

## EDO ESHET

DEAN, SAPIR ACADEMIC COLLEGE LAW SCHOOL

## THE KOTA CASE

In April 2021, the Israeli National Labor Court delivered its landmark decision in the KOTA case<sup>1</sup>. In a 200-page decision the labor court clarified a troubling question in Israel's labor law - the proper legal mechanism to be utilized in cases of retroactive declaration of employment status. This short note will first briefly examine the necessary legal background of the Kota case decision **(I)**, followed by a summary of the case **(II)** and a short note on status and contract under Israel's current labor law **(III)**.

**I - BRIEF LEGAL BACKGROUND**

Under Israeli labor law employees enjoy protected legal « status », covered by substantial protective legislation and collective rights and obligations, while independent contractor rights are determined exclusively by contract law.

The terms « employee » and « employer » are not defined in Israel's labor legislation. Therefore, since its establishment in 1970, it was the specialized judiciary tribunal in Israel, the labor court, which over the years was entrusted with the difficult task of defining and formulating the proper definition and meaning of these terms. During these years Israel's labor courts (and the National Labor Court in particular) developed a rich set of combined legal and factual tests which aim to distinguish, to the extent possible, between an employee and an independent contractor in Israel's labor law. Currently, the main test to be utilized is the integration test. This test evaluates the work performer's level of integration in the work provider's enterprise or organizational framework, while also verifying that the work performer does not use his or her own organizational framework or enterprise to supply the disputed work<sup>2</sup>.

One of the main problems with the judicial determination of employment status is its obvious and quite natural retrospective nature. Under Israeli labor law there is no external legal mechanism which can be used by the contracting parties to reduce the ambiguity surrounding work relationships. Therefore, it is only after the relationship between the parties has ended that the question of its proper legal definition is subject to judicial scrutiny.

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1 NCL 15868-04-18 *Kota v. the City of Raanana and el.* (2022).

2 NCL 3/27-31 *The City of Netanya v. Birger* (1971).

Based on Israel's common law legal tradition, in its decisions the National Labor Court does not only determine, retroactively, the proper legal relations between the contracting parties of the particular dispute to be adjudicated. It is also entrusted with the task of shaping and determining the proper legal norms which should govern, in the absence of legislation, these legal questions. Setting the proper precedent that will affect the future behavior of the parties serves as an important role in the casuistic legal development of Israel's labor law<sup>3</sup>.

Under Israel's adjudicated legal norms prior to the Kota case, if A was declared an employee by the labor court, but originally was considered an independent contractor by the mere wording of the parties' contract, then A was entitled only to the monetary benefits which he or she had lost, based on his or her false classification as an independent contractor<sup>4</sup>. Israel's labor court traditionally emphasized that it cannot « turn back the wheel » by magically turning a falsely classified independent contractor into an employee. For example, the labor court stressed that some non-monetary rights which the false independent contractor had lost, due to his or her false status, could not be compensated by the retroactive nature of the adjudication declaration, such as the opportunity to be promoted by the enterprise over the years, or the opportunity to join the enterprise bargaining unit and to be represented by the exclusive trade union<sup>5</sup>.

Nevertheless, under the proper set of circumstances, when the labor court declared that A is an employee rather than an independent contractor, it stressed the need to award A his or her entitlements as an employee, while also deterring future employers from falsely classifying employees as independent contractors. By doing so the court reprised the cogent nature of employment relations under Israeli legal doctrine and depicted employment relations as similar to a « status » which is beyond the party's power of control by using contractual means.

Furthermore, the labor courts acknowledged the inherent imbalance of the employment relationship, and traditionally were unwilling to accept the employer's allegations of employee bad faith behavior due to his or her reneging on the original wording of the contract, which classified the relations as a business relationship between an independent contractor and his or her customer<sup>6</sup>.

A problem occasionally arose when the labor court declared that B is an employee rather than an independent contractor and sought to award B his or her entitlements as an employee as deriving from this declaration.

3 E. Eshet, « Labor Law », *Israeli Legal System*, Walter, Medina, Scholz, Wabnitz (eds.), 2018.

4 For example, entitlement to severance payment according to Israel's Severance Pay Law 1963, entitlement for overtime payment according to Israel's Hours of Work and Rest Law 1951, and entitlement according to universally declared collective agreements such as the Mandatory Pension Law 2008. All aforementioned entitlements only apply to employees.

5 For Israel's exclusive representation model see E. Eshet, « Coercion and Freedom in Labor Law: American, Canadian, and Israeli Perspectives », *International Journal of Comparative Labor Law and Industrial Relations*, vol. 33, no. 4, 2017, p. 489.

