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May 2010

The California Supreme Court ruled in *Martinez v. Combs* that, for purposes of a suit to recover minimum or overtime wages due, the definition of employer under the California wage orders does not encompass individuals who merely contract with an employer without exercising more control over the workers.

California Supreme Court Rejects Personal Liability of Third Parties for Violations of Minimum and Overtime Wage Obligations

By Heather M. Davis and Lauren T. Howard

In its recent decision of *Martinez v. Combs*, Opinion No. S121522 (May 20, 2010), the California Supreme Court addressed an issue that has gone unresolved for many years: whether an employment relationship exists by virtue of the Industrial Welfare Commission's (IWC) wage orders' definition of "employer," and, therefore, who may be liable for violating California Labor Code section 1194, which allows a civil suit for recovery of minimum or overtime wages due. The court clarified its prior decision on whether individuals can be held liable as employers under section 1194, finding that the definition of employer under the applicable IWC wage order does not encompass individuals or businesses that merely contracted with an employer without exercising more control over the purported employees.

Factual Background

The plaintiffs in *Combs* worked as seasonal agricultural workers for Munoz & Sons (Munoz). Munoz grew and harvested strawberries in the Santa Maria Valley and employed the plaintiffs during the 2000 strawberry season. Munoz, with the assistance of his foremen, hired and fired his employees, trained them, supervised them, "told them when and where to report to work, when to start, stop and take breaks, provided their tools and equipment, set their wages, paid them, handled their payroll and taxes, and purchased workers' compensation insurance."

Apio, Inc. (Apio) and Combs Distribution Co. (Combs) were produce merchants who contracted with Munoz for the purchase of fresh strawberries. Apio and Combs sold the strawberries for a commission and paid Munoz the net proceeds. Corky and Larry Combs were principals in Combs and Juan Ruiz was Combs' field representative who inspected the quality of the available strawberries. When the market for fresh strawberries deteriorated in the Spring of 2000, Munoz failed to pay his employees.

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Procedural Background

Plaintiffs sought to recover unpaid minimum wages under Labor Code section 1194 against Munoz, Apio, and Combs, along with Combs' principals and Ruiz. During the case, Munoz filed for and was later granted a discharge in bankruptcy. Plaintiffs argued that the IWC's Wage Order No. 14-2001 (Wage Order 14) defined each of the defendants (Munoz, Combs, Apio) as employers for purposes of section 1194. The remaining defendants moved the trial court for summary judgment, asserting they were not employers under the law and could not be liable for Munoz's failure to pay its employees. Plaintiffs opposed summary judgment by arguing that under Wage Order 14 (applicable to agricultural occupations), defendants were joint employers with Munoz, and therefore liable under section 1194. In addition, plaintiffs argued that they were third-party beneficiaries of the contracts between Apio and Munoz and Combs and Munoz. The trial court rejected plaintiffs' argument and plaintiffs appealed.

On appeal the California Court of Appeal found that there was no case law interpreting Wage Order 14's definitions of "employ" or "employer." As a result, the court applied the "economic reality" test set forth under the federal Fair Labor Standards Act (FLSA). Applying that test, the court held that defendants did not exercise sufficient control over plaintiffs or Munoz's agricultural operations to "employ" the plaintiffs. Therefore, the court affirmed the grant of defendants' summary judgment.¹ The California Supreme Court granted plaintiffs' petition for review, but deferred ruling pending its decision in *Reynolds v. Bement*, 36 Cal. 4th 1075 (2005).

The IWC's Definition of "Employer" Is Binding

The Court Rejects the Reasoning of Reynolds and Applicability of Federal Law

Relying on the IWC's definition, plaintiffs argued that defendants employed them because they "suffer[ed] or permit[ted]" their work, as defendants knew Munoz needed to hire individuals to fulfill defendants' produce contracts. Further, they argued that defendants exercised the requisite control over plaintiffs' wages, hours and/or working conditions as defined by Wage Order 14, because defendants controlled payment of Munoz's share of the proceeds by virtue of their respective contracts with Munoz. Plaintiffs argued that the contracts controlled the portion of Munoz's income to be paid to the plaintiffs.

In response, defendants argued that *Reynolds* controlled the analysis because the California Supreme Court previously held that directors and officers of a corporation were not liable for the corporation's employees' unpaid overtime compensation. Alternatively, defendants argued that the court should construe the wage order as if it incorporated the "economic reality" definition developed under the federal FLSA.

The California Supreme Court admitted that it relied on common law in *Reynolds* to define employment under section 1194. However, the court conducted a lengthy analysis of the legislative history and intent behind the creation of the IWC. In conclusion, the court ruled that: (1) the scope of the IWC's delegated authority is over wages, hours and working conditions, (2) the IWC's definition of "employer" could reach situations in which multiple entities control different aspects of the employment relationship; and (3) the "employer" definition was intended to distinguish state wage law from federal law. The court confirmed that *Reynolds* stands solely for the proposition that the IWC wage orders do not impose individual liability on individual corporate agents. Therefore, the court determined that *Reynolds* did not govern the present case and that Wage Order 14, or other applicable wage orders, properly define(s) the employment relationship and who may be liable pursuant to section 1194.

