A Timely Analysis of Legal Developments

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New California Law Discourages Independent Contractors and Sole Proprietorships by Potentially Penalizing Businesses that Use Their Services

By GJ Stillson MacDonnell and Alison Hightower

In the last hours of his opportunity to veto new legislation, California Governor Jerry Brown signed SB 459. Similar to a bill previously vetoed by former Governor Schwarzenegger and dubbed the "Job Killer Act" by business, SB 459, effective January 1, 2012, might be called by some critics the "Small Business Killer Act." Championed by organized labor and supported by Democratic legislators, the practical consequences could prove to discourage businesses from utilizing independent contractors based in California, while also discouraging service-providing sole proprietorships and other independent contractors from providing services to other businesses in California.

What Does This Law Do? The Highlights

The new law:

- Potentially discourages the engagement of independent contractor/sole proprietorships by penalizing employers who commit a "pattern and practice" of "willfully misclassifying" such service providers up to $25,000 per violation.
- Provides for joint and several liability for consultants (excluding practicing lawyers) who advise employers on such independent contractor engagements.
- Makes it unlawful to charge "misclassified" independent contractors any fee or take deductions from the compensation paid such contractors.
- Provides that the penalties are in addition to existing penalties, interest and taxes that may be imposed at the state level for misclassifying contractors.
- Appears to concentrate enforcement with the Labor Commissioner, but also provides for private action, potentially including Private Attorney General Act (PAGA) lawsuits.
- Does nothing to clarify who is an independent contractor versus an employee, although it defines "willfully misclassifies."
- Effectively requires a one-year public prominent posting (on a website or at a worksite) of notice that the entity was found to have willfully misclassified an independent contractor.

Basically, under this newly enacted statute any entity that "willfully misclassifies" an individual as

an "independent contractor," when that individual is determined to have actually been an "employee," faces new stiff civil penalties and other repercussions. The law amends the Labor Code to add two new sections, Labor Code sections 226.8 and 2753.

New Penalties for Misclassification

Under this new statute, the California Labor and Workforce Development Agency can fine an entity that "willfully misclassifies" an "employee" not less than $5,000 and up to $15,000 per violation. Further, if that entity is found to have engaged in a "pattern or practice" of misclassification, then those fines are ratcheted up to a minimum of $10,000 per violation, with a cap of $25,000 per violation.

"Willful misclassification" means avoiding employee status for an individual "by voluntarily and knowingly misclassifying that individual as an independent contractor." As with penalties for willfully failing to pay employees their final pay, employers will argue that a good faith dispute over the individual's classification should defeat the necessary "willful" conduct.[1] However, until the courts interpret the statute, what standard is applied and what constitutes "voluntarily and knowingly misclassifying" an individual will remain open for debate.

While seemingly delegating express authority to the Labor Commissioner, the new law also potentially identifies as "enforcers" all the agencies, departments, commissions, boards and divisions of the California Labor and Workforce Development Agency (LWDA). The LWDA is a "super agency," encompassing not only the Labor Commissioner (under the Department of Industrial Relations), but also the Workers' Compensation Board, the Employment Development Department (EDD), and the California Unemployment Insurance Appeals Board (the Board to which appeals are made from EDD assessments).

The Labor Commissioner and the other agencies within the LWDA can enforce the penalties administratively or through a civil suit.

The Backstory

SB 459 partially evolved from legislation vetoed by Governor Schwarzenegger, which would have penalized employers (2007 SB 622, Padilla) and consultants advising employers (2008 SB 1583, Corbett) with respect to "misclassified" employees. SB 459, like most California legislation, started out as a bill involving another Labor Code section and was almost immediately amended into a bill that will penalize misclassification of workers.

All of these bills were predicated on the legislature's perception of widespread misclassification of employees as independent contractors, particularly relying on statistics compiled through certain California enforcement activity and on the conclusions contained in a 2007 U.S. Government Accountability Office (GAO) report.[2] The California statistics assume that the agencies were correct in their analyses of how many workers were "misclassified." The GAO report relied upon by the legislature did not provide any statistics on misclassified workers. Instead, it found that the United States Department of Labor's audit process did not generally encompass examination of worker status. In addition, the GAO provided extended analysis of the contrast between the "benefits" provided to employees versus independent contractors. The GAO report thus did not address the legitimacy of the use of independent contractors.

Law Specifically Targets the Construction Industry

Presumably because the legislature believes that the construction industry is misclassifying a significant number of independent contractors, the law also specifies that any final determination of misclassification by a state-licensed contractor will be sent to the Contractors' State License Board, which "shall" initiate disciplinary action against a licensee within 30 days. The legislation does not specify the nature of that disciplinary action.

Prohibits an Employer from Imposing Fees or Deductions on Misclassified Workers

The new statute also makes it unlawful to charge a "willfully" misclassified independent contractor a fee, or to make "any deduction from compensation for any purpose" from payments to such "misclassified" workers." Examples of such unlawful deductions are those made for the purpose of having the contractor pay for "goods, materials, space rental, services, government licenses, repairs, equipment maintenance, or fines arising from the individual's employment where any of the acts described in this law would have violated the law if the individual had

not been misclassified." If the workers should have been classified as "employees," such expenses might be reimbursable business expenses under Labor Code section 2802, but the new law renders a much steeper penalty for failing to reimburse misclassified independent contractors for these expenses.