6 Although in rare cases, in which the employee acted in extreme bad faith, the National Labor Court acknowledged the theoretical possibility of rescinding the employment status due to such behavior. See NCL 154/3-45 *State of Israel v. Buchris* (1997).

Let's assume an independent contractor *B* received remuneration above and beyond his or her salary (and entitlements) as an employee. Should that circumstance be ignored by the labor court? Should the labor court declare *B*'s claims as breach of his or her good faith requirement? Should the labor court offset *B*'s remuneration as an independent contractor against *B*'s entitlements as an employee? Prior to the Kota case the labor courts were divided on these issues. Several judges maintained that *B*'s remuneration should be offset against his or her entitlements as an employee only in cases where *B*'s bad faith was proved, and *B*'s remuneration as an independent contractor outweighed his or her entitlements as an employee. Some ordered not only offsetting but also partial restitution<sup>7</sup>. Still others set different thresholds for ordering offsetting. Thus, offsetting was the main tool utilized by the labor courts to deter employers from false classification of employees as independent contractors. It was against this legal background that the Kota case was decided.

## II - THE KOTA CASE

Seven judges and two lay judges adjudicated the Kota case over 200 pages, deciding on two main questions<sup>8</sup>. The first question, about which all the bench agreed, pertained to the proper legal mechanism to be utilized in retroactive declarations of employment status. The court decided that there was a need to change the deterrence tool in retroactive classification cases, from the binary offsetting option to a more delicate mechanism - judicial determination of non-monetary compensation<sup>9</sup>.

This change was also justified by academic writing which elaborated on the flaws in using the dichotomic offsetting option and recommended adopting a more sensitive and just legal mechanism aimed at deterring future employers from false classification of employees<sup>10</sup>.

The court's decision articulates the proper method of dealing with entitlements stemming from reclassification of an independent contractor as an employee. According to the court, the first step is to award monetary compensation to the employee, based on the monetary damage the employee suffered from their false classification. The calculation is based on balancing the theoretical employee's compensation (salary and other monetary benefits) as an employee with the actual

7 Meaning that the declared employee should restate the payments he or she received as an independent contractor which exceeded their entitlements as an employee.

8 The Kota case was decided by a full bench of judges of the National Labor Court and was long anticipated by the legal community. The decision in this case combined three similar cases. Regarding the court's use of its decision to raise awareness about the law see G. Davidov et E. Eshet, « Improving Compliance with Labor Law: The Role of Courts », *Comparative Labor Law & Policy Journal*, vol. 34, no. 1, 2023, p. 71.

9 The court also recognized the punitive aspects of non-monetary compensation, see p. 126.

10 See G. Davidov, « Contractual Stipulation Concerning 'Employee' Status and its Implications », *Mishpatim*, no. 50, 2020, p. 87 (Hebrew); Y. Procaccia, « On Misclassifications, Efficient Deterrence and the Law of Employment », *Tel Aviv University Law Review*, no. 43, 2020, p. 171 (Hebrew).

remuneration they received as an independent contractor<sup>11</sup>. In cases where the independent contractor's remuneration exceeded that of the theoretical employee's compensation, mandatory offset will be utilized<sup>12</sup>. In other cases, the employee should be awarded the monetary compensation.

The second step is to determine the non-monetary compensation and its extent. The court decided that compensation should be awarded in all cases which involve false classification unless the employer convinces the court to refrain from its award. The court explains that some employment-based rights (tenure, promotion) cannot be monetarily determined, and therefore cannot be compensated through the first step. Another important justification for awarding non-monetary compensation is the need to properly deter employers from false classification<sup>13</sup>.

The second question, on which the court was divided, dealt with the possibility of rescinding the employment status due to the employee's bad faith<sup>14</sup>. According to the lead minority opinion, written by the Chief Justice of the court, Justice *Virt-Livne*, due to changes in technology and in the modern workplace (remote work, outsourcing), and due to the need to recognize the mutual need for flexibility in determining the work relationship, it is justified, in proper cases, to provide a contractual leeway to the contracting parties<sup>15</sup>. This required leeway led justice *Virt-Livne* to recognize a possibility in which employee bad faith could prevail over the « status » of employment, at the initial phase, thus, removing the need to calculate the employee's entitlements as such.<sup>16</sup>

The majority opinion emphasized the principle of *jus-cogens* on which Israeli labor law was built, and was reluctant to recognize recent labor market changes as requiring adaptation of this fundamental principle. According to the majority opinion, since employment relations are close to employment « status », the proper « geometric-normative point »<sup>17</sup> in taking into consideration good or bad faith behavior is during the second phase. It is in this phase that entitlements are

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11 According to the decision, the employer bears the burden to prove the theoretical salary of the employee, otherwise, the employment entitlements will be constructed based on the independent contractor's actual remuneration.

