Was Winchester or a contractor the “employer” of a set of production workers? Eventually, the joint employer doctrine would recognize that two or more parties can be employers of the same group of workers for some purposes.<sup>173</sup> However, whether only one or both of the two parties were employers, employer status under the common law depended on a right or the exercise of “control.” The control test applied to questions of employer status in much the same fashion as it applied to problems of “employee” or “servant” status,<sup>174</sup> but the distribution of control among landlords, clients, master craftsmen, journeymen, servants, and “subservants”<sup>175</sup> could be complex in enlarged craft shops and factories like the Winchester facility at the end of the nineteenth century.

In short, control can be fragmented into as many examples as there are tasks and aspects of the work, including oversight, quality control, training, development of guidelines and procedures, control of the premises, control of equipment and uniforms, management of a schedule, and provision of insurance.<sup>176</sup> Control is sometimes a matter of contractual right, whether by letter or unwritten practice, and sometimes a non-contractual matter of respect, goodwill, or economic dominance. Employment contracts, if written at all, rarely itemize the allocation of control, making proof of the situation tedious. Even if a written contract did itemize control, a factfinder confronts the reality that there is

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172. *See id.* § 474, at 773-74.

173. An early variation of the joint employer doctrine was the “borrowed servant” doctrine. *See* RESTATEMENT (SECOND) OF AGENCY §§ 5, 226-227, 236 (AM LAW INST. 1958).

174. *See, e.g.,* Rhoades v. Varney, 39 A. 552, 553 (Me. 1898). *See* 1 LABATT, *supra* note 86, §§ 18-22, 27, 41.

175. A subservant was a servant of a servant, both of whom worked in the service of the same master. *See* RESTATEMENT (SECOND) OF AGENCY § 5.

176. *See, e.g.,* Nichols v. Harvey Hubbell, Inc., 103 A. 835, 837 (Conn. 1918) (“Their evidence is clear . . . that Abbott retained and exercised the right to direct what . . . should be done and how it should be done, and the oversight, direction, and control of the work and of those who should be engaged in the execution of it.”); Watson v. Ben, 459 So. 2d 230, 236 (La. Ct. App. 1984); Chevron Oil Co. v. Sutton, 515 P.2d 1283, 1286 (N.M. 1973) (outlining various factors of the control test).

no clear dividing line between a master's or employer's control and a client's control. Examples of control cannot be quantified and summed for purposes of measurement or comparison. "Control" factors often point both ways, making an individual worker's relation with a firm ambiguous.

Proving master or employer-like control became more difficult, and the limitations of the control test became more obvious, when the underlying issue related to an employment regulation rather than a tortious accident. If an alleged wrong is a violation of a minimum wage or collective bargaining statute, there is no specific task or performance of work to serve as a factfinder's focal point for purposes of a control test.<sup>177</sup> As employment regulations became a more frequent subject of employment disputes, courts looked toward the indefinite scope or purpose of the relationship as another important feature of a master-servant relation.

The scope and purpose of any engagement for service has two interrelated dimensions: The nature of the work or the worker's role, and the duration of the relation.<sup>178</sup> In the traditional master-servant tradition and most modern employment, a servant's or employee's role is defined by a category of service, not a precise task. It is the master's or employer's right to decide what tasks to begin or advance as long as the relationship continues. The relationship continues until either the end of an agreed fixed period or, in the absence of a fixed term, either party's termination of the relationship "at will."<sup>179</sup> What is most important about the duration of a master-servant or employment relation is that there is no particular task to mark the end of the engagement. The master-servant relation, or employment, is one of the two ultimate relational contracts—the other being marriage.

The parties' acceptance of a continuous relationship relieves them of the need to be very specific about what tasks the servant or employee will perform. As long as the relationship continues, the worker will perform the tasks required by the employer, within reason. Such a contract succeeds in large part because of the employer's right of control. There is no need to renegotiate

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177. See *Walling v. Portland Terminal Co.*, 330 U.S. 148, 150-51 (1947).

178. See, e.g., *Brighton Sch. Dist. v. Lyons*, 873 P.2d 26, 28-29 (Colo. App. 1993).

179. SCHOULER, *supra* note 84, § 458, at 751-53; WOOD, *supra* note 37, § 136, at 283-86.

the contract for each new task because the contract is highly adaptive to continuous accomplishment of the employer's needs. This arrangement also offers an important benefit for the worker: Security with respect to a continuous stream of income. If the employer lacks sufficient work to keep the worker busy, the employer still owes the promised wages, which are typically "per hour" or "per week," rather than a price for the completion of particular work.<sup>180</sup> Of course, this arrangement was most secure for servants in the old world when the hiring was often by the year and not subject to immediate termination. The modern "at will" feature of employment makes the relationship much less secure for either party. Modern employment also makes it somewhat easier for either party to abandon the relation if one party acts unreasonably. If an employer demands an accountant clean the lavatories, it is easier for the accountant to resign than to sue for breach of contract.

In contrast, a self-employed individual working as an independent contractor agrees to perform a specific task or set of tasks identified in advance. If the client desires completion of any other task, the parties will have to make an additional contract or renegotiate the one they have. The contractor's completion of the task or set of tasks automatically marks the end of the engagement. It is unnecessary for either party to "terminate" the relationship. In fact, if either party terminated the contract before the completion of the task, the termination might be a breach of contract.

Comparing a chauffeur and a taxi driver illustrates this aspect of the master-servant model. A chauffeur is employed in the role of a driver in a continuous relationship with his employer. The hiring does not require identification of a particular trip in advance. The open-ended nature of the relationship serves the employer's needs because he needs regular transportation, but probably could not make a complete list of all his needs in advance. The chauffeur agrees to drive if, when, and where the employer chooses, with the security of regular income that does not depend entirely on the employer's need for transportation. The chauffeur's completion of any particular trip will not automatically terminate the relationship. Nor is any particular trip the condition of his right to payment. The chauffeur is an "employee,"

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180. See SCHOULER, *supra* note 84, § 473.

even if the employer rarely tells the chauffeur how to drive or tries to control the driving.

A taxi driver, on the other hand, has an entirely different arrangement with a passenger. The driver agrees to drive the passenger to a specific destination, which was decided in advance, in return for a fee. The driver earns the fee and completes the engagement upon arrival at the destination. The relationship is over without the need for either party to “terminate” the relationship. The passenger lacks any further right to the driver’s prospective service, unless the parties renegotiate their contract or make a new one. The arrangement is a discrete transaction, not a continuing relationship. The driver is not an employee of the passenger, even if he politely adheres to the customer’s requests to reduce speed and drive politely. The driver might be self-employed as an independent contractor, or the driver might be employed by someone else, such as a dispatching service.

In the agrarian, domestic service, and craft shop world, indefinite and relational contracts for servants were easy to spot. After the rise of firms, however, innovation in the organization of work made the indefinite relation factor less useful for classifying workers. For Winchester’s craft workers, the indefinite relation factor pointed in both directions before and after their conversion from “inside contractors” to “employees.”<sup>181</sup> Before and after the conversion, the craft workers served one customer continuously, and completion of one part or a certain quantity of parts did not terminate their relationships. Their relationships with Winchester were indefinite, and in this way they resembled employees. But, like many modern industrial workers, their factory work was very specific. They repeatedly performed the same specific task: Completion of a particular unit for a price, as if they were independent contractors manufacturing goods for sale, rather than employees. Even after their conversion to “employees,” it is entirely possible that they continued to work for a piece rate (a sum of money per completed task) rather than time based wages.<sup>182</sup> Because their work was task-based, they resembled independent contractors before and after the conversion.

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181. See WOOD, *supra* note 37, § 100.

182. Piece rates became common for manufacturing employees in the late nineteenth century and have remained common. See STONE, *supra* note 107, at 29-33.

In the innovative world of firms, indefinite relation factors are of greatly diminished value for classifying workers. Like “control” factors, indefinite relation factors can be indecisive and can point in both directions at once. Employers frequently hire “temporary” employees, perhaps for periods as short as part of a single day, or to assist with one project. On the other hand, Winchester’s inside contractors appear to have worked for Winchester for a long time, which would have allowed them to become particularly knowledgeable about the means to achieve the exact specifications Winchester required. Many employees are paid on a “piece rate” or other incentive compensation, while some contractors, such as those who provide legal services or security services, charge a time-based rate like employees.<sup>183</sup> As long as the work is according to contract and freedom of contract reigns, there is no end to the ways parties can design their relationships.

Combining control and indefinite relation factors into a larger multi-factored test made the problem of worker classification more complex, not easier or more predictable. Nevertheless, “employee” and “employer” status based on the multi-factored test became lawmakers’ usual qualification for coverage in twentieth century laws to protect or benefit workers.<sup>184</sup> By the time of the Supreme Court’s decision in *NLRB v. Hearst Publications, Inc.*<sup>185</sup> in 1944, the difficulty was obvious. The Court stated that “[f]ew problems in the law have given greater variety of application and conflict in results than the cases arising in the borderland between what is clearly an employer-employee relationship and what is clearly one of independent, entrepreneurial dealing.”<sup>186</sup>

*Hearst* involved a finding by the National Labor Relations Board (NLRB) that “newsboys” selling newspapers on city streets were “employees” of the publishers.<sup>187</sup> The newsboys in question were the older and more stable members of a larger group including children and temporary or transient sellers of newspapers. The NLRB’s ruling was significant for the selected newsboys because it gave them the statutory right to form unions, engage in collective bargaining with the publishers, and strike in support of

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183. *See id.* at 31.

184. *See* Carlson, *supra* note 3, at 305-10.

185. *See generally* NLRB. v. Hearst Publ’ns, 322 U.S. 111 (1944).

186. *Id.* at 121.

187. *Id.* at 119.



bargaining demands.<sup>188</sup> The publishers appealed, arguing that the newsboys were independent contractors, and that independent contractors have no statutory right to demand collective bargaining or strike, even if they work mainly as individual workers.<sup>189</sup>

*Hearst* also involved the problem of multiple potential employees. If the newsboys were “employees,” were they necessarily the publishers’ employees, or were they employees of some other party? The publishers implied that the newsboys might be employees of intermediate distributors known as “district manager[s],” “checkmen” and “‘main spot’ boys” whose roles depended on the organization and practice of each particular publisher.<sup>190</sup> A “district manager,” for example, received a set fee—not a “salary,” according to the publishers—for his role in assigning corners to newsboys, distributing newspapers, providing sales accessories such as display racks, and collecting receipts within an assigned district. Most importantly, a district manager could set the price of the newspapers within his district.<sup>191</sup>

The Court upheld the NLRB’s finding that the newsboys were “employees” of the publishers, and that the district managers, checkmen, and “main spot boys” were also employees of the publishers. This decision endorsed two new ways of analyzing a question of worker status: economic realities and statutory purpose.<sup>192</sup> The facts in *Hearst* exemplify all four sets of factors: control, indefinite relation, economic realities, and statutory purpose.

The newsboys were arguably independent contractors based on control factors because they worked at locations beyond the publishers’ oversight doing tasks not requiring much supervision.<sup>193</sup> The publishers provided the newsboys with some orientation about sales techniques but exercised little ongoing oversight over the newsboys’ interactions with customers, except for a requirement that the newsboys sell newspapers on the day and during hours consistent with that edition.<sup>194</sup> The publishers had

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188. *See id.* at 113-14.

189. *Id.* at 120.

190. *Hearst Publ’ns*, 322 U.S. at 116-18.

191. *Id.* at 118 n.15.

192. *Id.* at 116-17, 127-30.

193. *See id.* at 119.

194. *Id.* at 118-19. As was typical of newspapers of the era, each publisher issued different editions at different times of day. *Id.* at 115.

little need to discipline newsboys to motivate their work because the newsboys' compensation was based on performance (sales), which was a significant incentive for their diligence. If a newsboy regularly returned a significant number of unsold newspapers, this likely affected the number of newspapers a publisher agreed to deliver to him in the future, but this exercise of control by the publishers would be perfectly consistent with a non-employment producer-distributor relation.<sup>195</sup>

The control factors might also have favored independent contractor status of the checkmen, "main spot boys," and district managers. District managers in particular made some significant managerial decisions in setting prices for their neighborhoods and assigning street corners. If the other newsboys were anyone's "employees," they might have been the employees of the checkmen, "main spot boys," or district managers, rather than the publishers.<sup>196</sup>

Indefinite relation factors also pointed in some ways toward independent contractor status for all the workers. Newsboys did not serve the publishers' ongoing indefinite needs for work within a general description of tasks. They agreed to perform just one specific task—sell a particular edition of newspapers delivered to and accepted by them on a day-to-day or hour-by-hour basis. The publishers did not command or need discretion to command any other work, and they did not pay the newsboys for their time in service. A newsboy's earnings were the difference between the price he paid the publishers for newspapers, and the price he collected from ultimate buyers. In this regard, the relationship was very result oriented. A newsboy's success depended mainly, if not exclusively, on the number of sales.

The control and indefinite relation factors also pointed in some ways in the opposite direction toward employee status,<sup>197</sup> but such ambiguity is the heart of the problem of a multi-factored approach. Multiple factors can point in multiple directions. Thus,

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195. *Hearst Publ'ns*, 322 U.S. at 117.

196. *See id.* at 116-17.

