Employee or Independent Contractor?  
Increased Enforcement Efforts and Enhanced Penalties  
Counsel Review of Non-Employee Classification Practices

Whether viewed from a local, state or federal perspective, it is important that companies utilizing the services of individuals as independent contractor workers as opposed to common law employees ensure that they have appropriately considered relevant factors to ensure the legal and operational compliance of their relationships. Misclassification issues continue to be front and center in state and federal government legislators’ minds, as they review ways to increase their budgets and streamline the receipt of tax revenues.

On October 9, 2011, Governor Jerry Brown signed California Senate Bill 459 (“SB 459”), which adds sections 226.8 and 2753 to the California Labor Code. SB 459, effective January 1, 2012, imposes steep penalties on employers who willfully misclassify employees. This legislation is but one example of a growing effort at both the federal and state level to identify, reclassify, and prevent misclassification of employees as independent contractors, deterring companies from doing so with significant penalties.

The State and Federal Reclassification Initiative

A federal study in 2009 estimated that the U.S. government loses $2.72 billion a year, in inflation-adjusted 2006 dollars, because of employees misclassified as independent contractors. The same report cited an estimate that state governments lose nearly $200 million a year in employment insurance compensation for every 1% of employees who are misclassified. These numbers, together with enormous budget deficits at the state and federal level, have encouraged government officials to unprecedented efforts to deter employee misclassification.

At the federal level, President Obama’s FY 2012 budget request sets aside $240 million for initiatives specifically related to addressing the misclassification of employees as independent contractors. In addition, there are currently two bills pending in Congress that address the issue of worker misclassification. One bill would effectively eliminate the safe harbor provisions of section 530 of the Internal Revenue Code on a prospective basis. Section 530 currently permits employers to continue to treat certain workers as independent contractors (even if they are employees within the meaning of the Internal Revenue Code) if the employers have a long-standing practice of consistently doing so and have a reasonable basis, within the meaning of the Section, for treating those workers as independent contractors. Another bill would amend the Fair Labor Standards Act to impose onerous notification and recordkeeping requirements on employers who retain independent contractors, and it provides for substantial civil penalties for the misclassification of employees as independent contractors. Also, the IRS is currently in the midst of a three-year employment tax audit of 6,000 randomly selected companies.
each year) which it started in February 2010. And in September of this year, the DOL and IRS signed a Memorandum of Understanding (“MOU”) to allow the sharing of information regarding worker misclassification. Seven states have also signed information sharing MOUs with the Wage and Hour Division of the DOL, and the DOL expects to sign similar MOUs with four additional states.

At the state level, in addition to entering into MOUs with DOL, some states have formed task forces to study the misclassification problem, make recommendations and coordinate enforcement activities among state agencies. Also, some states have passed new legislation imposing stiff penalties upon employers who misclassify employees, and some in some cases makes it a crime. For example, in 2010, Connecticut passed such a law, enhancing civil penalties to $300 per day per violation and imposing criminal felony penalties for those found intentionally violating the statute. California has now joined this effort with the enactment of SB 459.

Key Provisions of SB 459

SB 459 makes it unlawful:

• to willfully misclassify an individual as an independent contractor; or

• to charge a willfully misclassified contractor a fee or make any deductions from compensation for any purpose including for goods, materials, space rental, services, government licenses, repairs, equipment maintenance or fines.

In addition, SB 459:

• imposes a civil penalty of between $5,000 and $15,000 for each violation;

• increases the civil penalties to between $10,000 and $25,000 if the employer has engaged, or is engaging, in a pattern or practice of such violations;

• provides for the Contractor’s State License Board to initiate disciplinary action against any licensed contractor that has been found to have violated the Act;

• requires that any person or employer who has been found to have violated the Act to post a website notice (or to display prominently if there is no website) that, the person or employer has been found to have violated the Act and that the employer or person has changed its practices to prevent further violations;

• provides that violations and disciplinary actions shall “remain in effect” against successors if it has one or more principals or officers and is engaged in the same or similar business; and

• provides for joint and several liability for any person, other than an attorney or an employee providing advice to his or her employer, who knowingly advises an employer to treat an individual as an independent contractor to avoid employee status for that individual if the individual is found not to be an independent contractor.
Enforcement

SB 459 authorizes the Labor and Workforce Development Agency ("LWDA") or a court to determine if an employer has violated the provisions of SB 459, and to assess civil penalties. SB 459 also provides that the Labor Commissioner may enforce the statute and assess penalties through Labor Code section 98 proceedings. Despite the Legislative Counsel’s statement that SB 459 authorizes an individual to file a complaint to request the Labor Commissioner to assess penalties, the language of the statute does not expressly authorize an employee to bring such an action, either in court or before the Labor Commissioner.