12 See *Kota* case, p. 57. The court also invalidated the employer's claim for restitution of payments from the employee, thus limiting the balancing to only offsetting.

13 See *Kota* case, p. 58, 59. The court suggests a variety of considerations in deciding to award non-monetary compensation, while also determining its amount.

14 For example, if the evidence shows that the individual deemed to be the employee specifically demanded from the other party to be considered an independent contractor and not an employee due to his or her tax or other benefits, and later brought a claim to recognize him or her as an employee.

15 See *Kota*, p. 30.

16 The Chief Justice's opinion was supported by the opinions of Judge *Poliak*, Judge *Soffer* and Lay judge (Employers) *Lifshitz*.

17 An idiomatic phrase coined by Prof. Aaron Barak (former Chief Justice of the Israeli Supreme Court).

determined, not during the first phase in which legal classification of the work relationship is determined<sup>18</sup>.

In summary, in the eyes of the Israeli National Labor Court employment relations resemble « status », which cannot be waived by the employee or by the employer. Also, it should not depend on a good (or bad) conduct requirement, but on legal tests formulated over the years to distinguish between an employee and an independent contractor.

### III - A(NOTHER) NOTE ON STATUS AND CONTRACT

The tension between status and contract in labor law is neither new nor local. Nevertheless, it is quite odd that in 2022 Israeli labor law, as reflected in the Kota case, is still deliberating this issue. Maine's Ancient Law, formulated in 1861, never meant to describe modern employment relations. On the contrary, according to Maine, when referring to labor relations - « the status of the Slave has disappeared - it has been superseded by the contractual relation of the servant to his master »<sup>19</sup>. It was Prof. Kahn Freund who correctly distinguished between two separate legal techniques, between Maine's concept of legal «status» and England's labor law which can be conceptualized as placing limitations on the traditional freedom of contract<sup>20</sup>. Hence, labor relations are not considered legal « status », at least not through Maine's ancient lens, or Kahn Freund's modern lens<sup>21</sup>.

While Kahn Freund's note on status and contract was accurate, it was not complete. It dealt with the conceptualization of employment relations when their existence is not in question. In this case, as he rightly argued, these relations cannot be depicted as Maine's legal « status », but as a body of legal norms which supersede the parties' contractual freedom, as in other jus-cogens areas, such as consumer protective law.

However, the Kota case dealt with a slightly different question. It attempted to conceptualize the legal essence of employment relations when there is a preliminary question if they exist at all. One cannot find the answer to this question in Kahn Freund's note nor in Maine's writing. In the Kota case the Israeli National Labor Court

18 See p. 108 - 116 (juge Davidov-Motola); p. 154-158 (juge Itach & juge Gliksman); p. 171-172 (juge Ofek-Gandler); p. 190 (juge laïc Ron).

19 Sir Henry James Sumner Maine, *Ancient Law, Its Connection to the History of Early Society*, 1861, p. 99.

20 O. Kahn-Freund, *A Note on Status and Contract in British Labor Law, The Modern Law Review*, vol. 30, no. 6, 1967, p. 635. See on p. 640 his definition of employment relations: « (...) a legal relation-based agreement regulated by law, in the sense that its existence and its termination depended on the volition of the parties but its substance was determined by legal norms withdrawn from the contractual freedom parties ».

21 Sir H. J. S. Maine, *Ancient Law, Its Connection to the History of Early Society*, *op. cit.*, p. 99: « Starting, as from one terminus of history, from a condition of society in which all the relations of Persons are summed up in the relations of Family, we seem to have steadily moved towards a phase of social order in which all these relations arise from the free agreement of Individuals »; p. 100: « ... we may say that the movement of the progressive societies has hitherto been a movement from Status to Contract ».

provided us with some insights about the legal landscape of employment relations under Israeli law, but its unwillingness to take into consideration contractual practices, and its movement toward status-like legal concepts, requires further examination which is beyond the scope of this short note.

To summarize, the Kota case introduced a novel and progressive tool for achieving deterrence in retroactive classification cases by adopting non-monetary compensation while safeguarding and reinforcing the traditional *jus cogens* legal meaning of employment relations under Israel's labor law.