197. For example, the publishers assigned fixed newsboy locations and specified the retail price to minimize competition, and the publishers enforced a schedule for beginning and ending sales each day to assure availability and maximum sales of each edition. *Id.* at 117-18. However, such facts are far from decisive of employee status. These measures of control are completely consistent with restrictions a manufacturer or franchisor places on its independent distributors or franchisees.

the Court endorsed and applied a third set of factors centered on the “economic realities“ of the parties’ relationships.<sup>198</sup>

The adoption of these economic realities factors was the Court’s best effort to shift from the master-servant model to a more modern view of employer-employee relations.<sup>199</sup> Economic realities can be broken roughly into three separate inquiries. First, to what extent is a worker part of the a firm’s ordinary business?<sup>200</sup> Second, is the worker economically dependent on the firm so that the balance of bargaining power between the parties resembles the balance of power in employment?<sup>201</sup> Finally, does the worker have his own enterprise, including the sort of assets that could be the basis for an independent business?<sup>202</sup> The economic realities factors supplement and do not supplant the control or indefinite relations factors. Thus, while this new set of factors modernizes the test, it also makes it more complex and more likely to yield a mix of conflicting factors.

In *Hearst*, the newsboys’ economic dependence and lack of an “enterprise” were evidenced by their long and nearly exclusive service for the publishers,<sup>203</sup> dependence on sales of the publishers’ products,<sup>204</sup> lack of substantial assets,<sup>205</sup> and limited opportunities for profit or business expansion.<sup>206</sup> They also performed a work function (sales) that was “integral” to the publishers’ ordinary business: The production of newspapers for sale to the general public.<sup>207</sup>

In retrospect, however, even the economic realities factors did not point indisputably to the newsboys’ employee status. The publishers do not appear to have required the newsboys to commit to serve the publishers regularly, continuously, or exclusively, rather than casually, episodically, or from one newspaper edition to the next.<sup>208</sup> No doubt the reliable availability of the newsboys

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198. *Id.* at 128; see Carlson, *supra* note 3, at 324.

199. See Carlson, *supra* note 3, at 324.

200. *Id.* at 312.

201. See *id.* at 354.

202. See *id.* at 320.

203. *Hearst Publ’ns*, 322 U.S. at 116.

204. See *id.*

205. *Id.* at 119.

206. See *id.* at 117-18.

207. *Id.* at 119.

208. See *Hearst Publ’ns*, 322 U.S. at 116.

included in the NLRB proceeding made them the publishers' favorites for assignment of sites, supplies, or elevation to "main spot boy" or district manager, as one would expect in any producer distributor relation. And while "sales" work was essential and integral to the publishers' ordinary business, the selected newsboys were just one subset of a larger group of newsboys and represented only one of a variety of different channels for the sale of newspapers to the public.<sup>209</sup> In any event, it is a rare business that seeks or achieves complete vertical integration. There is nothing unusual or suspicious about a producer's contracting with independent distributors or retailers.

Finally, there was at least some argument that newsboys had their own small but real businesses. They earned a "profit" or suffered a loss depending on a combination of successful management of their work and luck.<sup>210</sup> They received newspapers on credit, promoted their newspapers to the public, collected money from buyers, returned unsold papers to the publishers for reverse credit, and used their sales receipts to pay off their debts to the publishers.<sup>211</sup> True, publishers or district managers could limit earnings opportunities by setting the retail price, awarding locations, and determining the quantity of papers delivered to each newsboy. However, such facts are consistent with a typical producer-distributor chain in which the producer prints its price on the product, assigns territories to prevent competition between distributors, and allocates a limited supply according to the track record of each distributor. Perhaps more importantly, the newsboys sold other products from their locations, sometimes "hire[d] assistants" or substitutes, and sometimes purchased sales locations from each other.<sup>212</sup> "Economic realities" factors are not necessarily more decisive than control or indefinite relation factors to clarify an ambiguous working relation.

Economic realities, control, and indefinite relation factors were still not enough for the Court's resolution of the issue in *Hearst*. In the end, the Court upheld the NLRB's order based mainly on a fourth perspective: Statutory purpose.<sup>213</sup> The purpose

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209. *Id.* at 115.

210. *See id.* at 117.

211. *Id.* at 116-17, 132 n.37.

212. *Id.* at 118 n.16, 119 n.17.

213. *Hearst Publ'ns*, 322 U.S. at 124-25.

of the National Labor Relations Act was to establish a system for worker representation and collective bargaining to reduce disruption caused by labor disputes and strikes.<sup>214</sup> Congress used the term “employee” in the Act not as a synonym for “servant” but to mean some broader class of individual workers facing the disproportionate bargaining power of large firms.<sup>215</sup> The Court’s statutory purposes approach allowed it to uphold the NLRB’s order regardless of whether the newsboys were self-employed independent contractors, employees of the district managers, or employees of the publishers under any configuration of the control-indefinite relations-economic realities test because the newsboys’ situation was characteristic of the kinds of workers Congress intended to protect with the National Labor Relations Act.<sup>216</sup>

The statutory purpose approach was the Court’s answer to lawmakers’ continued reliance on “employee” coverage to define the reach of worker protection statutes. However, a statutory purpose interpretation of “employee” is far from a perfect solution. A statutory purpose approach raises the possibility that judges will disagree about statutory purpose as much as they disagree about control, indefinite relations, and economic realities. Regardless of the merits of a statutory purpose approach, Congress rebuked the Court by overruling *Hearst* in a way best interpreted as a rejection of the statutory purpose approach to worker classification under the National Labor Relations Act.<sup>217</sup> The Court subsequently recognized this rejection of statutory purpose for interpreting the term “employee” in any federal law.<sup>218</sup> Thus, if there is a disconnect between legislative purpose and a denial of protection for some workers who are not “employees,” it is for Congress to write new rules of statutory coverage not based on

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214. *Id.* at 126.

215. *Id.* at 124-25.

216. *Id.* at 124-131. The Court believed the newsboys were the sort of workers Congress intended to have collective bargaining rights because they faced overwhelming bargaining power of the publishers, worked according to standardized terms, were appropriate for collective bargaining as a practical matter, and were more likely to engage in disruptive strikes if the publishers could not be compelled to engage in collective bargaining. *See* Carlson, *supra* note 3, at 318-19.

217. Carlson, *supra* note 3, at 321-26.

218. *Id.* at 329-34.

employee status. On the whole, however, Congress has not risen to this challenge.<sup>219</sup>

Even without a statutory purpose approach, the currently prevailing test of employee status—sometimes known as a “hybrid” test<sup>220</sup> which combines all the control, indefinite relation, and economic realities factors—now requires examination of a very long list of facts. Courts follow the same multi-factored approach to decide whether employees are employed by one firm, another firm, or both firms.<sup>221</sup> In *Nationwide Mutual Insurance Co., v. Darden*,<sup>222</sup> the Court’s most recent foray into the matter, the Court cited several versions of the test, each one with its own checklist of factors.<sup>223</sup> For example, the Court cited the Internal Revenue Service’s list of twenty questions to ask when evaluating a worker’s status.<sup>224</sup> But, the Court warned that “all of the incidents of the relationship must be assessed and weighed with no one factor being decisive.”<sup>225</sup> If eleven factors are positive for employee status and nine are negative, there is no rule that eleven positive factors must outweigh nine negative factors. Some factors might be more compelling to a given factfinder than others.

Multi-factored tests are not uncommon in the law, and are often unavoidable. But it is important to recognize and limit the difficulties multi-factored tests cause. Multi-factored tests cause uncertainty in a wide range of cases that do not fall clearly to one

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219. There are some statutes with rules of worker coverage not depending entirely on a traditional concept of “employee” or “employer.” For example, the Internal Revenue Code’s withholding requirements apply to compensation a firm pays to “statutory employees” who perform work under defined conditions regardless of whether they are employees or independent contractors under the usual rules. CARLSON & MOSS, *supra* note 7, at 37-38; see 26 U.S.C. §§ 3121(d), 3306(i), 3401(c) (2012). Many states have adopted the so-called “ABC Test,” which treats some workers as employees even if they would qualify as independent contractors, for purposes of unemployment compensation taxes and benefits. See CARLSON & MOSS, *supra* note 7, at 39.

220. See, e.g., *Hickey v. Arkla Indus., Inc.*, 699 F.2d 748, 751-52 (5th Cir. 1983); see also RESTATEMENT OF EMPLOYMENT LAW § 1.01 (AM. LAW INST. 2015).

221. See, e.g., *Zheng v. Liberty Apparel Co.*, 355 F.3d 61, 66-69 (2d Cir. 2003) (finding an issue of fact whether an apparel firm was an employer of employees who performed a specific stage of assembly work but who performed their work on the premises and under the supervision of a separate firm and received their pay from that separate firm); *Polanco v. UPS Freight Servs., Inc.*, 217 F. Supp. 3d 470, 504-05 (D.P.R. 2016).

222. 503 U.S. 318 (1992).

223. See *id.* at 323-24.

224. See Rev. Rul. 87-41, 1987-1 C.B. 296.

225. *Darden*, 503 U.S. at 324 (quoting *NLRB v. United Ins. Co. of Am.*, 390 U.S. 254, 258 (1968)).

side or the other.<sup>226</sup> Multi-factored tests encourage litigation because any side to a dispute can usually find some factors pointing its way. Settlement is difficult because a multi-factored test makes a prediction of outcome difficult.<sup>227</sup> Uncertain rules of employee status encourage firms to manipulate the details of its relationship with workers to support a plausible denial that workers are employees, simply to gain a competitive advantage by evasion of employment regulation. At the same time, legitimate innovation in the organization of work might be discouraged if investors cannot predict how regulators and courts will weigh all the factors.

Multi-factored tests also impose certain burdens on the parties and factfinders in adjudication of worker status. In an employment law proceeding, the issue of worker status usually arises as a threshold for statutory coverage, but this issue can be more difficult than all the others combined.<sup>228</sup> The complexity of worker status usually operates to the serious disadvantage of the party challenging a firm's assertion that workers are self-employed or employed by some other party.<sup>229</sup> The challenger must engage in substantial discovery of the firm's business practices, organization of work, and relationships with workers or other

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226. Carlson, *supra* note 3, at 299, 335.

227. *Id.* at 301, 335.

228. A recent example is *O'Connor v. Uber Technologies, Inc.*, where the primary issue is the status of Uber drivers as employees. A brief filed in the proceeding states:

[T]he parties have engaged in exhaustive discovery and extensive motion practice, as exemplified by the more than 500 entries on the court docket in this case. The parties have taken depositions of ten witnesses; Plaintiffs have deposed two Uber managers, two Rule 30(b)(6) witnesses, and Uber's Senior Vice-President of Global Operations Ryan Graves, while Defendants have deposed five named plaintiffs . . . . Plaintiffs have propounded and Uber has responded to thirty-six separate Requests For Production and thirty-six Interrogatories, while the named Plaintiffs have collectively responded to 290 Requests For Production, 180 Interrogatories, and 71 Requests for Admission since the start of the case. To date, the parties have collectively produced more than 36,000 pages of documents in discovery.

Notice of Motion and Motion for Preliminary Approval and Memorandum of Points and Authorities in Support Thereof at 2-3, *O'Connor v. Uber Tech., Inc.*, No. CV 3:13-03826-EMC (N.D. Cal. May 9, 2016) (citations omitted).

229. See EUROFOUND, SELF-EMPLOYED OR NOT SELF-EMPLOYED? WORKING CONDITIONS OF 'ECONOMICALLY DEPENDENT WORKERS' 1 (2013), <https://digitalcommons.ilr.cornell.edu/cgi/viewcontent.cgi?referer=https://www.google.com/&httpsredir=1&article=1297&context=intl> [<https://perma.cc/2F8Y-YCCR>].

firms. The range of facts potentially important in discovery is enormous because there is no clear limit to the details as to which control might be exercised, the ways control might be exercised, the assets that might be owned or shared by the parties, or the types of work that might be in question.<sup>230</sup> Nevertheless, the challenger must collect and organize all the relevant facts, and must present the facts in a way that is comprehensible to the fact finder.

The alleged employer firm faces a similar burden but enjoys the advantage of possession of the facts and knowledge of its own business organization and strategy. Moreover, a firm's trial strategy (not its business strategy) might be to overwhelm the challenger by filling the record with every detail that might plausibly be relevant to one or more of the factors of worker status. The challenger bears the burden of persuasion, and a blizzard of facts can make it difficult for the factfinder to determine that this burden has been satisfied.<sup>231</sup>

The factfinder faces another burden. The factfinder must absorb, organize, and evaluate all the evidence submitted in reference to each factor and sub-factor. Adjudicatory proceedings to receive this evidence are likely to be lengthy and tedious, and without much focus.<sup>232</sup> The factfinder must then evaluate the evidence, with no rules or guidance for weighing the importance of the factors. A firm's strategy of overburdening the record will take its toll on the factfinder as well and the challenger. Again, since the burden of persuasion is on the challenger, the burden for the factfinder normally works to the alleged employer firm's advantage.

Pending legislative adoption of new coverage rules that do not depend entirely on employee status, the next best solution is to improve the process legislators have left us. One way to improve the process is to link the law of worker status to the Theory of the Firm. The Theory of the Firm offers reasons why a firm might choose to hire employees instead of buying work from

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230. See *Zheng v. Liberty Apparel Co.*, 355 F.3d 61, 66-68 (2d Cir. 2003) (illustrating the numerous factors considered by courts when determining worker status).

231. See, e.g., *id.* (holding that the facts provided by the challenger did not sufficiently establish an employee's status).

