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New California Law Prescribes Stiff Penalties for Employers' Willful Misclassification of Employees as Independent Contractors

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On October 9, California Governor Jerry Brown signed into law Senate Bill 459, which prohibits employers from willfully misclassifying workers as independent contractors. The new law, designed to force businesses to rethink their relationship with independent contractors, imposes civil penalties between $5,000 and $25,000 per violation and requires businesses to publicize findings of violations of the new law on their company websites.

The Scope of the Law

The legislation is reflected in newly added Labor Code sections 226.8 and 2753. Section 226.8(a) sets forth the law's objective, stating that it is unlawful for any person or employer to willfully misclassify an individual as an independent contractor. Section 226.8(a) also prohibits businesses from charging fees or making any deductions from compensation for any purpose, including goods, materials, space rental, services, licenses, repairs, maintenance, and fines, when such fees or deductions would have been impermissible had the individual not been misclassified.

Section 226.8(b) sets forth the penalties. For "each" violation, an employer can face a penalty between $5,000 and $15,000, which is in addition to any other penalties permitted by law.

Section 226.8(c) provides the penalty can increase to between $10,000 and $25,000 per violation if either California's Labor and Workforce Development Agency (LWDA) or a court determines that an employer has engaged in a "pattern or practice" of violations.

Section 226.8(d) goes beyond monetary penalties, requiring businesses to publicize a finding by a court or the LWDA that a violation occurred. An employer found in violation must prominently display a notice on its company website (or if the company does not have a website, in an area accessible to all employees and the general public) stating that (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, and (3) any employee who believes he or she is misclassified may contact the LWDA (with the LWDA's contact information provided). The notice must be signed by a corporate officer and posted for one year. Licensed contractors under the California State License Law found in violation will be reported to the Contractors State License Board, which will initiate disciplinary proceedings against the offending contractor. (Section 226.8(d)).

Section 226.8 targets successor companies for liability as well. Successor companies are liable for a former entity's acts where one or more of the same principals or officers of the prior company are engaging in the same or similar business. (Section 226.8(h)).

Even an employer's third-party advisors, such as financial, accounting, and human resources professionals, can be jointly and severally liable with the employer for fines and penalties. Labor Code section 2753 further broadens the range of potentially liable parties, extending joint and several liability to any person who, for money or other valuable consideration, knowingly advises an employer to misclassify an individual as an independent contractor to avoid employee status. The joint liability section expressly excludes attorneys providing legal advice and employees providing advice to their employer.

No Express Private Right of Action

Similar to other Labor Code provisions, Section 226.8 establishes the California Labor Commissioner as the law's chief enforcer. The Labor Commissioner may enforce section 226.8 either through Labor Code section 98 (which allows the Labor Commissioner to investigate complaints and conduct hearings) or a civil suit.

Section 226.8 does not expressly create a private right of action for individuals seeking to file a civil lawsuit, nor does the legislative history appear to express any such intent. Based on the California Supreme Court's reasoning in *Lu v. Hawaiian Gardens*, 50 Cal. 4th 592 (2010), a statutory private right of action under section 226.8 should not exist under these circumstances. However, given the expansive use of California's Private Attorneys General Act (PAGA), which allows a private citizen to pursue civil penalties on behalf of the LWDA provided the formal notice and waiting procedures of the law are followed, businesses should anticipate seeing section 226.8 claims alleged under PAGA. In the end, an individual's right to pursue a claim under section 226.8 may have to be resolved in the courts.

What Labor Code Section 226.8 Means for Businesses That Engage Independent Contractors

The California legislature clearly intends to create a strong disincentive to classify individual workers as independent contractors. Potential civil penalties are high, and could easily reach hundreds of thousands (or even millions) of dollars depending on the LWDA's or a court's interpretation of "each violation," the number of purportedly affected individuals, and the potential finding that an employer engaged in a pattern and practice of willfully misclassifying workers. Given these high stakes, the classification of virtually every worker in California who is currently classified as an independent contractor may need reexamination.

Labor Code section 226.8's ultimate impact will depend on how the LWDA and courts interpret the term "willful misclassification." Section 226.8(i)(4) specifically prohibits employers from "avoiding employee status for an individual by voluntarily and knowingly misclassifying that individual as an independent contractor." Based on the legislative record, this language appears to suggest a heightened standard designed to avoid opening the floodgates to nuisance actions. According to legislative staff comments, the final language, which differed from earlier versions, was intended to require "generally an intentional or voluntary violation of a known legal duty, [which] is a higher test and may make it more difficult to find a violation, thereby constraining the number of enforcement actions." While this "willfulness" standard should provide some protection for businesses under the new law, the standard has not yet been tested, and California courts' prior interpretations of "willfulness" may impact the final definition.

