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Law Alert

To: Firm Clients and Contacts

From: Niesar & Vestal LLP

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Re: **New California Law Prohibiting Independent Contractor Misclassification**

On Sunday, October 9, 2011, California Governor Brown signed into law Senate Bill 459. This law prohibits employers from willfully misclassifying workers as independent contractors. Repeat violators can face penalties of up to $25,000 for each violation.

What is "Misclassification"?

Misclassification occurs when an employer designates or treats a worker as an independent contractor when that worker actually should be classified as an employee. The determination is not an easy one to make and there is no clear cut rule to guide the employer (see How do I properly make the determination (Factors)?, below).

Generally, with regard to employees, employers face various requirements and withholding and payment obligations. Specifically, an employer must pay wages exceeding the applicable minimum wage level, withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment tax on wages paid to the employee. With regard to independent contractors, employers generally do not face these requirements and withholding obligations. Not surprisingly, employers often misclassify employees as independent contractors and thereby fail to meet withholding requirements and avoid paying proper wages, payroll taxes, workers compensation costs and other mandated worker expenses.

Currently, there exist many penalties for misclassifying an employee as an independent contractor, including federal and state agency audits and enforcement actions, class action and individual lawsuits, and criminal sanctions. Senate Bill 459 provides for additional penalties for independent contractor misclassification.

What is Senate Bill 459?

Senate Bill 459 adds two new sections (226.8 and 2753) to the California Labor Code. The new law creates civil penalties ranging from $5,000 to $15,000 for each instance of misclassifying a worker as an independent contractor. Employers who demonstrate a "pattern or practice" of misclassifying workers could be fined from $10,000 up to $25,000 for each instance of misclassifying a worker as an independent contractor. These penalties are in addition to all other penalties and fines permitted by state and federal law. A "willful misclassification" is defined as "avoiding employee status for an individual by voluntarily or knowingly misclassifying that individual as an independent contractor".

Next, the new law prohibits employers from charging fees to, or making deductions from, the compensation otherwise payable to the misclassified workers if the fee or deduction would have been prohibited if the worker was an employee (e.g., for materials, space rental, equipment maintenance, etc.). Additionally, the new law creates joint and several liability for paid consultants (with the exception of lawyers or in-house advisors, such as personnel managers) for recommending employers improperly declare workers independent contractors so they can avoid taxes and other costs.

Last, the new law requires any employer who is determined to have willfully misclassified a worker as a contractor to prominently display a notice on its website that 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; (3) that any employee who believes he or she is being misclassified may contact the Labor Workforce Development Agency; and (4) that the notice is being posted pursuant to a state order. The notice must be posted for one year and be signed by an officer of the employer. Where the employer does not have a website, the employer must display the notice prominently in an area that is accessible to all employees and the general public at each physical location where a violation occurred.

As with other California Labor Code violations, the penalties can be sought by either the California Labor Commissioner or through private action.

What should I do?

Employers should immediately undertake a review of their workforce to determine if there are any potential misclassifications. With the new law potentially creating relatively severe penalties for making even mistaken classifications, employers should resolve all doubtful cases in favor of the employee classification. If the employer determines that there are instances of improperly classified workers, or cases too close to call with confidence, some options may include:

a) convert the "contractors" to employees and make the required withholdings and payments;

b) make adjustments to the worker's arrangement with the employer such that they are more likely to be deemed an independent contractor; or

c) consider whether termination of the relationship would be appropriate.

Going forward, when considering adding to an existing workforce, with each new "hire", an employer should:

a) consider the degree or extent of the right to direct and control that new worker's service to the employer, and

b) document each of the factors used in coming up with that determination (see How do I properly make the determination (Factors)?, below).

How do I properly make the determination (Factors)?

The important thing to note is that the mere act of calling a worker an "independent contractor" will not, by itself, ensure that worker will ultimately be determined to be an independent contractor. In other words, for classification purposes, an employee by any other name is still an employee. An employer is free to refer to a worker as an "independent contractor", but a court of law, any relevant state employment agency and/or the Internal Revenue Service always reserve the right to make their own evaluation.

Before one can determine how to properly treat payments made for services to a worker, one must first examine the business relationship that exists with the person performing the services. Although there is no bright line rule, and there are various tests for determining whether a worker is properly classified as a contractor, most tests center around the concept of control. For example, if the employer exercises sufficient control over the worker and/or the work performed, the worker likely will be classified as an employee. A few specific examples include:

a) Does the employer closely supervise the worker?

b) Does the employer set work hours?

c) Does the employer provide specific direction on how/when to perform certain work?

d) Can the worker hire assistants?

e) Can the worker contract out the work?

f) Does the worker use the employer's tools/equipment?

g) Is the worker reimbursed for business expenses?

h) Can the worker work for other companies simultaneously?

i) Is the worker paid an hourly wage (or salary) as opposed to being paid by the project or completed job?

j) Is the worker paid as an individual (as opposed to being formally organized and paid as an entity, e.g., an S Corporation or LLC)?

k) Is the worker performing the services at the employer's premises?

l) Is the worker hired for an extended period of time (vs. shorter, discrete periods of time with a specific end date)?

m) Does the worker's service agreement with the employer include a "work for hire" clause?

Unfortunately, there is no single most important factor or clear rule for determining whether a worker is an employee or independent contractor. Employers must therefore weigh all of these factors on a case by case basis when making the determination.