

Contracting May Squeeze Employers

New state fines to enforce worker classifications.

by **Howard Fine**

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For Burbank executive Sunder Ramani, a new state law is promising a lot of headaches.

The law, backed by unions and opposed by business groups, targets businesses that classify their workers as independent contractors even though they work full time for those businesses. When companies classify workers as independent contractors, the businesses do not have to pay them overtime, health benefits, workers' compensation benefits or reimburse them for on-the-job expenses.

Ramani is senior vice president with Burbank postproduction house West Wind Media Inc. West Wind doesn't use independent contractors, but an affiliate owns adjacent land and uses independent contractors – including landscapers and roofers – to maintain the property.

Ramani said the penalties for violating the new state law are so steep – possibly as high as \$25,000 for each employee for each pay period – that just one misstep in completing complex federal and state paperwork could wreak serious financial havoc on the company.

Even worse, Ramani fears the law will open the door for enterprising plaintiff attorneys to conduct shakedowns of companies like his, alleging misclassification of workers as a way to force companies to pay hundreds of thousands of dollars in settlements or take their chances in court.

Ramani, a former president of the Burbank Chamber of Commerce, said the law creates an arena in which lawyers can do battle with employers.

“It's one more area for business regulation in California that prevents businesses from thriving,” he said.

The law could have a big impact. While nearly every industry uses independent contractors to some extent, several stand to be especially vulnerable. The entertainment sector makes extensive use of independent contractors, as does the logistics industry at the ports. Real estate

agents are typically classified as independent contractors, even if they work much of their careers at one company.

If state regulators start targeting one or more of these industries for alleged misclassification, companies might have to change the way they operate.

The affect could be dramatic now because many companies, especially small businesses, cannot afford to bring in full-time employees. Some have even converted existing employees to independent contractors rather than lay them off.

‘A way to survive’

“A lot of small businesses have been resorting to independent contractors as a way to survive during these tough economic times,” said Ken Devore, legislative director for the California chapter of the National Federation of Independent Business. “If the price now becomes too high to use independent contractors, many of these companies will simply fold. That puts even more people out of work.”

It remains legal to hire independent contract workers for specific jobs and set durations. For an example, a construction firm might hire an additional engineer to work on a road project; when that road project is finished, the engineer's contract ends.

However, if that engineer receives a string of projects from the construction company that lasts for several years, then it's no longer so clear. Whether that engineer is legally considered an independent contractor or a full-time employee would depend on other factors, including the degree of control the company exercises over the engineer and whether the engineer is allowed to work for other companies during that time.

Gov. Jerry Brown signed the bill into law earlier this month. SB 459 was written by state Senate Majority Leader Ellen Corbett, D-San Leandro, and will take effect Jan. 1. It makes “willful misclassification” of a worker as an independent contractor a violation of the labor code punishable with civil fines of \$5,000 to \$15,000 for each violation, or

\$10,000 to \$25,000 for “repeated pattern and practice” violations. That's about 10 times more than the penalties for other labor code violations, such as failure to pay overtime.

Critics and opponents of the law note that the term “violation” is ill-defined in the law and fear that aggressive enforcers or judges could determine that each employee and each pay period where misclassification occurs is a separate violation. They note that's how total penalties are calculated for some cases involving failure to pay overtime.

As a result, a company accused of misclassifying 20 workers as independent contractors for two years could face fines of up to \$24 million.

The law also for the first time explicitly gives the Labor Commissioner's Office and other state agencies the power to enforce the rules of classification; currently, they can only pursue companies that fail to pay workers overtime, benefits and reimbursements for expenses, or fail to provide workers' compensation coverage.

The law was sponsored by the California Labor Federation and is supported by numerous other unions throughout the state. It was their third try. The previous two bills were vetoed by then-Gov. Arnold Schwarzenegger.

Critics said the unions are looking for ways to get more members. They note that independent contractors cannot be unionized; however, once workers are full-time employees, they can organize.

Unions say it's an essential tool to crack down on what they claim is a widespread practice among companies of classifying workers as independent contractors as a way to avoid paying benefits. They cite national studies that claim as many as one-fourth of all employers illegitimately classify some or all of their workers as independent contractors.

“Perhaps the most effective way to get off the hook for worker wage and hour violations is by misclassifying the worker as an independent contractor,” the California Labor Federation said in written comments on the bill.

Proponents say enforcement agencies have faced years of budget cuts and no longer have adequate numbers of inspectors to pursue misclassification cases. The stiffer penalties will help beef up enforcement efforts while also acting as a deterrent against companies that misclassify workers.

Business opposition

Opponents of the law – including business groups such as the California Chamber of Commerce, the Los Angeles Area Chamber of Commerce, the National Federation of Independent Business and the California Grocers Association – say the law will heavily penalize companies for mistakes. Determining whether a worker should be classified as an employee or an independent contractor depends on many variables. Even with a 20-point test from the Internal Revenue Service, there are gray areas.

“The whole issue of classification is a very muddy area of the law to begin with,” said Esra Hudson, partner with West L.A. law firm of Manatt Phelps & Phillips LLP, who defends companies facing wage and hour violations or lawsuits. “Now with the penalties as high as \$25,000 per worker per pay period, the price for getting it wrong has skyrocketed.”

As a result, companies may be more reluctant to use independent contractors, even if it appears that all the tests are met.

The law, signed this month, on classification of workers invites litigation, Hudson said, because it adds misclassification to the list of labor code violations.

Judges could use the new civil penalties under the law as guideposts in determining damages.

Until the law takes effect, workers can sue for overtime or benefits they felt they were owed. Under the new law, employers fear that any ruling of misclassification would automatically lead to back pay and benefits. That tab could easily run into the hundreds of thousands of dollars for individual workers.

“The whole cottage industry of plaintiffs’ attorneys going after labor code violations now has a tempting new target,” Hudson said.

When faced with these lawsuits, most businesses usually decide to settle before the case reaches court to avoid an expensive legal battle. With plaintiff attorneys typically receiving one-third of the settlement money, this raises the specter of lawsuits being filed against companies just to shake them down, she said.

However, Scot Bernstein, a Folsom attorney and board member of the California Employment Lawyers Association, said the bill wouldn’t cause a flood of litigation.

“Attorneys are only going to file cases in which there are substantial amounts of overtime pay or out-of-pocket expenses that workers should have coming to them,” Bernstein said.

He expects the higher penalties in the law will result in more enforcement actions from state agencies. That in turn will put more pressure on companies using independent contractors to convert those workers to full-time employees.

“This law creates strong incentives for companies to bring themselves into compliance voluntarily,” Bernstein said, “and strong incentives for enforcement agencies to pursue these cases.”