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Misclassification Gets More Expensive

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What do truck drivers, home health aides and exotic dancers have in common? The answer is, that like millions of other workers across this country, many are retained as "independent contractors" rather than "employees." Many of these workers prefer the independent contractor status for its flexibility, including the ability to decide how and when to work and for whom. But a new law recently signed by Gov. Jerry Brown raises a large red flag for entities engaging independent contractors in California because it dramatically raises the ante for businesses found to have willfully misclassified workers.

Under the newly enacted statute — Labor Code §226.8 — any entity that "willfully misclassifies" an individual as an "independent contractor," when that individual is determined to have actually been an "employee," faces stiff civil penalties and unprecedented repercussions — all in addition to the existing penalty structure.

The law signed by Brown (effective Jan. 1) amends the Labor Code to add two new sections specifically aimed at the perceived practice of misclassification of employees as independent contractors and the purported loss of substantial dollars in unpaid taxes. This perceived loss of taxes appears to be contributing to the legislative interest in deterring the retention of independent contractors.

NEW FINES FOR MISCLASSIFICATION

The most striking feature of this new statute is the imposition of steep new penalties on an entity that "willfully misclassifies" an "employee." Fines start at $5,000 and range as high as $15,000 per violation. Further, if the entity is found to have engaged in a "pattern or practice" of misclassification, these fines skyrocket up to a minimum of $10,000 per violation, with a cap of a whopping $25,000 per violation.

The size of these penalties is unprecedented in the Labor Code, where most violations result in penalties in the $50 to $100 range.

The law defines "willful misclassification" as avoiding employee status for an individual "by voluntarily and knowingly misclassifying that individual as an independent contractor."

The new law also adds Labor Code §2753, which imposes joint and several liability on any consultant or other person who receives valuable consideration for knowingly advising an employer to treat an individual as an independent contractor to avoid employee status if that person was found to have been willfully misclassified. Thus, if the employer cannot pay the penalty, the prosecuting agency or employee can look to the employer's adviser to pay it. However, attorneys and persons advising their employer are exempt from this joint and several liability.

UNLAWFUL FEES OR DEDUCTIONS

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." Examples of the purposes for such unlawful deductions are requiring the contractor to 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 §2802, but the new law renders a much steeper penalty for failing to reimburse these expenses from misclassified independent contractors.

ENFORCEMENT OPTIONS

These new penalties can be imposed by an assortment of state agencies — all the agencies, departments, commissions, boards and divisions of the Labor and Workforce Development Agency, which is a "super agency" encompassing not only the Labor Commissioner (under the Department of Industrial Relations), but also the Workers' Compensation Board and the Employment Development Department as well as its appellate arm, the California Unemployment Insurance Appeals Board. These agencies may bring administrative enforcement actions or, in the case of the labor commissioner, file suit in court.

CLASS AND REPRESENTATIVE ACTIONS

In addition to administrative enforcement, Labor Code §226.8 permits these new penalties to be assessed by the state and federal courts. The new statute thus is likely to spawn more litigation over the use and classification of independent contractors. Class actions — already commonplace — likely will increase as plaintiffs' counsel seek the new steep penalties, as well as any unpaid minimum wage, overtime, business expense reimbursement and other compensation or benefits.

Whether plaintiffs' attorneys also may bring suit on behalf of a group of "aggrieved" contract workers as a "private attorney general" action based on California's Private Attorney General Act (Labor

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Code §2698 et seq.) remains to be seen. 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. Three-quarters of the penalties collected go to the state, but the prevailing employee is entitled to recoup reasonable attorneys' fees.

Under PAGA, the "aggrieved" independent contractor would need to give the employer 33 days to "cure" the purported "violation" before bringing a PAGA claim. An entity receiving notice thus will need to decide whether to fight the claim or reclassify its independent contractors.

INTERNET NOTICE OF VIOLATION REQUIRED

While the severe penalties should raise eyebrows, the new law imposes a novel remedy for unlawful misclassification. The agency or a court enforcing the law may require a violator to display prominently on its website — in an area accessible to all employees and the general public — a notice stating 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 section, and how persons who believe they have been misclassified can 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. Any violator without a website must instead post the notice in a prominent location accessible to both employees and the general public where a violation occurred.

THE CONSTRUCTION INDUSTRY

Presumably because the Legislature believes that the construction industry is misclassifying a significant number of employees, the law also specifies that a state-licensed contractor will have any final determination of misclassification 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.

WHAT THE LAW MEANS FOR EMPLOYERS

The difference between an "employee" and an "independent contractor" remains far from 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 rarely, if ever, dispositive when challenged. To make matters worse, different legal tests are used by different agencies and by the courts. The IRS has its famous 20-factor test, but there is no comprehensive checklist covering all state and federal laws. In fact, some laws are conflicting. The courts may apply the common law test, which is similar to the IRS' test. Under other laws, the courts look to the "economic realities" of the worker's situation, but that requires an examination of the "totality of the circumstances," and decisions vary in their analyses of specific fact patterns.

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. The entity retaining an independent contractor should control the results, not the means of achieving those results. Thus, independent contractors generally do not need to be trained or managed in detail, depending on the nature of the work performed.

Other factors generally considered to distinguish contractors from employees include: whether the worker has a significant investment in facilities and equipment, an opportunity to make a profit or incur a loss, the degree of skill and independent initiative required, whether the contractor is performing work that is integral or critical to the daily business operations, and the duration or permanence of the working relationship with the retaining entity. While there is no magic cutoff date that indicates a worker has crossed the line from "independent contractor" to "employee," long-term relationships raise warning flags.

Entities that directly retain 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 because reliance on such a legal opinion negates "willful" misclassification.