232. In one of several recent cases involving the status of FedEx drivers in different states, *In re FedEx Ground Package System, Inc.*, the court's summary of facts relating to worker status continued for fifteen pages. 734 F. Supp. 2d 557, 560-75 (N.D. Ind. 2010).



other parties, or vice versa.<sup>233</sup> Looking at the reasons for firm behavior makes it possible to focus the collection and presentation of evidence, analyze the evidence, and test the credibility of a firm's assertions about worker status. Focusing on the reasons for a firm's choices also offers a basis for shifting the burden of production to the firm, relieving the challenger of one of the more difficult aspects of worker status adjudication. Advocates and can improve the process by presenting a reason to presume the firm performs work with its own employees, and factfinders can improve the process by requiring an alleged employer firm to explain its alleged decision to buy work from the market.

#### IV. THE THEORY OF THE FIRM AND THE "MAKE OR BUY" PROBLEM

##### A. Coase's Theory on the Nature of the Firm

The Theory of the Firm is a field of inquiry that seeks answers to many different questions about a firm's purpose, organization, and borders. This article focuses mainly on theories related to the "make or buy" problem insofar as it relates to the choice between hiring employees to perform work versus buying work from nonemployee sellers of work.

The beginning of the Theory of the Firm endeavor began as the industrial revolution was reaching a crescendo. While lawyers and courts were struggling over the question how to distinguish "employees" from "independent contractors," economists were asking a different question: *Why* does a firm perform some work itself by hiring employees, while buying other work from other parties?<sup>234</sup> The choice between employees and nonemployees has sometimes been called the "make or buy" problem. The authors of theories about the firm have often taken it for granted that employees will be easy to distinguish from nonemployees, and that it will be easy to know whether a firm is making or buying.

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233. See Margaret M. Blair et al., *Outsourcing, Modularity, and The Theory of the Firm*, 2011 B.Y.U. L. REV. 263, 265-67 (2011).

234. Lewis L. Maltby & David C. Yamada, *Beyond "Economic Realities": The Case for Amending Federal Employment Discrimination Laws to Include Independent Contractors*, 38 B.C. L. REV. 239, 245-46 (1997).

Professor Frank Knight, one of the earliest authors of a theory of reasons for the existence of firms,<sup>235</sup> assumed that the master-servant model was alive and well and descriptive of relationships within the modern world. In *Risk, Uncertainty, and Profit*,<sup>236</sup> he wrote, “Under the enterprise system, a special social class, the business men, direct economic activity . . . while the great mass of the population merely furnish them with productive services, placing their persons and their property at the disposal of this class . . . .”<sup>237</sup> The “business men” were “entrepreneurs” who worked mainly for a “profit” and bore a corresponding risk of a loss. The “service providers” submitted to the direction and control of these entrepreneurs in return for a “fixed remuneration” with protection against business loss but no right to a share of profits.<sup>238</sup> In short, the factory was not far removed from the manor or craft shop. The social class of “masters” was replaced by a new “special social class” of entrepreneurs.

Knight’s theory was that dangerous uncertainty about prospective business conditions leads entrepreneurs to extend their control—by the organization and enlargement of a firm—over as much business activity as practical.<sup>239</sup> Standing alone, such a theory does not suggest a rule for distinguishing employees from independent contractors as a legal matter. However, the premise of any firm-organization theory is that a firm decides to do one thing or another for a reason.<sup>240</sup> A firm’s “make or buy” decisions are not random. When a firm organizes work, an alleged decision to buy work from self-employed individual workers rather than hiring the same workers as employees is intentional and should be explainable. The explanation is probably consistent with one of the many theories of firm organization and behavior. Moreover, there are two sides to every transaction. Work is available for purchase in the market only if there are suppliers willing to perform

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235. Ross B. Emmett, *Frank H. Knight on the “Entrepreneur Function” in Modern Enterprise*, 34 SEATTLE U. L. REV. 1139, 1140 (2011).

236. FRANK H. KNIGHT, *RISK, UNCERTAINTY, AND PROFIT* pt. III, ch. IX, para. 12 (1921).

237. *Id.* at para. 12.

238. *See id.* at paras. 12-13, 21-22.

239. *Id.* at para 36.

240. *See generally, e.g.*, DEMETRI KANTARELIS, *THEORIES OF THE FIRM* (2d ed. 2007); Harold Demsetz, *The Theory of the Firm Revisited*, 4 J.L., ECON., & ORG. 141 (1988); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

the work as separate firms or self-employed individuals. Suppliers of work must decide whether to perform as employees of another firm or remain independent of the buyer firm, and they are likely to have reasons for their choice. One possible reason for a supplier to be an independent contractor is the limited availability of promising employment opportunities, but there are also many other reasons why some individuals prefer to remain self-employed.<sup>241</sup>

Professor Ronald Coase presented what most scholars accept as the real start for the theory of the firm in a 1937 article, *The Nature of the Firm*.<sup>242</sup> Coase began with the observation that business activity occurs either through market transactions between independent parties, or among employees within a firm. A transaction within the firm among employees is fundamentally different from a transaction in the market. According to Coase, “[The market] is under no central control . . . .”<sup>243</sup> Instead, “supply is adjusted to demand, and production to consumption, by a process that is automatic, elastic and responsive” and “co-ordinated by the price mechanism . . . .”<sup>244</sup> In contrast, transactions within a firm occur by command.

Coase used the example of a “workman” to illustrate the difference. “If a workman moves from department Y to department X, he does not go because of a change in relative prices, but because he is ordered to do so.”<sup>245</sup> Coase’s “workman” was an employee subject to the employer firm’s fiat. If the employer firm decided to buy the work from another firm or individual in the market, the transaction would be based on the market price mechanism rather than the firm’s fiat. According to Coase, a firm needing work decides between hiring employees versus buying work in the market by comparing the advantages and costs each option entails.<sup>246</sup> A firm expands to perform work best performed

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241. An independent firm might have much stronger incentives to invest in improvements in the work because that firm will reap all the gains from those improvements. If that firm purchases a set of employees from a larger firm, the larger firm would likely appropriate a large share of those gains. See Gibbons, *supra* note 8, at 205-06.

242. See generally Coase, *supra* note 9.

243. *Id.* at 387-88.

244. *Id.* at 387.

245. *Id.*

246. *Id.* at 404-05.

by employees. It stops at the point where work is better purchased from other parties.<sup>247</sup>

Coase offered a few reasons why some work is best assigned to employees while other work is best purchased from the market.<sup>248</sup> In general, a firm can grow successfully by taking on some work to be performed by employees because of economies of scale. At some point, however, further growth leads to diminishing or even negative returns because of the complexity of managed coordination of large numbers of workers in diverse operations, or because of advantages in specializing in the management of a limited quantity or range of work.<sup>249</sup> These considerations do not necessarily explain how a firm chooses to expand in some directions by hiring employees while abandoning other types of work and relying on the market for what it needs. In other words, why might a firm hire employees to make one input, such as a particular component, while buying another input from other parties? What is different about the two inputs?

One potential difference is that the inputs a firm makes by hiring employees are regular and long term needs, while the inputs it buys from other parties in the market are sporadic or short term needs. Reasons for hiring employees for regular, long term work begin with the difficulty of forecasting for the long term. A long term need might be obvious, but the firm may find it difficult or undesirable to bind itself by contract to exact quantities, specifications or details of performance. By hiring employees and performing the needed work itself, a firm assures itself a reasonable, reliable supply of the input plus the power, as an employer, to change the work by fiat as needed.<sup>250</sup>

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247. See Coase, *supra* note 9, at 404-05.

248. Coase also observed that government action can make it less expensive to bring work within the firm rather than buying the same work outside the firm. He offered as examples taxes on market transactions, quotas, rationing or price controls, which might be avoided by performing work within a firm. Such government actions are likely to foster the growth of firms. See *id.* at 393. Of course, in today's regulatory environment, government action can also have the reverse effect. For example, "small firm" exemptions in many employment laws reduce regulatory costs for small firms in comparison with large firms, encouraging firms to stay small or to divide into small firms. See Carlson, *supra* note 63, at 1204-05, 1238-46.

249. Coase, *supra* note 9, at 394-97.

250. *Id.* at 391-92.

Coase's theory presumes that there is something fundamentally different between contracting with "employees" and contracting with non-employee sellers of work. But if this is so, how can we tell the difference between an employee and any other individual service provider? Coase believed the common law "control" test of servant or employee status supported his view of a firm's make or buy decision.<sup>251</sup> A firm gains more control by hiring an employee than by contracting with a non-employee seller because an employee submits to the firm's assignments and instructions, even as to the smallest details, according to the firm's ongoing needs.<sup>252</sup> In contrast, a supplier in the market requires a contract for each requested task, and a change or adjustment in a set of tasks requires renegotiation or a search for a new contractor.

Coase's theory was the first step toward a better understanding of the nature of the firm, but his theory was incomplete standing alone. A distinction between long term and short term needs sets the stage for the firm's "make or buy" decision, but is far from decisive. True, a firm will rarely hire employees to perform work it needs only momentarily or sporadically, such as repairing the roof of a single building. However, long term needs do not necessarily lead to a decision in favor of employees. Firms satisfy many long term and regular needs by market purchases. For example, few firms make their own electricity. And many manufacturers rely on other parties to provide components, transport goods, advertise, or manage retail sales. Some firms buy daily office maintenance from other firms or individual independent contractors. Thus, a distinction between long term and short term needs is only the first piece of the puzzle.

Coase's theory was the inspiration for decades of further scholarly exploration, resulting in not one but many theories of the firm.<sup>253</sup> On the whole, these theories supplement each other

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251. *See id.* at 390.

252. *Id.* at 403-04.

253. Robert Gibbons, Cyert and March (1963) at Fifty: A Perspective from Organizational Economics 1 (Apr. 7, 2013) (unpublished manuscript) (<http://web.mit.edu/rgibbons/www/Gibbons%20CM%20at%2050%20v6.pdf> [<https://perma.cc/CF83-HY6Y>]).

and validate the essential features of Coase's theory.<sup>254</sup> A message of all these theories is that firms have *reasons* to choose between performing work and buying work from the market.<sup>255</sup>

Theories of the firm have another common premise: There is something fundamentally different between hiring employees to do the work versus buying the same work from other parties. But the real world is more complicated. Both ways of doing business are based on contracts, and the contracts firms make are not limited to fixed models. Contracting for work clearly by "employment" is one end of a scale leading by degrees to contracting for work clearly by purchase from non-employees. Either arrangement offers a different set of advantages, and a firm might feel pulled in both directions. The firm might invent a hybrid that is somewhere in the middle of the scale. In fact, hybrid arrangements have been common since the beginning of the industrial revolution.<sup>256</sup> Winchester's use of "inside contractors" in the nineteenth century was a hybrid. Hybrids like Uber are simply the latest of many generations of hybrids.

Theories about the "make or buy" decision do not provide a rule for determining when an arrangement should be called making or buying in hybrid or ambiguous situations. From a strictly economic point of view, there is no reason to draw an arbitrary line. The need for a line is a legal problem caused by statutes that rely on "employee" status to mark the limits of statutory coverage.

While theories of the firm are not designed to mark the point when workers are a firm's employees as a legal matter, they do lead to reasons a firm probably hired or did not hire employees. Knowing what a firm would likely do under the circumstances is a path to evaluating the credibility of a firm's classification of workers and a ground for shifting the burden of "articulat[ion]"<sup>257</sup>

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254. *See id.*

255. Some of a firm's long established ways of doing business might be a matter of inertia. A current generation of managers might not be conscious of the reasons why their firm first adopted a particular practice. A firm is likely to be most conscious of a choice and of reasons for doing one thing or the other when it is adding or eliminating a line of work within the firm, or when the firm is reorganizing work.

256. *See supra* text accompanying notes 129-65.

257. By "articulation" I mean something analogous to an employer's articulation of a "legitimate nondiscriminatory reason" in an employment discrimination case. *See* Tex. Dep't of Cmty. Affairs v. Burdine, 450 U.S. 248, 257-58 (1981); McDonnell Douglas Corp. v. Green, 411 U.S. 792, 802 (1973).

and production of evidence to the firm. The challenger can then attempt to prove the employer's explanation is inconsistent with what the employer has done in fact, or that circumstances provide a reason to presume the arrangement involves work by the firm's employees. The following section of this article is a summary of some reasons why a firm performs some work itself with its own employees and buys other work from other parties.

## B. Reasons for "Making" or "Buying"

### 1. *Economies and Diseconomies of Scale*

Coase noted that a firm exists and grows in part because it enjoys economies of scale by combining the work of many persons in a hierarchy of employees rather than buying the work in the market.<sup>258</sup> Economies of scale might result from sharing a building, equipment, or managerial resources, or by using a firm's financing capacity to acquire resources no single worker could afford. Winchester's nineteenth century enterprise, viewed as a firm including its "inside contractors," enjoyed economies of scale in all these ways.<sup>259</sup> However, Winchester was not necessarily the "employer" of the inside contractors or their workers. Winchester and modern "sharing economy" enterprises<sup>260</sup> show that a firm might gain economies of scale without performing work "within" the firm, and without being the employer of all workers who share the same resources.<sup>261</sup> A firm might rely on non-employment contracts, such as a lease for sharing working space, to gain some economies of scale. Economies of scale can be a reason for firms and workers to participate and cooperate in work and share resources, but there must be some additional reason why a firm chooses to be the "employer" of a set of workers. An employment contract might be better than a non-employment contract in some situations, and the reverse might be true in other situations.