Employees likely will attempt to recover SB 459 penalties via the California Labor Code Private Attorneys General Act ("PAGA"). Under PAGA, aggrieved employees can bring a representative action on behalf of all other current and former employees to recover civil penalties in the Labor Code that may be assessed by the LWDA. This may include civil penalties under SB 459. Penalties recovered by an employee in a PAGA action are apportioned as follows: 75% to the LWDA, and 25% to the aggrieved employees. Also, although an employee would not be able to recover SB 459 penalties via California’s Unfair Competition Law (Business and Professions Code section 17200 et seq.), the employee could use the UCL to seek injunctive relief.

SB 459 is considered “non-urgency” legislation, meaning it is effective January 1, 2012. The statute does not indicate whether the Legislature intended it to apply retroactively, so enforcement of SB 459 likely will be prospective only. The statute of limitations for the recovery of SB 459 penalties, whether pursued under the statute itself or via a PAGA action, should be limited to one year.

Willful Misclassification

Any violation of the statute requires a showing of “willful” misclassification, but SB 459 provides little guidance as to what is “willful.” Rather, the Act simply defines willful misclassification as a misclassification that is voluntary and knowing, which is also vague.

Whether an individual is an employee or an independent contractor under California or federal law varies depending upon the law being applied. In each case, however, the determination is fact-specific and requires the decision-maker to balance numerous factors. While no single factor is controlling, the most important factor is whether the putative employer has the right to control not merely a worker’s results but the manner and means used to obtain those results. The test is vague and ambiguous. Accordingly, it would seem that a finding of willfulness should be limited to the most egregious cases, particularly in light of the draconian consequences of a violation.

Until further guidance is provided, employers will face numerous questions in attempting to comply with the willfulness standard. For example, if an administrator determines that an individual has been misclassified as an independent contractor under California’s workers compensation laws, must the employer thereafter treat that individual and all others similarly situated as employees under all laws? What if the employer disagrees with the decision of the administrator? What if the employer has an opinion from an accountant or lawyer that the individual was properly classified as an independent contractor? The answers to these questions must await further development.
Charging or Deducting Fees

Providing equipment or supplies or reimbursing a worker for expenses incurred is evidence of employment status. Thus, most companies will avoid paying or reimbursing a contractor for expenses incurred to prevent a finding of employment status. Similarly, if the contractor uses supplies or space provided by the company, the company will charge the contractor appropriate fees so that it cannot be argued that the company is paying for the contractor’s expenses. But this practice would constitute a violation of SB 459 if the contractor was willfully misclassified. Employers should be able to avoid a violation of this fee provision even in the case of a willful misclassification, however, by requiring the contractor to obtain any necessary supplies, tools or equipment from unrelated third parties. The employer could still be liable under Labor Code section 2802, if that section – which requires employers to indemnify employees for expenditures or losses incurred in discharging employment duties – applies to ordinary expenses, as some courts have held.

SB 459 is silent concerning what constitutes a separate violation of the fee provision. Does it constitute a violation of SB 459 each time it charges a fee to a misclassified independent contractor (the Act does not expressly say so), or is it a violation for each misclassified contractor who is charged a fee or is subjected to a deduction? Again, further guidance is necessary to answer this question.

Other Ambiguities

As noted above, SB 459 provides for a range of civil penalties for each violation. But no guidance is provided as to what merits a $5,000 penalty or $15,000 penalty. There is also no guidance as to what constitutes a “pattern or practice” that will result in larger civil penalties.

Recommendations

In light of federal initiatives and California’s enactment of SB 459, employers should consider taking various steps to evaluate their existing independent contractor relationships:

- Develop and publish a corporate policy on the engagement of independent contractors and the management of those relationships. As part of this policy, require that approval be obtained from a knowledgeable employee before any independent contractor relationship is established.

- Train employees who manage independent contractor agreements as to how to work with independent contractor relationships.

- Ensure that the company has a well-written independent contractor agreement for each contractor, that it is accurate, complete, and individually negotiated.

- Audit the company’s independent contractor relationships, including a review of any past decisions or determinations concerning independent contractor status.

- Obtain a written legal opinion from counsel regarding the appropriateness of the classification of workers as independent contractors, based on counsel’s understanding of the specific factual situations at issue.

This new legislation raises additional complex questions beyond the scope of this analysis. For example, even though the Act does not contain an express right of action, does it support an implied one? If you would like to discuss any of these issues further, please contact a Seyfarth Shaw attorney.
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