The court also rejected using the "economic reality" test under the FLSA to define employment. Having found that the IWC defines the employment relationship, the court quickly disposed of defendants' alternative reliance upon the FLSA by finding that: (1) the wage orders predate the FLSA; (2) the language used in the wage orders does not appear in the FLSA or its regulations; and (3) the wage orders do not incorporate federal law (FLSA or otherwise) in defining the terms "employ" or "employer."² The court accordingly found no basis for interpreting the wage orders using law not founded in California.

No Employment Relationship Based on Benefits from Contract

Plaintiffs initially argued that Apio and Combs suffered or permitted plaintiffs to work because defendants had knowledge plaintiffs were working to perform Munoz's contractual obligations and plaintiffs' work ultimately benefited the defendants. The court dismissed this theory, however, because the "concept of a benefit is neither a necessary nor a sufficient condition for liability under the 'suffer or permit' standard." Plainly, a business relationship was insufficient to transform the downstream beneficiary (the purchaser in this case) into an employer under section 1194. The court's conclusion was largely based on the concern that plaintiffs' proffered reasoning would create an endless chain of liability. Therefore, the court rejected plaintiffs' arguments and found that for a business proprietor (such as Apio or Combs) to "suffer or permit" work under the IWC's wage orders and section 1194, the proprietor must: (1) know that persons are working within the "business without being formally hired or while being paid less than the minimum wage," and (2) fail to prevent it, (3) "while having the power to do so."³

Distinction from Borello

Plaintiffs also attempted to correlate their relationship to defendant Apio to the sharefarmers' relationship to the large agricultural landowner in *S. G. Borello & Sons, Inc. v. Department of Industrial Relations*, 38 Cal. 3d 341 (1989). *S.G. Borello & Sons, Inc.* involved a determination as to whether the sharefarmers were employees rather than independent contractors for purposes of workers' compensation law. In *S.G. Borello & Sons, Inc.*, the California Supreme Court analyzed whether, under the common law test of employment, the sharefarmers were employees. The court determined that the sharefarmers were "without a doubt, ... a class of workers to whom the protection of the [workers' compensation law] is intended to extend."

In contrast, here, the court noted that Munoz, who operated and held himself out as a business, was clearly plaintiffs' employer. Examples of Munoz's separate existence from Apio was his investment in substantial equipment and capital and his opportunity for profit or loss, based on factors separate from Apio. Importantly, the court noted that had Munoz been an independent contractor for Apio, the result would be different. In that situation, the court noted that a strong possibility would exist that Munoz, as an independent contractor, would have been jointly liable with Apio as plaintiffs' employer.

Corporate Agent's Liability

Finally, plaintiffs argued that Combs offered plaintiffs employment based on the fact that Combs' agent, Ruiz, asked plaintiffs to continue working to help Munoz and told them that Munoz would receive funds from Combs. The court disposed of this argument, finding the evidence did not support an inference that Ruiz offered plaintiffs employment because the plaintiffs understood (based on declarations submitted) that they were not working for Combs. However, the court left open the possibility that a corporate agent could create an employment relationship through an offer or "promise to pay a person for work."

Conclusion

Combs further defines the distinction between the actual employer and individual agents of employers. Employers should be mindful, however, that the decision in *Combs* is not necessarily a far-reaching one. At present, the case only applies to Labor Code section 1194. The court was silent as to whether the case applies to all Labor Code sections using similar terminology. Further, employees can still pursue actions against individual corporate agents for wage claims under federal law because the FLSA defines employer to include individuals. However, as a practical matter in California, FLSA claims are disadvantageous to employees because the case can be removed to federal court and FLSA substantive law is not as favorable to employees as California law. On the same note, *Combs* does not preclude all liability for individuals in California, as it does not preclude "alter ego" liability if plaintiffs "pierce the corporate veil" by proving individuals disregarded the separate status of the entity and used the entity's assets as their own.

Overall, the *Combs* decision is a positive development for California employers, but employers should ensure that their corporate

agents continue to comply with federal and state wage laws, because any actions that could be deemed outside the scope of that agency may impose liability on the individuals.

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¹ The court reversed the trial court's grant of summary judgment on plaintiffs' joint employer claims against Combs. Combs did not seek review of the court's reversal.

² In other instances, the wage orders expressly incorporate specific federal regulations issued pursuant to the FLSA; for example, in defining exempt executive, administrative and/or professional employees.

³ The court also rejected plaintiffs' argument that a contractual obligation existed to establish an employment relationship with the defendants. It found plaintiffs' argument that they were employed by defendants as a third-party beneficiary was without merit.