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258. Coase, *supra* note 9, at 395.

259. *See supra* text accompanying notes 157-62.

260. *See* Inara Scott & Elizabeth Brown, *Redefining and Regulating the New Sharing Economy*, 19 U. PA. J. BUS. L. 553, 558-61 (2017).

261. *See supra* text accompanying notes 159-60.

One reason firms do not hire employees for every needed input is that growth does not always lead to economies of scale. In fact, growth sometimes leads to diseconomies of scale.<sup>262</sup> For example, diseconomies of scale arise if the firm expands into work the firm does not need on a consistent basis. It would not be efficient for a firm to hire a maintenance worker if it lacks enough regular work to keep at least one part-time employee busy. Moreover, the firm needs more than regular work for employment to make sense. Maintenance work also requires tools, supplies, and management, and a firm might not have enough regular need for these assets to make the acquisition efficient. A particularly capable maintenance worker might “self-manage,” avoiding the need for hiring an additional manager or extending the capacities and responsibilities of an existing manager. However, the value of a capable and self-managing worker is best realized by using his managerial skills to lead a team of employees, and a team might be more than the firm needs. A skilled and self-managing worker also might prefer managing his or her own firm for independence and greater profit. In the case of Winchester, it appears that the master craftsmen who could manage the work essential to production of components resisted becoming employees, regardless of the economies of scale the parties might have enjoyed by becoming a single firm with one hierarchy of employees.<sup>263</sup> The independent-minded master craftsmen relented and became Winchester’s employees only when compelled by economic circumstances.

As suggested by the discussion above, the cost of management is one of the most important reasons it might not be efficient for a firm to expand into a new line of work, even when it needs the work on a regular basis. However, the cost of higher management of work is likely to be much more important than the cost of regular supervision in determining whether a firm can efficiently expand into a new line of work. Taking on a different line of work requires, among other things, new managerial knowledge and possibly a new set of managers who understand the work well enough to plan, organize, coordinate, design, and standardize the

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262. See Hannah J. Wiseman, *Remedying Regulatory Diseconomies of Scale*, 94 B.U. L. REV. 235, 238-39 (2014) (noting that growth may cause “society [to] have inadequate opportunities to bargain for harm reduction . . . does not change.”).

263. See *supra* text accompanying notes 159-60.



work process. If the work can be planned, designed, and managed well-enough at a high level, the additional cost of supervision might not be a significant factor. Deskilling or a standardized design for the work can even make it possible for responsible workers to perform under very simple supervision or without much supervision at all. However, the firm that supervises de-skilled or highly specialized work must also have the managerial ability to understand the work and the work process.

Coase observed that a single firm can only manage so much.<sup>264</sup> Growth in general leads to additional complexity, more layers of corporate bureaucracy, a less cohesive management and workforce, and other organizational problems that might put the firm at a disadvantage in comparison with a smaller, nimbler firm.<sup>265</sup> Managers are best at managing the work they know.<sup>266</sup> A school's management might be expert at leading a faculty and teaching students, but not at overseeing floor maintenance, plumbing, and general repair work regularly needed for the school's building. The school might be better off buying such work—making a contract with another party to perform *and manage* the work—instead of employing and managing the work as an employer.

As the Winchester case illustrates, however, there may come a point when an independent firm's specialized management cannot competently handle some of the broader managerial challenges of the modern world.<sup>267</sup> The master craftsmen in Winchester's factory were experts at metalwork and production of components. However, they were poor at personnel relations, and they depended on Winchester for a variety of other managerial needs. Ultimately it made sense for Winchester to turn the master craftsmen into employees and gain managerial control at every level. In other words, the desirability of a firm's management of the work must be assessed at several levels, such as the cost and

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264. Coase, *supra* note 9, at 394-96; *see also* DEMSETZ, *supra* note 109, at 17 (describing the importance of management as an input separate from labor).

265. Coase, *supra* note 9, at 394-96; *see also* DEMSETZ, *supra* note 109, at 32, 34; Gibbons, *supra* note 8, at 205-06 (noting that an independent seller of worker has a greater incentive to invest in its enterprise, and is more likely to achieve important advances, if it remains independent and reaps all the gains of its advances).

266. *See* DEMSETZ, *supra* note 109, at 31-32 (discussing the economies of scale a firm achieves by specialization).

267. Buttrick, *supra* note 105, at 210-11.

convenience of immediate supervision, the cost of acquiring managers familiar with the specialized work, and the cost or benefits of using the firm's higher management skills such as personnel relations, finance, and regulatory compliance to improve the performance of certain work.<sup>268</sup>

If the employer does engage in management of the work process, it has extended itself into work supervision, even if the supervision seems weak according to ordinary notions of supervision. Under these circumstances, it is reasonable to presume that workers who perform the work are the firm's employees, regardless of how the firm classifies them for purposes of legal compliance. Of course, presumptions can be rebutted, but the burdens of articulation, production of evidence, and possibly even persuasion should shift to the firm.

## 2. *The Process of Hiring Versus the Process of Buying*

Recruiting, selecting, and hiring employees is another cost of employment that might affect the efficiency of a firm's growth. Procedural differences between hiring employees and buying work from others may account for some of the relative costs and advantages of hiring versus buying. Procedural differences can also be helpful for determining whether an employer is in fact hiring or buying.

When a firm hires employees, it solicits in a labor market of individuals seeking employment and not presenting themselves as firms even if we include self-employed individuals within the meaning of a "firm." Workers in this market are probably seeking employment for the usual reasons. At a minimum, employment offers a reliable and predictable stream of pay and relief from the need to search constantly for new business. At best, employment offers opportunities to develop skills, relief from the need to manage pension and insurance needs, participation in the society of a workplace, and advancement and prestige in an organization.<sup>269</sup>

Recruiting and selecting employees can be expensive, especially in the case of managerial or professional employees. However, the process of hiring is not always more expensive than the

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268. *See id.* at 220.

269. *See, e.g.,* Rajan & Zingales, *supra* note 123, at 388-90.

process of buying, especially for work performed by non-managerial and non-professional workers.<sup>270</sup> There are at least some ways in which the hiring process can be less expensive. Negotiating a rate pay in the hiring process is comparatively simple. A firm might set a “take it or leave it” rate of pay for some employee classifications with little room for individual bargaining. Setting the rate may take some research, but information about the market is not hard to find,<sup>271</sup> and the firm can nudge its uniform offer up or down depending on the reaction it gets from the market. A greater expense might be the managerial cost of accounting and budgeting: How much is the work worth, how many workers and what new assets will the work require, what will it cost for the firm to perform the work itself, and what is the firm willing to spend? A firm can best answer these questions if it manages the work. Managing the work makes it possible to observe, study, and control the work process. A firm that manages the work is also in the best position to answer these questions if it can standardize the work, making the work process as uniform, predictable, and easily managed as possible.<sup>272</sup>

Second, not much effort is required to negotiate and write the other terms of employment.<sup>273</sup> In fact, many employees work under oral contracts subject to standardized policies promulgated unilaterally by the employer in “employee handbooks” or other employer memoranda. Standardization of workplace policies results in a contract of adhesion similar to the form contracts that dominate consumer transactions.<sup>274</sup> There is very little left to negotiate. Moreover, since most employment is “at will,” there is

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270. John Boitnott, *3 Factors When Choosing Between a Contractor or Full-Time Employee*, ENTREPRENEUR (Aug. 4, 2015), <https://www.entrepreneur.com/article/249064> [<https://perma.cc/H6UY-HAHS>].

271. The Bureau of Labor Statistics collects and organizes a vast amount of wage, salary and benefit information, and it makes this data available on its website. BUREAU LAB. STAT., <https://www.bls.gov/> [<https://perma.cc/F35B-7E5N>].

272. Mike Woznyj, *The Benefits of Standard Operating Procedures (SOPs)*, LINKEDIN (July 28, 2015), <https://www.linkedin.com/pulse/benefits-standard-operating-procedures-sops-mike-woznyj/> [<https://perma.cc/XDZ9-UWV3>].

273. See Laura Handrick, *Free Employment Contract Templates and When to Use Them*, FITSMALLBUSINESS (Feb. 14, 2018), <https://fitsmallbusiness.com/employment-contract-template/> [[perma.cc/CK46-G6V8](https://perma.cc/CK46-G6V8)].

274. See Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1173, 1184 (1983).

little need or possibility for either party to draft long-range binding promises unless the work involves trade secrets or other valuable data.<sup>275</sup> The firm's main cost in writing an employment contract is the unilateral development of standardized policies and forms, but the firm bears this cost one time for all employees, and that cost can be spread over many employment transactions.

Buying work or work product from non-employees involves a very different process. When a firm buys work, some of the costs it bears in hiring employees shift to prospective sellers.<sup>276</sup> Firms buying work rarely advertise to seek sellers, or list "openings" for sellers in the media they use for hiring employees. Instead, sellers are more likely to advertise their availability, and they present themselves as independent firms or self-employed individuals rather than prospective employees. Sellers bear the managerial costs of determining fixed and variable expenses and expected profits of each transaction because sellers, not buyers, have managed the work and know the real costs of the work to be performed. The firm acting as a buyer avoids these managerial costs but also loses access to information about the work.<sup>277</sup> The buyer firm can get some sense of the market rate by soliciting and comparing bids, but sellers of work, especially skilled or difficult-to-manage work, are not necessarily a homogenous group. Some sellers are much better at managing the work than others.<sup>278</sup> Bargaining over the price for skilled work managed by a seller is likely to be very different from bargaining over wages and salary for an employee.

Buying work in the market also requires a different set of contract terms and a different drafting process compared to employment contracts. Compared with employers and employees,

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275. If the work does involve valuable data, the firm can draft a covenant not to compete, nondisclosure, or non-solicitation agreement. But these agreements do not necessarily require long-ranging promises with respect to any of the other terms of employment.

276. See generally ROBERT HABANS, EXPLORING THE COSTS OF CLASSIFYING WORKERS AS INDEPENDENT CONTRACTORS: FOUR ILLUSTRATIVE SECTORS (2015), [http://irle.ucla.edu/wp-content/uploads/2016/03/IndependentContractorCost\\_20151209-1-2.pdf](http://irle.ucla.edu/wp-content/uploads/2016/03/IndependentContractorCost_20151209-1-2.pdf) [<https://perma.cc/B6D2-NVZ8>].

277. See Coase, *supra* note 9, at 390-91; see also DEMSETZ, *supra* note 109, at 34 (regarding the importance of gaining or losing information about work in a decision to hire employees or buy work from non-employees).

278. See David G. Javitch, *Managing an Independent Contractor*, ENTREPRENEUR (Sept. 12, 2006), <https://www.entrepreneur.com/article/166668> [<https://perma.cc/STA4-958P>].

buyers and sellers need to be very specific about the work. When a firm hires an employee, the parties need no more than a general description of a line of work because an employee submits to the firm's instructions about what to do and how to do it. Employment contracts are undefinitized.<sup>279</sup> The actual work will be as determined in the future by the employer. In contrast, a seller of work or work products does not submit to a buyer's continuing right to decide what will be done and how to do it. If the buyer has special requirements, such as the time and place of the work or coordination with other work, the buyer must negotiate and draft the terms to address these needs. The seller, on the other hand, needs the contract to be precise about what work is promised in order to predict costs, set a price, and avoid disputes about whether the work performed is less than or different from what was promised.<sup>280</sup>

A seller and buyer might also need to address rules for the seller's liability for failing to perform its promise. A seller promising work in return for the contract price bears a greater liability than an employee.<sup>281</sup> An "at will" employee makes no promise to work or to achieve a result. Work is simply the condition of

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279. The term "undefinitized" has its origins in government contracts, particularly military contracts, in which the performance must begin as a practical matter before the parties have negotiated a final set of material terms. See 10 U.S.C. § 2326 (2012) (statutory requirements for undefinitized government contracts); see also, e.g., *Morpho Detection, Inc. v. Transp. Sec. Admin.*, 717 F.3d 975, 976-78 (D.C. Cir. 2013); *United States v. Bae Sys. Tactical Vehicle Sys.*, No. 15-12225, 2016 WL 894567, at \*1 (E.D. Mich. Mar. 9, 2016). The term is also appropriate for employment contracts in the sense that an "at-will" employee's performance is undefinitized. The exact performance is yet to be determined but will be determined by the employer, subject to the employee's right to resign.

280. An employee also has reason to worry that an employer will demand something more than the employee expected to provide, but an employee "at-will" can resign if the employer's demands become oppressive. Moreover, the employee is entitled to his or her wages or salary even in a dispute about whether a certain task is complete or properly done, and an employee is not liable for failure to achieve a promised result because an "at will" employee has not promised to perform for a particular period of time or to complete a particular task. The employee's liability is limited to negligent performance of work causing damage to the employer's property or business. See *Carlson & Moss*, *supra* note 7, at 325-26. Thus, employment contracts are naturally much less exact than contracts for work by non-employee sellers.