Of course, one of the traditional indicia of an independent contractor is that contractors have recurring business expenses. Under this provision, it is advisable for businesses that continue to utilize the services of independent contractors to refrain from charging fees or taking deductions and let such contractors procure on their own what is needed.

Internet Notice Required of Any Employer Found to Have Misclassified

In addition to imposing new civil penalties for willful misclassification and charging unlawful fees or making prohibited deductions, the new law imposes a novel remedy. It authorizes the agency or a court to require a violator of the law to display "prominently" on its public website—in an area accessible to all employees and the general public—a notice that states that the agency or a court has found that the person or employer engaged in the willful misclassification of employees, that the employer has changed its business practices to avoid committing further violations of this law, and informing persons who believe they have been misclassified how to contact the LWDA.

This notice must be posted for a full year after the "final" decision has been issued, meaning after all appeals have been exhausted. And any violator without a website must instead post the notice in a "prominent" location where a violation occurred accessible to both employees and the general public.

Consultants to Share Joint and Several Liability

Another important feature of this new law—added as Section 2753 of the Labor Code—is that any consultant, non-practicing lawyer or other person who receives valuable consideration for knowingly advising an employer to treat an individual as an independent contractor to avoid employee status will be jointly and severally liable with the employer if that individual is determined by the court or an agency not to be an independent contractor. Thus, if the employer cannot pay the fine, the agency or prosecuting employee can look to this advisor to pay it.

The law does exempt from this joint and several liability a person who provides advice to his or her employer as well as attorneys who provide legal advice in the course of the practice of law.

Judicial Enforcement Could Fuel Class and Representative Actions

In addition to administrative enforcement, SB 459 also permits these new penalties to be assessed by the state and federal courts. The statute thus is likely to spawn more litigation over the use and classification of independent contractors.

Private plaintiffs' attorneys also may bring suit on behalf of individuals to challenge their independent contractor status and seek unpaid overtime and other compensation, including by a class action, as they have done for many years. Plaintiffs' attorneys may sue on behalf of a group of contract workers as a "private attorney general" action based on California's Private Attorney General Act (Labor Code sections 2698 *et seq.*). PAGA empowers individuals to bring a lawsuit as a purported stand-in for the attorney general in order to seek any civil penalty that the LWDA or its departments could seek for a violation of the Labor Code. The penalties afforded by SB 459 are significantly greater than any penalty imposed by any other Labor Code provision, including the PAGA "default penalty" of $100 per violation. As PAGA is currently written, the aggrieved employee would have to give the employer 33 days to "cure" the "violation" before bringing a PAGA claim, placing the business in the quandary of deciding whether to re-classify these independent contractors as employees or fight in court.

Law Provides No Guidance on Who Is an Independent Contractor

The difference between an "employee" and an "independent contractor" remains far less than crystal clear, and although entering into a contract with the worker specifying that the parties understand the worker to be an "independent contractor" is helpful, it is never dispositive when challenged. To make matters worse, different legal tests are used by different California agencies and by the courts. The IRS has its well-known 20-factor test, while the EDD has a 10-factor test, and the Labor Commissioner heavily relies on the "economic realities" test.[3] There is

no checklist that an entity can use to be sure that a worker is properly classified as an independent contractor under the various tests. The courts may apply the common law test, or "economic realities" test, or other tests depending on the issues and the "totality of the circumstances."

The *right* of the retaining entity to control the worker remains central to the analysis under all of the tests, even if that right is not exercised. An employment relationship also is more likely to be found when the worker renders services that are critical to the entity's business, such as when a software developer hires software engineers as independent contractors to write computer code needed for the business's core product.

Other factors generally considered include the amount of the worker's investment in facilities and equipment, his or her opportunity to make a profit or incur a loss, the degree of skill and independent initiative required, and the duration or permanence of the working relationship with the retaining entity. While there is no magic cutoff point that indicates a worker has crossed the line from "independent" to "employee," long-term relationships raise warning flags.

With this new law, California has established potentially significant penalties, while failing to establish a clear standard of conduct delineating who is an independent contractor. The law potentially requires entities using independent contractors to have to defend themselves under all of the various tests utilized under California law.

Furthermore, by granting "lead" authority to the Labor Commissioner, the new law may result in that agency using its "economic realities" test to the exclusion of other tests.

Next Steps

- Entities using independent contractors currently in California and/or planning to do so in 2012 should review the status of such contractors, preferably with the assistance experienced California legal counsel. Entities that directly employ independent contractors should exercise caution in continuing to use such persons within California. A legal opinion that supports classification of workers as independent contractors may be the best defense to a claim under the new Labor Code sections, since reliance on such a legal opinion is likely to negate "willful" misclassification.
- Business consultants offering business structuring consulting should consider limiting such services to issues other than the proper engagement of independent contractors.

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[1] *Amaral v. Cintas Corp.*, 163 Cal. App. 4th 1157, 1201-04 (2008) (good faith belief in defense negates finding of willfulness under section 203); *Barnhill v. Robert Saunders & Co.*, 125 Cal. App. 3d 1, 8-9 (1981) (in light of the ambiguity in the law regarding setoffs, employer could not willfully have withheld wages).

[2] U.S. Government Accountability Office, *Employee Misclassifications: Improved Outreach Could Help Ensure Proper Work Classification*, GAO-07-859T (May 8, 2007).

[3] *S.G. Borello & Sons, Inc. v. Department of Industrial Relations*, 48 Cal. 3d 341 (1989).