

## Paying A Price For Misclassifying Workers In Calif.

*Law360, New York (September 22, 2011, 12:35 PM ET)* -- On Sept. 8, 2011, the California legislature passed Senate Bill 459 prohibiting the willful misclassification of individuals as independent contractors. Labeled by some as the "Job Killer Act," this new legislation creates civil penalties of between \$5,000 and \$25,000 per violation. In addition to making it illegal to willfully misclassify individuals as independent contractors, the new law will also prohibit charging fees to or making deductions from the compensation paid to those misclassified workers. Although still requiring Gov. Jerry Brown's signature, it is anticipated that this legislation will become law within 30 days.

### The Law

SB 459 adds two new Labor Code sections, 226.8 and 2753, which set forth the provisions of the new law with which all employers need to comply. Specifically, section 226.8(a) provides that it is unlawful for any person or employer to willfully misclassify an individual as an independent contractor. An employer who has willfully misclassified an individual is also prohibited from charging that individual a fee or making any deductions from the individual's compensation where such fee or deduction would have been prohibited if the individual were not an independent contractor.

Subdivision (a) of 226.8 also provides a list of the prohibited fees and deductions, including goods, materials, space rental, services, licenses, repairs, maintenance and fines. Subdivision (b) imposes penalties of between \$5,000 and \$15,000 for each violation in addition to any other penalties permitted by law. Under this new legislation, every deduction or fee charged to a willfully misclassified independent contractor could give rise to a separate penalty. Moreover, if either the Labor Workforce Development Agency (LWDA) or a court determines that the person or employer has engaged in a pattern or practice of violations, the penalty is increased to between \$10,000 and \$25,000 per violation. (§ 226.8(c)).

Section 226.8 also includes a non-monetary penalty. Any person or employer who has violated subdivision (a) must prominently display a notice on its Internet website (or if there is no website, in an area accessible to all employees and the general public) which states: (1) it has committed a serious violation of the law by engaging in the willful misclassification of employees; (2) it has changed its business practices to avoid further violations; and (3) that any employee who believes he is being misclassified may contact the LWDA.

The notice must also include the mailing address, email address and telephone number of the LWDA. (§ 226.8(e)). Additionally, the notice must be signed by an officer (or owner) and must be posted for one year. (§ 226.8(f)). The new law also provides that any licensed contractor who violates section 226.8(a) must be reported to the Contractors' State License Board, which must initiate disciplinary action against the offending contractor. (§ 226.8(d)).

To prevent employers from avoiding these penalties and notice requirements, successor corporations or businesses are liable for the former entity's acts where one or more of the same principals or officers are engaging in the same or similar business. (§ 226.8(h)).

Significantly, the version of SB 459 passed by the Senate was much watered down from the version initially proposed. The initial proposal contained onerous record-keeping requirements, that would have required employers to keep records related to all independent contractors for two years. It would also have made it a misdemeanor to fail to keep those records or provide the LWDA access to them.

The proponents of the original bill also wanted all employers to give independent contractors a form created by the California Employment Development Department (EDD) specifying (1) that they were classified as an independent contractor; (2) the factors used by the EDD to determine independent contractor classification; (3) the details of the independent contractor's tax obligations; (4) the telephone numbers for the EDD and the labor commissioner; and (5) a notice that they could seek advice regarding their employment status. While these provisions were also dropped, they may resurface in the future.

## **Purpose**

According to proponents of the legislation, reports show that 10 to 30 percent of employers misclassify workers as independent contractors, costing the state billions in lost revenue. In 2008, the Tax Audit Program conducted 6,356 audits and investigations, resulting in assessments totaling \$193,761,599 and identifying 64,539 previously unreported employees.

Proponents argue that this legislation will help address the loss of standard employee protections, such as minimum wage, overtime, health and vacation benefits, antidiscrimination laws, and safety regulations, which do not apply to independent contractors. Although affecting all industries, the new law will have a significant impact on construction and transportation companies as well as employers using seasonal, short-term, and direct salespersons.

## **The Test for Independent Contractors vs. Employees**

This new law is particularly troublesome because the test for establishing whether a worker is an employee or an independent contractor is far from straightforward. Indeed, the California Department Of Industrial Relations states on its website: "There is no set definition of the term 'independent contractor' for all purposes, and the issue of whether a worker is an employee or independent contractor depends upon the particular area of law to be applied."

Generally, an employee is an individual hired to perform services where the employer retains the right to control the manner and means of the employee's work. In contrast, an independent contractor is under the control of the principal only as to the result of his work and not as to the means by which such result is accomplished. Courts have established a multifactor test to differentiate between these two standards, which is highly fact-dependent. Under this new law, applying that test correctly is going to be critical to avoid the hefty penalties associated with getting it wrong.

## **Enforcement**

The labor commissioner is charged with enforcement of this new law, but like other provisions of the Labor Code, it gives affected individuals the right to file a complaint. Although the bill does not specifically list its provisions under the Private Attorney General Act (PAGA), it could potentially give rise to PAGA representative actions as well.

## **What Does It Mean For Your Business?**

The potential civil penalties arising from this new law are astronomical. For example, consider the penalties for a worker improperly classified as an independent contractor who is charged a fee to rent equipment essential to perform his duties. The civil penalties for one year for this one individual could be tens of thousands of dollars depending on the interpretation of "each violation" and the penalty imposed. That penalty could rise into the hundreds of thousands of dollars if a court finds a pattern and practice of willful misclassification. Multiply that by dozens or hundreds of misclassified workers and the numbers spiral out of control.

The true impact of this new legislation, however, will hinge on the interpretation of "willful misclassification." Originally defined as "voluntary and intentional," the bill now defines willful misclassification as "avoiding employee status for an individual by voluntarily and knowingly misclassifying that individual as an independent contractor." This change was intended to reflect a heightened standard so as to avoid unintended consequences. Indeed, legislative staff commented during passage of the bill that "willful, generally an intentional or voluntary violation of a known legal duty, is a higher test and may make it more difficult to find a violation, thereby constraining the number of enforcement actions."

In discerning the meaning of "willful misclassification" other Labor Code provisions that apply a willfulness standard may also be instructive. Terms such as "knowingly and intentionally" (§ 226.6) and "willful misconduct" (§ 4553) have been interpreted to suggest that "willfulness" requires the person to know that the thing which they are doing is wrong. Indeed, the California Supreme Court, in analyzing willfulness in the context of one Labor Code provision, stated: "Willfulness necessarily involves the performance of a deliberate or intentional act or omission regardless of consequence." *Mercer-Fraser Company v. Industrial Accident Commission* (1953) 40 Cal. 2d 102, 117.

## **Conclusion**

Employers should be vigilant to ensure that they have a sound basis for their decision to classify workers as independent contractors to avoid these penalties. Although the California Supreme Court's previous interpretation of "willfulness" suggests that employers will be protected unless they know that they have misclassified workers, interpretations can change between different statutory provisions, and this law remains untested.

Furthermore, where workers raise concerns about their classification, employers cannot simply put their head in the sand and claim ignorance of the misclassification. At a time when the state is desperate for revenue, this is one to watch.

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