281. See, e.g., Office of Child Support Enforcement, *What's the Difference Between an Independent Contractor and an Employee?*, ADMIN. FOR CHILD. & FAMS. (Mar. 24, 2015) <https://www.acf.hhs.gov/css/resource/the-difference-between-an-independent-contractor-and-an-employee> [<https://perma.cc/8ZK5-FW72>] (comparing differences in the business relationships of employees and independent contractors); see also *supra* note 280 and accompanying text.

the employee's right to pay.<sup>282</sup> Neither resignation nor poor performance standing alone exposes the employee to contractual liability.<sup>283</sup> The employee suffers only the loss of prospective wages or salary. A seller of service, on the other hand, promises to perform in return for the contract price and is liable for damages in the event of a failure to deliver. Even if the seller promises only "best efforts" it cannot simply abandon the contract without committing a breach.<sup>284</sup> A seller can be sued for "resigning."<sup>285</sup>

The differences between hiring and buying are important for two reasons. The relative costs of hiring versus buying is one more item for a firm to consider when it must decide whether to perform work itself with employees versus buying work from another party. Second, if a firm acquires the services of individual workers by a process resembling hiring, there is reason to presume the employer is hiring employees compared to self-employed individuals. If an employer nevertheless argues that it buys, and does not hire, it should be required to provide a credible explanation why it has adopted the process of one to accomplish the other.

### *3. Securing Supply and Preserving the Ability to Change*

Many of the reasons for hiring employees rather than buying work or work product relate in some fashion to the advantages to a firm's fiat power over employees. A specific advantage singled out by Coase was a firm's ability to use its fiat to command employees to make important changes in work while maintaining a secure supply of the work.<sup>286</sup>

The power to command change by fiat can be valuable when the firm needs work or work product over a long period of time

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282. "At-will" employment is widely regarded as a unilateral contract, in which an employee's service is a non-promissory consideration for the employer's promise to pay for the service. See *Bankey v. Storer Broad. Co.*, 443 N.W.2d 112, 115-19 (Mich. 1989) (answering a certified question from the United States Court of Appeals for the Sixth Circuit).

283. See *supra* note 280.

284. See RESTATEMENT (SECOND) OF CONTRACTS, Ch. 11 introductory note (AM. LAW INST. 1981); *Bloor v. Falstaff Brewing Corp.*, 601 F.2d 609, 612-14 (2d Cir. 1979).

285. By "resigning" in reference to a seller, I mean something equivalent to repudiation of a binding promise. See RESTATEMENT (SECOND) OF CONTRACTS § 250 (AM. LAW INST. 1981).

286. Coase, *supra* note 9, at 391-92.

but expects its needs to change. Hiring employees to perform work subject to the firm's fiat can be the best way to achieve two goals that otherwise might be incompatible: (1) transacting to secure a supply of work over the long run, and (2) preserving the ability to change the work over the long run.

A firm does not need to secure all of its long-term needs by contract. For many generic or fungible goods and services a firm can bear the usual unpredictability of market price changes and buy what it needs as it needs.<sup>287</sup> But this practice may be impractical for some key inputs, especially those specially configured for the firm. Making the special input might require such substantial and specialized investment in knowledge, design and equipment that no seller would offer that input without a very large single order or a long-term commitment. Making the input might also require sharing valuable trade secret information, which would require careful contracting and other precautions between two independent firms.

Workers can be tailored inputs. Over time, they acquire specialized familiarity with a firm's business, organization, product, and customers. Workers can become specialized in this fashion as employees of the firm, as employees of another firm that regularly serves the first firm, or as self-employed independent contractors who serve the firm regularly over a long period of time. Experience serving the same employer or client can lead to specialization that is particularly valuable to that employer or client but not necessarily to any other employer or client. Under these circumstances, what is the best arrangement from the firm's point of view?

If a firm has a long term need for a uniquely specialized input, such as workers who understand the firm's business, "as needed" market purchases might not be practical. In the case of individual workers, sporadic contracting in the market is not the best way to gain the advantage of familiarity the firm needs. If a firm needs legal service, for example, it might want at least some lawyers who understand the firm's business and who do not need to re-learn the business for every new task.

If a firm needs a uniquely specialized input over the long term, it has two alternatives to "as needed" market purchases: (1)

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287. SUDHI SESHADRI, *SOURCING STRATEGY: PRINCIPLES, POLICY AND DESIGNS* 82 (2005).

make a long term contract with a seller willing to make the necessary investments to provide what the buyer firm needs according to the buyer firm's specifications, or (2) hire employees and acquire other necessary resources so that the firm can perform the work itself according to its specialized needs.<sup>288</sup>

The first option, a long term contract with another party, avoids a potentially inefficient expansion into a new line of work but requires the firm to forecast long term needs and bind itself to that forecast. The difficulty of forecasting can be alleviated somewhat by a long-term "requirements" contract binding the buyer only to what it needs in "good faith."<sup>289</sup> However, such a contract still confines the buyer firm's right to make a major change in the scope or direction of its business or line of work, and does not prevent a difficult contract dispute if the market or the firm's needs or goals change significantly.<sup>290</sup> Moreover, while a requirements contract can be flexible about quantity, it is unlikely to be flexible about the very nature of what the seller is to provide.<sup>291</sup> A seller cannot submit to unlimited control by a buyer. Under some circumstances, a firm's best option for securing what it needs with long term flexibility is to perform the work itself with its own employees.

Hiring employees to perform the work maximizes the firm's control over the work.<sup>292</sup> In contrast with transactions in the market, transactions within the firm occur by fiat. Employees, especially those employed at will, submit to the firm's instructions without the re-negotiation of a contract for every change in the firm's needs. The firm can move workers smoothly from one task to another, change the organization of the work to improve the results or coordinate it with other work, or change the mission of the work without renegotiating contracts. As Coase observed, "[i]f a workman moves from department Y to department X . . .

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288. Protection of trade secrets can still be a problem in hiring employees, but employees owe a duty of loyalty not to misappropriate trade secrets, and the employer can strengthen its protection of trade secrets by a variety of employment contract clauses. See CARLSON & MOSS, *supra* note 7, at 853-62, 867-68.

289. RESTATEMENT (SECOND) OF CONTRACTS § 77 cmt. d, illus. 8 (AM. LAW INST. 1981); U.C.C. § 2-306 (AM. LAW INST. & UNIF. LAW COMM'N 1977).

290. See U.C.C. § 2-306 cmt. 2.

291. See *id.*

292. See Gibbons, *supra* note 8, at 207-08.



[it is] . . . because he is ordered to do so.”<sup>293</sup> Even employees subject to fixed term contracts may be subject to reassignment within the scope allowed by the contract.<sup>294</sup> The firm’s ability to redirect, retrain, and reassign its own employees makes the firm nimble, especially for changing specialized work according to the firm’s immediate needs.<sup>295</sup>

Even if future changes could be addressed in a series of market purchases or long term contracts, there is another advantage of employment: Avoidance of a “holdup.” A holdup, as the term implies, resembles highway robbery. A firm becomes vulnerable to a holdup if it becomes overly dependent on a single supplier.<sup>296</sup> Imagine, for example that the firm pays a supplier to design special software for the firm’s unique business. The special software will need to be maintained, tweaked, and improved over time. The firm might negotiate a long term contract with a vague statement of duties for services that cannot be identified with particularity in advance, or it might negotiate new contracts for additional service as needed. However, this “market transaction” approach exposes the firm to the danger of a holdup by the software designer. If the parties are not bound by a long term contract, the software designer might demand a very steep price for needed maintenance knowing it will be no easy matter for the firm to turn to a substitute supplier unfamiliar with the software.

A firm is vulnerable to a holdup whenever a specialized input cannot be purchased “off the shelf” in the market and will

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293. Coase, *supra* note 9, at 387.

294. See *Murray v. Monroe-Gregg Sch. Dist.*, 585 N.E.2d 687, 691-92 (Ind. Ct. App. 1992); see WOOD, *supra* note 37, § 89.

295. Some of the flexibility of employment stems from its governance by “self-enforcing norms” rather than contracts. Professor Oliver Hart noted that self-enforcing norms can be especially important with respect to issues that cannot be effectively addressed by contract. Such issues include matters that are “observable,” but not “verifiable.” Oliver Hart, *Norms and the Theory of the Firm*, 149 U. PA. L. REV. 1701, 1702 (2001). For example, if a firm decides to motivate better work by promising a “fair bonus,” the obligation to pay the bonus might be observable to the parties, but it will be difficult if not impossible for a court to verify and enforce the obligation. Such a promise might still have some value and purpose as a self-enforcing norm (if the employer cheats the employee, the employee will resign, and others will cease to trust the employer), but a system of self-enforcing norms is more likely to be effective in an employment setting than in a relation between a buyer and non-employee seller. See *id.*

296. See Gibbons, *supra* note 8, at 204-05.

require original work for some new supplier.<sup>297</sup> To avoid this danger, a firm can perform the work itself by hiring employees.

Hiring employees “at will” or for short terms best preserves the firm’s ability to adapt and change, but how can a firm secure its supply of work if it relies on employees who can resign at any time or on short notice without liability for failing to finish assigned work? A workforce of employees can be reasonably secure because employees are bound by contractual and non-contractual glues that discourage resignation, reduce turnover and prevent the resignation of an unexpectedly large part of the workforce all at once.

Contractual glues include lawfully deferred compensation conditioned on employment through a certain date, pension benefits that fully vest only after a certain period of employment, and employee health plan coverage without regard to age, health or pre-existing conditions.<sup>298</sup> An employee who resigns before deferred compensation vests might forfeit a considerable sum.<sup>299</sup> At times, depending on the current state of the law, employer-subsidized medical insurance has been the most powerful glue for employees who have experienced ongoing medical conditions for themselves or their dependents and who cannot easily acquire equivalent insurance on their own or with another employer.<sup>300</sup> A covenant not to compete, which prevents an employee from serving a competitor or forming his own business in competition with the employer for a particular period of time after termination, can be another contractual glue for employees whose greatest value is in the very field and region from which they will be prohibited from working if they resign.<sup>301</sup>

Non-contractual glues begin with the aspirations of employees as compared with firms and self-employed individuals. Employees likely enter the labor market seeking jobs with stable, regular, and predictable pay in the form of wages and salary. Such jobs require either full time work for a single employer or part-

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297. *See id.*

298. *See* CARLSON & MOSS, *supra* note 7, at 298-99

299. *See, e.g.,* Schachter v. Citigroup, Inc., 218 P.3d 262, 270-71 (Cal. 2009) (upholding compensation plan forfeiture provisions for employees who voluntarily terminated employment).

300. *See* CARLSON & MOSS, *supra* note 7, at 333-34, 345-47.

301. *See* Angie Davis et al., *Developing Trends in Non-Compete Agreements and Other Restrictive Covenants*, 30 ABA J. LAB. & EMP. L. 255, 255-56 (2015).

time work for no more than two employers. Employees are income dependent on one or in some cases two employers. For this reason, it is usually more difficult for an employee to resign than for a seller to terminate business with a buyer. The typical seller loses a fraction of its business income, depending on the number of buyers it serves, and it can often adapt to the loss by laying off some of its own employees. An employee, on the other hand, suffers a major loss of sustenance, possibly amplified by disqualification from employee benefits. An income-dependent employee is likely to resign only when another firm has extended a better job offer or he or she has a reasonable certainty of quick re-employment in an equal or better job.

Another non-contractual glue is an employee's specific investment in his employment.<sup>302</sup> A specific investment is dedicated to and valuable for a particular transaction, and usually has little or no value for any other transaction. A simple example of a specific investment is a railroad's construction of a rail line to a coal mine. The rail line enables the railroad to sell transportation services to the mine, but the rail line is worthless for selling transportation to any other buyer.

Employees make specific investments by learning about and gaining experience in a firm's business, products, processes, organization, personnel and customers. An employee's specific investments are valuable to the firm because he or she knows how to work without much direction, understands the needs of the firm and its clients, and is in a good position to contribute to the firm's accumulation of knowledge and experience. If the employee resigns, much of this specific investment may go to waste.<sup>303</sup> The employee might find some of his knowledge is valuable to some other firms provided he does not misappropriate his prior employer's trade secrets or violate a covenant not to compete. The fact that the employee cannot use his former employer's trade secrets might make his most important knowledge worthless.<sup>304</sup> His non-trade secret knowledge might be completely useless to another firm that makes a different product, requires a different set

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302. See Marvin H. Stroud, "Don't Put Your Eggs in One Basket": Reforming 401(k) Pensions to Address the Educational and Psychological Issues That Drive Good Employees to Make Bad Investment Decisions, 41 MCGEORGE L. REV. 437, 452-54 (2010).

303. See Stuart J. Schwab, *Life-Cycle Justice: Accommodating Just Cause and Employment at Will*, 92 MICH. L. REV. 8, 13-14 (1993).

304. Davis et al., *supra* note 301, at 260.

of skills and serves a different market. In short, an employee cannot always assume that he or she is more valuable and will earn more pay as an employee with some other firm.

Income dependence and specific investment are just two of several non-contractual glues that keep employees in their jobs and secure a firm's supply of specialized work over the long run. Other non-contractual glues for some employees are the social life of a workplace or prestige in an organization.

Obviously, contractual and non-contractual glues do not prevent some employees from resigning eventually. However, employment glues are a restraint against an unexpectedly rapid turnover in a workforce.<sup>305</sup> A firm does not need perfect continuity in its workforce over a long period of time. If it has several employees in a particular line of work, a normal turnover rate will not severely impact its supply of experienced, qualified, and familiar workers. In fact, a slow but steady turnover might allow the firm to regularly add new employees with fresh ideas, energy, and motivation. If too many employees resign at once, the firm can temporarily redistribute the work load until it finds enough substitutes.