Adding to potential uncertainty, the new law fails to provide a clear and objective test for determining whether an independent contractor is misclassified. Businesses will need to look to the courts for guidance on how the law is applied. In this regard, courts have created, at least in one context, a fact-intensive test to differentiate between an independent contractor and an employee. This test, known as the "economic realities" test, was adopted by the California Supreme Court in *S. G. Borello & Sons, Inc. v. Dept. of Industrial Relations*, 48 Cal. 3d 341 (1989). While there are many secondary factors, the most significant factor considered is whether the person to whom service is rendered (the employer or principal) has control or the right to control the worker both as to the work done and the manner and means in which it is performed.

This new law will clearly add to the continued scrutiny businesses face in engaging independent contractors. Companies who retain independent contractors must carefully analyze the relationships with these workers to ensure they are properly classified. Given the many relevant factors, legal intricacies, and significant potential penalties for reaching the wrong decision, businesses should seek legal assistance in conducting their evaluation.

The New Law Should Apply Prospectively, With a One-Year Statute of Limitations

The new law does not specifically state either its effective date or the applicable statute of limitations. In the absence of express language indicating the legislature's contrary intent, section 226.8's effective date should be the date that it was signed. The new law increases potential liability to businesses, and California courts have been unwilling to apply such laws retroactively without supporting statutory language. Section 226.8's language further suggests that it will be subject to a one-year statute of limitations. California Code of Civil Procedure section 340 creates a one-year statute for claims for penalties. While there is no time limit for filing complaints with the Labor Commissioner under Labor Code section 98, the Commissioner previously has adopted the same statute of limitations applicable to civil suits. In this case, section 226.8 creates some ambiguity because it references both "penalties" and "damages," the latter of which could arguably carry a longer statute of limitations. Nonetheless, given that this legislation reflects an intent to penalize, the Labor Commissioner likely will apply the one-year statute. Both the effective date and statute of limitations, however, may not be definitively determined until they are challenged in court.

The Federal Government Incentivizes Disclosure and Reclassification

California's new legislation arrives on the heels of the federal government's recent announcement of its intent to incentivize businesses to self-report prior misclassification. On September 19, 2011, the U.S. Department of Labor (DOL) and the Internal Revenue Service (IRS) signed a memorandum of understanding to improve the agencies' coordination on employee misclassification, compliance, and education. As announced by the agencies, this memorandum "will enable the U.S. Department of Labor to share information and coordinate law enforcement with the IRS and participating states in order to level the playing field for law-abiding employers and ensure that employees receive the protections to which they are entitled under federal and state law."

On September 22, the IRS unveiled its Voluntary Classification Settlement Program (VCSP) for workers misclassified as independent contractors. Under this program, eligible employers may voluntarily self-report in order to limit federal employment tax liability for the past nonemployee treatment of workers who should have been classified as employees.

Employers are eligible for this program if they (1) have consistently treated the workers as independent contractors, (2) have filed all required Forms 1099 for the previous three years, and (3) are not currently being audited by the IRS or by the DOL or a state agency for classification of workers. An employer participating in the program must agree prospectively to treat the class of workers as employees, and is required to pay 10% of the employment tax liability that would have been due on compensation paid to the workers for the most recent tax year, but will not be liable for any interest and penalties on the liability. In addition, the employer will not be subject to an employment tax audit with respect to the worker classification of the workers being reclassified under the program for prior years and will agree to extend the period of limitations on assessment of employment taxes for three years.

IRS VCSP Presents a Dilemma for California Businesses

The IRS's VCSP creates a quandary for California businesses that are evaluating the possibility of reclassifying independent contractors as employees. Indeed, businesses may be concerned that seeking the tax benefits of the IRS's VCSP could operate as an admission of liability for purposes of California Labor Code section 226.8. Thus, while availing itself of the safe harbor offered under the IRS's program, an employer could still be exposing itself to a year's worth of penalties under the new California law. California businesses that are considering voluntary classification under the IRS's program should seek legal counsel to assist in understanding the potential implications.

Given the clear state and federal interest in weeding out independent contractor misclassification, this is a critical time for businesses to take a careful look at their independent contractors to confirm that they are properly classified.

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