Because "at will" employees are bound by non-contractual glues, a firm can secure special or important work it needs and simultaneously maintain *adaptability* by hiring employees to perform the work.<sup>306</sup> Making "as needed" or spot market purchases or making long term requirements contracts with non-employee sellers might achieve either security or adaptability, but rarely both. Thus, a firm seeking both goals for certain work is likely to hire employees as economies of scale are favorable. If workers are part of a stable workforce and subject to the firm's fiat, there is a strong possibility that they are the firm's employees, and employment should be presumed.<sup>307</sup>

A firm's achievement of these combined goals will not always be obvious if workers are viewed through the lens of master servant law, control factors, and indefinite relation factors.<sup>308</sup> The

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305. See Alfreda P. Iglehart, *Turnover in the Social Services: Turning Over to the Benefits*, 64 SOC. SERV. REV. 649, 654 (1990).

306. See Anil Arya et al., *The Make-or-Buy Decision in the Presence of a Rival: Strategic Outsourcing to a Common Supplier*, 54 MGMT. SCI. 1747, 1747 (2008).

307. See Liya Palagashvili, *Disrupting the Employee and Contractor Laws*, 2017 U. CHI. LEGAL F. 379, 380-81 (2017).

308. See discussion *supra* Section II.

old control factors focus on close supervision of the details of the work, but such supervision is unnecessary for a firm to achieve Coase's version of employer control by fiat over a secure workforce. The important control takes place at a higher level of management, not a lower supervisory level. A firm achieves the advantages of employment by its ability to design, standardize, coordinate, gather information and feedback, and modify the work process and output.<sup>309</sup>

Such fiat over workers might be demonstrated by the firm's methods and success in controlling the work process over time, its methods for collecting the sorts of information a manager needs to manage and improve work over time, and its record and success in implementing unilateral modifications of the work process and output. If the firm engages in very little direct supervision, are the workers of a skill class that tends to supervise itself, such as professionals or specialists? Has the firm's control and standardization of the work process eliminated the need for much supervision because the work procedure is so simplified and regularized as to minimize or eliminate important decision-making by individual workers? What real management or self-supervision is left for an individual worker after the firm has established its process? Has the firm been able to announce policies and procedures or make changes by unilateral declaration, or has the firm found it necessary to negotiate bilaterally and individually with the workers the way it does with other suppliers?

Has the firm acquired the securely attached workforce envisioned by Coase?<sup>310</sup> The process of hiring is one sign that it has. If the firm recruits workers from the market of prospective employees, the workers were likely looking for and value regular pay from a reliable source. If the firm alleges the workers became self-employed "independent contractors" for the purpose of obtaining work from the firm, the manner in which they converted to being self-employed is important. Did the workers accept the firm's standardized design for their businesses and work processes? If so, they are not only subject to the firm's fiat, they are also securely attached to the firm's business model.

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309. DEMSETZ, *supra* note 109, at 34 (regarding the importance of gaining or losing information about work in a decision to hire employees or buy work from non-employees).

310. *See* Coase, *supra* note 9, at 392-93.

A firm's fiat, and the security of its supply of work, is augmented by the workers' significant income dependence on the firm. Income dependency takes the place of the traditional "indefinite relation" factors and requires a look at the employee-like immediate aspirations of the workers and the wage-like function of firm payments in the workers' daily lives.<sup>311</sup> Firms relying on indefinite relation factors often classify workers as "independent contractors" if the work is irregular, there is no fixed schedule, or workers maintain control over their days and hours of work.<sup>312</sup> However, a fixed schedule is less revealing than the regularity and sufficiency of earning opportunities and the importance of these opportunities for a worker's sustenance.<sup>313</sup> Freedom to choose hours of work says more about the nature of the work and the firm's needs than it says about the strength of the worker's attachment to the firm. Worker freedom over hours can also be the sort of benefit that makes the work attractive and glues workers to the firm. Moreover, a worker can be income dependent on a firm even when it is not the worker's exclusive source of income. Many employees perform two jobs for two different employers.

A firm might deny that some workers are income dependent "employees" because they are not secured by all the glues that secure workers it does classify as "employees."<sup>314</sup> Workers that a firm classifies as "independent contractors" are unlikely to participate in the firm's employee benefit, bonus, or profit sharing plans.<sup>315</sup> The firm might discourage them from imagining they are on a career track within the firm, and the workers might not participate in the firm's social life as much as designated "employees" do. Workers classified as "independent contractors"

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311. See *contra* Palagashvili, *supra* note 307, at 380.

312. See *id.* at 383.

313. The "economic realities" factors do take account of a workers' dependency on the alleged employer, but the "economic realities" as framed by the Supreme Court include the degree to which work is an integrated part of the alleged employer's "enterprise." In other words, is the work in question part of the vertical chain of production from beginning of production to ultimate sale of products? See *supra* text accompanying notes 199-210. The "making or buying" approach, on the other hand, allows for subcontracting of nearly any phase of an enterprise, provided the subcontractor workforce is not part of a secure supply of work subject to the alleged employer firm's fiat.

314. See *Understanding Employee v. Contractor Designation*, IRS (July 20, 2017), <https://www.irs.gov/newsroom/understanding-employee-vs-contractor-designation> [<https://perma.cc/U27W-F9GE>].

315. *Id.*

might not expect to serve the firm longer than a season, the duration of a project, or a short to medium fixed term. In fact, some firms probably classify some workers as “independent contractors” at least in part to signal that it offers and expects a lesser commitment.<sup>316</sup> If eventual termination of the work is likely, termination of an “independent contractor” will be less demoralizing to those safely classified as employees.

The ultimate question, however, is not whether a firm leads workers to expect a job for life or even for a year, but whether the workers are presently income dependent on the firm. Temporary, seasonal or project-based employment is not inconsistent with employee status.<sup>317</sup> In fact, temporary employment is a normal variety of employment in some industries, such as construction or education.<sup>318</sup> Employee status is possible even if the contract is for a single and highly specific task, such as deskilled assembly line work for a piece rate or driving from one place to another in return for a trip rate. If the relation continues a series of tasks and the contract is a standardized form for multiple performances, the worker might be as income dependent as any other employee, for as long as the relation continues.

Thus, even “temporary” workers might be income dependent on a firm in the same fashion as other employees, and they might constitute a secure supply of work subject to the firm’s fiat. If the workers are numerous enough, their work is standardized or similar enough, and the firm solicited them from the market for prospective employees, their turnover rate might not be much different from the turnover rate for “permanent” employees.<sup>319</sup> Proving a firm’s “independent contractors” are employees might therefore include a look at the turnover rate, after accounting for the naturally seasonal or temporary duration of the work in question.

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316. *See id.*

317. *See* Kelly Phillips Erb, *Employees Or Independent Contractors? Categorizing Workers Properly*, FORBES (Aug. 21, 2015), <https://www.forbes.com/sites/kellyphillips-erb/2015/08/21/employees-or-independent-contractors-categorizing-workers-properly/#33982deb7472> [<https://perma.cc/MNW5-W268>].

318. Jennifer Borland, *Seasonal Workers*, SPECTRUM ENTERPRISES (June 6, 2013), <http://www.spectrumlihtc.com/file-maintenance/seasonal-workers/> [<https://perma.cc/FEG3-L2EX>].

319. *See supra* text accompanying notes 297-307.

What if there is no dispute that the workers in question are employees, but it is an issue whether they are employees of the target firm or another firm? A firm providing services might assign its own team of employees to serve a client firm. Could the service provider's employees actually be part of the principal firm's workforce under any circumstances? This question becomes important when the supplier is insolvent, can easily disappear to evade the law, or is too small standing alone to be a covered employer under an employee protective statute.<sup>320</sup>

There are circumstances when the client firm is in fact the employer or joint employer of a service supplier's employees.<sup>321</sup> In the extreme case, the client firm and the supplier have arranged their relationship at least in part to evade regulation or the collection of future judgements in favor of workers.<sup>322</sup> The client firm might believe that a financially shallow and itinerant labor supplier insulates it from liability by serving as the nominal employer of a team of workers. If the supplier has little capital or investment at stake, it can disappear in case of legal trouble. The supplier in such a transaction charges the client for the cost of labor, and divides and distributes the funds to itself for a profit and to the employees for their wages.<sup>323</sup> The client firm benefits by obtaining work at a very low cost—perhaps a bargain obtainable only by violation of labor standards or by a firm exempt by size from regulation.<sup>324</sup>

To determine whether the client firm is performing the work itself or buying the work from the supplier firm, an important inquiry is whether the supplier firm provides real management of the work and not just direct supervision of the employees. Does

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320. See CARLSON & MOSS, *supra* note 7, at 90-91.

321. *Id.* at 81-84.

322. *Id.* at 90-91, 326-27.

323. A client firm might argue that this method of distribution pay demonstrates that the service supplier not the client, is the employer. However, this method of payment is not completely inconsistent with employment, considering the parties' freedom to design relationships creatively and without regard to standard models. It is certainly unusual and risky for a firm to pay an employee supervisor by lump sum to be divided between the firm's other employees, but it does happen. See *Rutherford Food Corp. v. McComb*, 331 U.S. 722, 729 (1947). An analogous arrangement involves the distribution of a bonus pool to a supervisor or manager to distribute to subordinates. Such a payment scheme enables the supervisor to gain greater authority over subordinates and strengthens the supervisor's incentive to keep labor costs low.

324. See *id.* at 727-29.



the supplier firm develop work methods and processes, train the employees, use the information and feedback it gains to improve the work process, or modify the process without the need to negotiate with the client? Of course, any change in the essential work product would naturally require the request and approval of the firm buying the work product, but a true employer firm can make many changes in work process and methods on its own. On the other hand, if the client firm is primarily responsible for designing the work process, gains important information about the work, and uses that information to direct changes in the work process, it is reasonable to presume it is an employer of the supplier (the client's supervisory employee)<sup>325</sup> and the subordinate employees.

Again, presumptions are subject to rebuttal. For example, the client firm might be able to prove it bought work, and did not perform the work itself, because the work required expensive physical assets, and it was more efficient for these assets to remain the property of an independent firm serving multiple clients. However, in the situation described above, there are some important indicia of pretext. If the arrangement tends to serve avoidance of the law (because of small firm exemptions) or the evasion of the law because of the supplier's scant financial responsibility or ability to disappear, an argument that the supplier was an independent firm selling work to the client firm should be especially suspect.

#### 4. Other Reasons for "Making" Instead of "Buying"

The reasons for "making" identified thus far are derived from Coase's observations about the nature of the firm. Since Coase's article, scholars have developed other theories why firms sometimes make, and sometimes buy.<sup>326</sup> This subsection is a

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325. The supplier's status as a supervisory employee depends on the usual questions: Is the proprietor of that firm income dependent on the principal firm and subject to the principal firm's fiat? The supplier might be dependent if the principal firm is the sole or a primary buyer of work, even if only for a limited duration. Is the supplier also subject to the firm's fiat over the work? The answer depends on the extent to which the client firm has designed and retains practical control over the organization, process and output of the work. For an example of a scenario in which the supplier was very likely a supervisory employee of the client firm, see *id.* at 729-31.

326. See, e.g., DEMSETZ, *supra* note 109, at 1-2.

brief summary of some of the other reasons a firm hires employees to make what it needs. It is brief because firms acting based on these other reasons are less likely to arrange their relations in ways that lead to ambiguity. In other words, a firm motivated significantly by one of the reasons described in this subsection will probably hire employees and be clear about doing so. On the other hand, given the creativity of the business world and the difficulty of anticipating changes in technology or organizational strategy, these additional reasons for hiring employees might someday become important in distinguishing employees from non-employees for legal purposes. Of course, they might already be important in situations overlooked by this article.

Several scholars have observed that complex work requiring a high degree of coordination and cooperation is best performed by employees of a single firm.<sup>327</sup> Such work might be exemplified by a group of engineers working together in design work, assembly work that must be performed by a team working together at the same time, or other workers engaged in work that cannot easily be broken into separately performed units.<sup>328</sup> Ongoing cooperation requiring constant and rapid decision-making, accommodation, and dispute resolution is better managed by a firm's fiat power than by market transactions between independent parties.<sup>329</sup> While independent parties might with luck cooperate successfully, they cannot be compelled to do so without hierarchy, and judicial resolution of their disputes will be corrosive to personal relations. By employment, a firm uses its fiat and hierarchy to command cooperation, monitor behavior, reward or penalize behavior, and resolve disputes. The firm can also create the hierarchy it needs within the relevant group by inside promotions based on direct observation and experience as an employer.<sup>330</sup> Moreover, a single firm employing all the participants

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327. *See id.* at 17.

328. Dividing work into very specific and narrow or deskilled units can increase the need for coordination for a variety of reasons. For example, work moving down an assembly line cannot easily be assigned to separately managed firms at each stage of assembly. *Id.* at 21. Management of work is also best coordinated and performed by a single person or firm if the work involves continuous activity that is difficult to sub-divide. *Id.*

329. *See id.*

330. *See* Jonathan Berk et al., *Matching Capital and Labor*, 72 J. FIN. 2467, 2468 (2017).

with the usual “glues” of employment<sup>331</sup> is more likely to maintain a continuity of participants, which is valuable whenever the work requires considerable “on the job” learning, familiarity, experience, or interpersonal relations.<sup>332</sup>

Not all coordination requires the exercise of fiat over employees. General contractors in the construction industry routinely coordinate the work of multiple independent subcontractors.<sup>333</sup> In fact, a general contractor might hire very few employees. However, the fact that construction can be done in discrete and separately timed stages reduces the complexity of cooperation between the subcontractors.<sup>334</sup> The management of multiple parties in construction is mainly a matter of timing.<sup>335</sup> Separate parties need not work together so much as in the right order and at the right time. A general contractor can organize the work without much managerial skill with respect to each of the inputs, such as pouring concrete, electrical wiring, or plumbing.

When a group of workers is engaged in complex work that requires a high degree of cooperation and a firm achieves cooperation by fiat and hierarchy, the workers’ status as employees of the firm is likely to be obvious. In this situation, the firm is likely to exercise fiat in obvious ways. Complex work requiring cooperation cannot easily be standardized, and the firm will likely exhibit its fiat power in the day to day coordination of the work. The hierarchy within the group is also likely to be obvious. The firm’s resolution of disputes and its methods of reward and punishment are likely to be obvious. If continuity is important, the firm is more likely to rely on the most obvious contractual and non-contractual glues of employment.

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331. See *supra* text accompanying notes 298-306.

332. Amitai Aviram, *A Note on Economic Theories of the Firm 3* (Florida State Univ. Coll. of Law Pub. Law & Legal Theory Working Paper Grp., Working Paper No. 182, 2006). Professor Aviram uses the example of a football team to explain the advantages of employment. A football team depends on coordination and cooperation of a number of individuals. They perform best as a stable team of individuals familiar with each other. The team would perform poorly if the owner or coach were required to return to the market and build the team from scratch for each new game.

333. Robert G. Eccles, *The Quasifirm in the Construction Industry*, 2 J. ECON. BEHAV. & ORG. 335, 335 (1981).

334. Some scholars have suggested that the general contractor-subcontractor relation in construction is a kind of “quasi-firm,” and employment law sometimes treats a general contractor and its subcontractors as a single employer for at least some purposes. *Id.* at 337-38.

335. See *id.* at 337.

One more reason to hire employees involves the problem of intangible or intellectual assets. Such assets cannot easily be protected by the usual methods of contract and property ownership.<sup>336</sup> Trade secrets or other non-patentable “know-how” are difficult to protect because a firm cannot acquire exclusive ownership of these assets, it must share them with workers involved in the use of the assets, and it has limited contractual solutions for preventing workers from taking these assets with them when they leave.<sup>337</sup> Imagine, for example, that the firm has perfected a process or formula for making a product. To make the product, the firm must share all or part of the process or formula with workers involved in production. The workers will acquire that part of the asset, and they might still have what they learned if and when employment terminates and they begin working for another firm, possibly a competitor.

Assets such as know-how are not entirely unprotectable. Misappropriation of trade secrets is a violation of the duty of loyalty and a tort,<sup>338</sup> and a firm can supplement this protection by a non-disclosure agreement that identifies the information that has been or will be shared, agrees that the information is protected, and prohibits disclosure or use of the information except in the course of employment with the firm. However, a firm faces a difficult practical problem in enforcing its rights against misappropriation of its trade secrets.<sup>339</sup> The firm cannot always know when its trade secrets are being misappropriated. Because trade secrets are intangible, there may be no direct or physical evidence of the misappropriation, and the firm might not discover grounds to suspect or prove a misappropriation until after it has already suffered great damage.

Enforcement of rights with respect to know-how can be difficult under any circumstances. But a firm is in the best position if the workers with whom it shares its know-how are its own employees. Depending on local law, a firm might negotiate enforceable covenants not to compete with its employees. A contracting

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336. See *8 Must-Dos to Protect Your Trade Secrets*, A.B.A. (May 2016), <https://www.americanbar.org/publications/youraba/2016/may-2016/8-must-dos-to-protect-your-trade-secrets.html> [<https://perma.cc/BAW6-D4J6>].

337. *Id.*

338. See CARLSON & MOSS, *supra* note 7, at 853-62 (discussing *PepsiCo, Inc. v. Redmond*, 54 F.3d 1262 (7th Cir. 1995)).

339. See *id.* at 853-55.

employee is less likely to misappropriate if he or she is barred from working for a competitor for a reasonable time after termination. Also, it is easier to spot and enjoin competitive activity than it is to spot and enjoin misappropriation of a trade secret. In most states, the law is most likely to allow for enforcement of an anti-competitive contract if the parties are an employee and an employer.<sup>340</sup> Thus, a firm depending on a worker's covenant not to compete will want the worker to be an employee.

There are additional reasons why a firm best protects trade secrets and other know-how by hiring employees. The firm can use the usual glues of employment to reduce turnover and the amount of monitoring required to guard against misappropriation.<sup>341</sup> The firm can also use a long term employment relationship to build trust or learn which employees deserve trust.

In general, when a firm organizes work and designs its relations with workers to maximize its protection of know-how, it will be obvious that the workers are the firm's employees and it would undermine the firm's goals to deny the workers' employee status.<sup>342</sup> Denying their status as employees would weaken the firm's protection of its know-how.

This list of reasons for hiring employees is far from exhaustive. However, any of the other reasons for hiring employees and performing work within the firm will lead to arrangements in which the workers' status as employees is clear, and there is not likely to be a dispute about status.<sup>343</sup>

##### 5. A Firm's Reasons for "Buying" Work

As discussed earlier, under certain circumstances it is reasonable to presume that workers are employees because they are part of a firm's secure supply of work and subject to the firm's fiat under circumstances making it likely for a firm to rely on employees for needed work. A firm might rebut this presumption by demonstrating that it chose to buy the work in the market, and that

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340. See, e.g., TEX. BUS. & COMM. CODE ANN. §§ 15.05, 15.50(a) (West 2017).

341. See CARLSON & MOSS, *supra* note 7, at 835-54.

342. *Id.*

343. See, e.g., DEMSETZ, *supra* note 109, at 19-20 (describing a firm's ownership of key assets to prevent opportunistic behavior by parties sharing access to or use of the asset).

it had a credible reason for doing so. What reasons might a firm have for buying work instead of hiring employees?

a. Agency Costs

One reason for buying is to avoid certain “agency costs” in hiring employees. As discussed earlier, a firm will not want to accept the cost of managing an additional type of work if it is more efficient to buy specialized management from some independent seller in the market.<sup>344</sup> There appear to be at least two different situations in which agency costs lead the firm to buy, rather than hire.

First, economies of scale may work against an expensive extension of the firm’s management. If the firm takes this position in arguing that it has bought work and has not hired employees, it must back its position with facts showing that it does not actually manage the work.<sup>345</sup> For example, it must prove that it relies on sellers to design work methods, that the firm has not designed or standardized the work process, and that the firm cannot change the work process by fiat. Evidence that the workers self-supervise is not particularly important if the firm has already resolved managerial issues for the workers. In short, the firm must rebut the very facts the challenger might have presented to establish a presumption that the workers are the firm’s employees.

Second, the firm might have discovered that a unit of employees and their managers protected from market competition are more prone to “shirk.”<sup>346</sup> Whatever the economies or diseconomies of scale, the cost of the work might best be controlled by inviting independent parties to bid on the work. Regular exposure to such competition might deter shirking or inflated demands for more resources. Whether the problem of shirking is more important than efficiencies of scale depends a great deal on the nature of the work and the managers. The problem of shirking is likely to be greatest when the work is professional or involves

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344. *See supra* Part IV.B.1.

345. *See supra* Part IV.B.1.

346. DEMSETZ, *supra* note 109, at 24. Closely related to the problem of shirking is the difficulty teams of employees have identifying and measuring the relative contributions of each team member. *See id.* at 17-18.

a degree of creativity that makes it difficult for the firm to determine the workers' and managers' actual effort and effectiveness.<sup>347</sup> However, as the work becomes more professional and creative, bidding might become less effective for comparing different suppliers. A lower bid might reflect a lower quality. The complexity of choosing between the efficiencies of hiring versus competitive bidding are evident in firms that hire lawyers as employees for some legal work but also buy some legal work from independent law firms. Finding the best choice might require an ongoing experiment.

If a firm's defense is that it avoids agency costs by inviting sellers to bid for the work, its evidence must show that the firm is in fact exposing the workers or the managers of the work to real bidding and competition. For example, the firm must demonstrate that it invites proposals for work by sellers, and that the parties arrive at a price in a fashion consistent with a bidding process. It is true that even employees engage in some semblance of bidding when they initially negotiate compensation and subsequently seek a "raise."<sup>348</sup> However, to the extent employment includes what could be described as a bidding process, employee bidding is different from seller bidding.<sup>349</sup> In employment, it is the employer that bids by offering a rate based on its own substantial information about the work and about the worker (especially if the firm is offering a "raise" to an incumbent employee). If the employee rejects the bid, he or she might not do so "on the spot" because of the various glues of employment. The employee is more likely to wait until he or she has secured alternate employment, and then resign.

On the other hand, when a firm invites sellers to bid, the firm lacks information about the workers, the work, the management of the work, and the costs.<sup>350</sup> In fact, the reason a firm resorts to a bidding process is probably because it has no other way of knowing what the cost should be. Sellers have the greater knowledge of the costs because the sellers, not the buying firm, actually manage the work. If the seller is disappointed with what the buyer is willing to pay, the seller is unlikely to accept the job

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347. See Aviram, *supra* note 332, at 9-11.

348. See *supra* Part IV.B.2.

349. See *supra* Part IV.B.2.

350. See Coase, *supra* note 9, at 391-92.

and remain until a better opportunity arrives. In sum, if a firm seeks to rebut a presumption of employment by arguing that it relies on competitive bidding to avoid agency costs, it should be required to prove that bidding occurs in a buyer-seller relation, not an employment relation.

b. The Most Efficient Ownership of an Asset

As noted earlier, economies of scale might make it more efficient for a firm to hire employees and buy the other assets it needs to perform certain work.<sup>351</sup> However, there are some reasons why certain assets are better owned separately by the party performing the work, regardless of what economies of scale might otherwise have suggested.

The party who owns an asset, such as a delivery vehicle, has the strongest incentive to assure proper operation, maintenance, and effective use. This incentive is particularly important if the worker will necessarily exercise the principal use and control of the asset.<sup>352</sup> For example, a truck driver in a delivery enterprise will have much greater “hands on” control of the truck than another party receiving the benefit of the driver’s use of the truck. The driver is much more likely to drive carefully and maintain the truck if the truck belongs to the driver. Moreover, if the driver owns the vehicle and manages its use, the driver can maximize revenue from the truck by serving multiple clients.<sup>353</sup> For example, if the driver delivers cargo from Houston to Dallas but must then return to Houston for the next load, the driver’s right to serve another client in Dallas making a delivery to Houston makes the driver’s use of the truck much more profitable.

The party who owns an asset also has the strongest incentive to invest in further improvements and advances in the technology or process for working.<sup>354</sup> This factor is not likely to be important in a decision whether to buy from or hire individual workers with ownership of relatively standard physical assets like a truck. However, the question of investment incentives might be important when certain intangible assets are at stake. It might be

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351. *See supra* Part IV.B.1.

352. *See* Gibbons, *supra* note 8, at 211-12.

353. *Id.*

354. *See id.* at 205-07; Bengt Holmstrom & Paul Milgrom, *The Firm as an Incentive System*, 84 AM. ECON. REV. 972, 972 (1994).



most efficient to buy work from an individual or a group performing work for which they possess special know-how. A worker's ownership of specialized know-how encourages the worker to maintain and improve his or her skill, continue training, and efficiently use the skill for multiple clients.<sup>355</sup> A worker serving one client risks developing only skills mainly or exclusively valuable to that particular client.<sup>356</sup> Thus, for example, a lawyer or group of lawyers in a law firm might resist becoming employees of a client. Moreover, even if the client might reduce costs by hiring employee lawyers, it might believe that independent or "outside" counsel will operate under incentives that make outside counsel more determined, proficient, and effective.<sup>357</sup>

If a firm seeks to prove that workers are not its employees because they own some asset, and that advantages of worker ownership are reasons for the firm to "buy" and not "make," it will be important to determine whether the workers' ownership of the asset truly removes the client firm from the management of the work.<sup>358</sup> It is routine for employees to own at least some of the assets of their work.<sup>359</sup> Assets with a mixture of work and personal function, such as a car or good clothes, are usually best owned by employees. If an employee uses a car or clothes partly for work and partly for personal endeavors, the employer will not want to bear the costs of personal use. Moreover, some assets must be tailored to an employee's needs. An employee with a family might need a large car even if work does not require a large car. Clothes must be fitted to the employee. An employee's ability to manage the asset to serve personal needs to this extent is not inconsistent with employment.

### c. Maximizing Flexibility for Especially Rapid Change

As discussed earlier, a firm will usually want to manage and perform work itself with its own employees if it needs a secure

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355. Holmstrom & Milgrom, *supra* note 354, at 972-73.

356. See Aviram, *supra* note 332, at 11.

357. See Gibbons, *supra* note 8, at 206-07; Herbert A. Simon, *A Formal Theory of the Employment Relationship*, 19 *ECONOMETRICA*, 293, 293 (1951).

358. See Gibbons, *supra* note 8, at 232-33.

359. See Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 *AM. ECON. REV.* 777, 792 (1972).

supply of the work but also needs to preserve the ability to change the work by fiat.<sup>360</sup> Under some circumstances, however, a firm might be reasonably confident that it will be able to secure what it needs in the future from sellers in the market, and that its greatest need is for maximum flexibility.<sup>361</sup> If so, buying what the firm needs from sellers in the market in short term contracts or spot purchases might be the most flexible approach of all.<sup>362</sup> Securing a workforce, after all, can make change difficult for the firm in some ways. Eliminating part of an employee workforce might demoralize remaining employees, expose the firm to sabotage by unhappily terminated employees, increase unemployment compensation tax rates, create Worker Adjustment and Retraining Notification Act (WARN) difficulties,<sup>363</sup> and lead to a surge in employment law litigation by former employees who allege discrimination or previously overlooked violations of various employer obligations. Buying from non-employee sellers in the market avoids these problems. Buying means a loss of fiat power over the work, but the firm might have reason to believe its sometimes radically changing needs can be satisfied in the market. If the firm is very confident that it can avoid a hold-up or other opportunistic behavior by sellers, buying from sellers with no long term commitment or with very loose and renegotiable commitments might be the firm's best option in an environment of high velocity change or significant uncertainty.

If a firm asserts that it did not hire workers as its own employees because it wished to maintain maximum flexibility to address significant changes in its needs an important issue will be whether the employer's business is in fact exposed to or undergoing rapid change.<sup>364</sup> For example, is the firm's business significantly affected by very rapid changes in technology? Is the firm's business one with an uncertain future, such that the firm might need to rapidly end some of its work or acquire a much larger volume of work? In other words, what is the cause of the firm's uncertainty? The firm's actual arrangements with alleged sellers

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360. See *supra* text accompanying notes 240-50.

361. See Demsetz, *supra* note 109, at 23

362. *Id.*

363. See *supra* text accompanying notes 48-51.

364. See *supra* text accompanying notes 128-29.

and its history of change will be other tests of the credibility of its explanation. Does the firm appear to exercise fiat power by unilaterally demanding changes in the work, and yet maintain a labor supply that exhibits the same continuity one would expect of an employee workforce? Does the firm recruit sellers from the general labor market, or does it search for sellers in the usual fashion of a buyer seeking a seller? What does the firm do to maintain the workers' attachment to the firm? If the firm's actions fail to match its alleged reason, it is probably because the workers really are employees.

## V. REFORMING THE DISPUTE RESOLUTION PROCESS FOR WORKER CLASSIFICATION

The preceding section discussed a firm's reasons to "make" what it needs by hiring employees in some cases, and buying what it needs from non-employees in other cases. Neither making nor buying is a random act. In most cases, it should be possible to identify a firm's likely reasons for doing one thing or the other. A test of worker status should take these motivations into account, and it should be consistent with what firms are and what they do. A firm is not a "master" of "servants." A firm's relations with its workers are impersonal, and become bureaucratic as the firm grows.<sup>365</sup> Worker status is not a fixed condition or relation that can be classified into clear categories because firms reinvent and design their working relations to suit their needs. However, whenever modern firms need work or to change the way they acquire work, they face the same "make or buy" decision.<sup>366</sup> A legal concept of "employment" should start with the firm's "make or buy" decision because that decision is the beginning of a division between workers who are attached to the firm from those who are not.

How can a theory of the firm be incorporated into the law of employee status in a way that is comprehensible and helpful to the parties, advocates and factfinders? A proposal for incorporating economic and organizational theories of the firm into the law

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365. See Peter F. Drucker, *They're Not Employees, They're People*, HARV. BUS. REV., (Feb. 2002), <https://hbr.org/2002/02/theyre-not-employees-theyre-people> [<https://perma.cc/C7M9-2RD6>].

366. See *supra* text accompanying notes 128-29.

of worker status might seem to be a step toward greater complexity, and greater complexity is not what the law of worker status needs. However, the theory of the firm also offers simplification by linking the issue of worker status to motive and intent.

Understanding what a firm sought to accomplish makes it easier to understand and to prove what the firm did in fact, but current multi-factored tests of worker status fail to prompt much inquiry about a firm's reasons for hiring employees or buying from non-employees.<sup>367</sup> Instead, current tests simply ask for objective facts traditionally associated with employee or independent contractor status.<sup>368</sup> A firm's purpose is largely ignored, except to the extent that a firm's possible intent to evade regulation always lies in the background of a dispute about worker status.

Reconfiguring the test of worker status to include consideration of a firm's likely goals, purposes, and design offers several advantages. Identifying a firm's purpose as a central theme of the dispute can facilitate the parties' gathering, organization, and presentation of evidence.<sup>369</sup> Identifying a firm's possible purposes can also provide a path for a factfinder's analysis of a firm's actions and the credibility of a firm's assertion that it did not hire employees (or that it did hire employees, in the rare case a firm seeks to claim some advantage of employer status).

Making the firm's design for obtaining work a central issue in a dispute about worker status is easily accomplished by following the model of proof laid out in two famous employment discrimination cases, *McDonnell Douglas Corp. v. Green*,<sup>370</sup> and *Texas Department of Community Affairs v. Burdine*.<sup>371</sup>

In a discrimination case, the importance of divining an employer's motive is obvious. In fact, Title VII states that a plaintiff proves an employer's unlawful discrimination by demonstrating that unlawful bias was a "motivating factor."<sup>372</sup> "Direct" evidence of bias is often lacking, but certain biases, such as widespread biases against certain minorities, are easily suspected as

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367. See *supra* text accompanying notes 220-33.

368. See *id.*

369. See *supra* text accompanying notes 226-33.

370. 411 U.S. 792 (1973).

371. 450 U.S. 248 (1981).

372. 42 U.S.C. § 2000e-2(m) (2012).

possible causes of an employer's otherwise unexplained actions.<sup>373</sup> Thus, in *McDonnell Douglas*, the Supreme Court held that a plaintiff armed with certain facts can establish a minimal inference of discrimination that compels a defendant employer to *explain* some alternative reason for taking the challenged action against the plaintiff.<sup>374</sup> In other words, the burden of production shifts to the employer to present a "legitimate nondiscriminatory reason" for its action, and an employer's failure to offer a legitimate nondiscriminatory reason permits an inference that the employer was motivated by an illegal reason.<sup>375</sup> As a practical matter, the employer must offer some explanation to avoid a judgment for the plaintiff. In *Burdine*, the Court explained that the employer need only "articulate" its nondiscriminatory reason, but must do so by admissible evidence.<sup>376</sup> Explaining by witness testimony or other admissible evidence creates a target for the plaintiff. And a plaintiff lacking any other evidence of discrimination can attack the credibility of the employer's explanation.

The effect of these rules for the order of proof is to clear a path for a plaintiff, even when the circumstantial evidence is otherwise inconclusive. The issue whether the employer's explanation is true becomes a proxy for—or at least an important part of—the ultimate issue of discrimination. In fact, a plaintiff's entire case might rest on nothing more than disproving the employer's nondiscriminatory reason.<sup>377</sup>

A similar rule compelling an employer's provable and credible explanation could aid the parties' proof and the factfinder's analysis in a dispute over worker status. The actual function of such a rule would operate with one important difference in a worker status dispute. Whereas a rule compelling an employer's explanation is a solution for a shortage of evidence in discrimination cases, such a rule is a solution for an over-abundance of facts and "factors" in a worker status dispute.

The first part of a rule modeled after *McDonnell Douglas* is a set of facts that, left unexplained, permits an inference supporting the plaintiff's claim that workers are a firm's employees.<sup>378</sup> A

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373. *McDonnell Douglas*, 411 U.S. at 804-05.

374. *Id.* at 801-03.

375. *Id.* at 802; *see also Burdine*, 450 U.S. at 254-56.

376. *Burdine*, 450 U.S. at 254-56.

377. *See Reeves v. Sanderson Plumbing Prods., Inc.*, 530 U.S. 133, 146-48 (2000).

378. *See Burdine*, 450 U.S. at 254 n.7 (citing *McDonnell Douglas*, 411 U.S. 792).

firm's potential motivation to avoid regulations is obvious and probably widespread. Nevertheless, just as an employer's illegal bias must not be presumed at the outset, neither should a firm's intent to evade regulation be presumed at the outset.

To support a preliminary inference that workers are a firm's employees, the plaintiff might present facts showing that the relationship between the firm and the workers is at least ambiguous and includes some attributes of employment. Such a showing might include facts frequently presented as evidence of employment under the traditional control-centered multi-factored approach, such as a firm's control over some aspect of work procedure.<sup>379</sup> For example, if a plaintiff had challenged Winchester's inside "contractor" arrangement, the plaintiff might have pointed to Winchester's use of its control of the worksite to control the contractors' schedule and Winchester's exercise of higher management with respect to finance and supplies.<sup>380</sup> Alternatively, a plaintiff might have presented facts suggesting the firm's motivation to hire employees under the theory of the firm. A plaintiff challenging Winchester would note Winchester's risk of a "hold-up" by inside contractors and its strong motivation to prevent holdups by wielding as much fiat as possible.

A plaintiff's evidence should be subject to a minimal standard of sufficiency at this stage. For example, the standard might be whether the plaintiff has shown that the workers' relation with the firm is at least ambiguous. This is not to say that the plaintiff avoids the ultimate burden of persuasion. However, a function of the plaintiff's initial *prima facie* case is to shift the burden to the defendant firm to articulate its strategy to "buy" work under ambiguous circumstances. Assuming the firm is unable to negate the specific facts the plaintiff has alleged to create the ambiguity, the firm will be compelled to explain why it is "buying" and how its conduct is consistent with buying in order to avoid the inference that it is hiring. For example, Winchester, if challenged, might have presented evidence that the real management, and not just supervision of component production, remained in the hands of the inside contractors.<sup>381</sup> Winchester could have adduced in-

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379. *See supra* text accompanying notes 83-86.

380. *See supra* text accompanying notes 131-38.

381. *See supra* text accompanying notes 143-46.

stances of the inside contractors effective resistance to Winchester's management, including their resistance to Winchester's establishment of standardized rates of pay.

Just as an employer's "legitimate nondiscriminatory reason" establishes an issue upon which the parties in a Title VII lawsuit can focus their attention and argument, an employer's explanation of its decision to "buy" arranges otherwise seemingly random facts about an ambiguous firm-worker relation into a more coherent picture, based on how firms really design their relations and arrange work.<sup>382</sup> And as in an employment discrimination case, the final stage of the presentation of evidence and analysis is the "pretext" stage. Is the employer's explanation for "buying" a "pretext" for "hiring?" In the Winchester case, for example, it might be that while the inside contractors supervised the work, there was little of importance left for them to "manage." For example, the process and procedure was designed in advance by Winchester, and Winchester engaged in nearly all the other higher management functions for the contractors. Moreover, the contractors formed a secure supply of work for Winchester, and were bound by substantial income dependency.<sup>383</sup>

Making the theory of the firm a part of the substantive law of worker status appears to tip somewhat in favor of employee status for a larger number of ambiguous workers.<sup>384</sup> This tilt is because the theory of the firm elevates the importance of higher management of the work and discounts the importance of some traditional factors such as direct supervision or a worker's right to moonlight (working two jobs and serving two employers at once). The theory of the firm might also be more likely to lead to employee status for a worker who appears to be an independent firm because that worker employs subordinate workers. A law based on the theory of the firm might be more likely to treat such a worker as the firm's supervisory employee, supervising other employees of the firm.

The more important effect of inclusion of the theory of the firm is likely to be on the procedural side. The clarity achieved by a rule demanding the firm's explanation works mainly to the advantage of the challenger for several reasons. First, a theme or

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382. See *supra* text accompanying notes 239-58.

383. See *supra* text accompanying notes 129-38.

384. See *McDonnell Douglas Corp. v. Green*, 411 U.S. 792, 804-05 (1972).

conception of the firm's "make or buy" decision can guide the challenger in the search for relevant facts during the pleading, discovery, and trial preparation process. Second, the challenger's presentation of evidence will have a central theme, the "make or buy" decision, which is more relevant and meaningful in the modern world than a simple notion of control. Third, by shifting the burden of explanation to the firm, the challenger also shifts an important part of the burden of the litigation to the defendant: Assembling and relating facts to a pair of alternative pictures of the working arrangement. Was the firm buying, or was it hiring, and why did it make the choice it alleges it made? The challenger will then have a clear target, and can present the case at least in part as a test of the credibility of the firm's explanation. It is, in general, easier to rebut than to build.

This burden shifting approach can also aid the factfinder. The factfinder will have a more refined and coherent issue to address and, if the parties have done their jobs, a better organized, and more comprehensible collection of facts to absorb. A debate over a firm's reason for "buying" and actions in buying results in a clearer question for the factfinder. The analysis has a storyline. What were the firm's motivations, how did it design its relations with the suppliers of work, and is the firm's version of the story credible?

Another important advantage of this proposal is that it requires no action by a legislative body. It might be accomplished by the parties to the disputes, especially those who challenge a firm's classification of workers. The challenger needs only to present the evidence, argue the case within the framework of the theory of the firm, and use the theory of the firm to challenge the firm's credibility. Courts might be happy to embrace the theory and adopt the burden shifting procedure described in this article if they experience and appreciate the advantages of this approach to the litigation process.

## VI. CONCLUSION

"Employee" status is not necessarily the best rule of coverage for worker protection statutes, but employee status remains legislators' favorite rule. It is far from clear that there are any practical alternatives. For now, and probably for much longer,



we will be debating who is an “employee” and who is not. The theory of the firm offers significant insight for answering the question based on the realities of firm behavior and the relationship between firms and workers. To know whether a firm did one thing or another, it is helpful to know its motivations and its design. The current tests of worker status take little account of firm motivation or intent.<sup>385</sup> The theory of the firm cures that omission and offers a clearer road for the parties who argue or decide worker status issues.

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385. *See supra* text accompanying notes 367-77.