WSGR ALERT

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CALIFORNIA SUPREME COURT RULING INCREASES RISK OF INDIVIDUAL LIABILITY IN WAGE AND HOUR ACTIONS

In a significant ruling for California employers, on May 20, 2010, the California Supreme Court addressed the question of who is included in the definition of "employer" for purposes of liability in a Labor Code Section 1194 action for unpaid wages. In *Martinez v. Combs*, the California Supreme Court adopted the Industrial Welfare Commission's (IWC's) definition of employer: **one who exercises control over the wages, hours, or working conditions of the employee; or suffers or permits the employee to work; or engages the employee**. This definition of employer is broader than many understood to be the case under the California Supreme Court's previous decision in *Reynolds v. Bement* (discussed at http://www.wsgr.com/WSGR/Display.aspx?SectionName=publications/pdfsearch/clientalert_reynolds_v_bement.htm), and has clear implications in important areas such as officer and director liability and the misclassification of independent contractors.

The plaintiffs in *Martinez* were agricultural workers seeking payment of unpaid wages from third parties that had business dealings with their now-bankrupt employer. The defendants were produce merchants that sold the bankrupt employer's produce, along with their principals and a supervisor of one of the merchants. The plaintiffs sued the defendants for, among other claims, the failure to pay minimum wages under California Labor Code Section 1194. Although the *Martinez* court found each of the defendants involved not liable, in reaching that result it adopted the broad definition of employer found in the IWC wage order at issue.

Martinez increases the risk that a third-party corporate entity or individual not ordinarily thought of as an employer will nevertheless be found to be the employer. In a significant retreat from what the California employer community believed to be the broader holding of the California Supreme Court's earlier *Reynolds* decision, the court rejected the conclusion that the common law alone defines the employment relationship in actions under Section 1194. Instead, based on what it described as the "full historical and statutory context" of Section 1194, the court determined that as used in that statute, the meaning of employer is found in the IWC's above-described three-alternative definition.

After *Reynolds*, California employers widely believed that individuals enjoyed nearly complete immunity from personal liability for unpaid wages. In *Reynolds*, the plaintiffs sued eight officers and directors of the defendant company in their individual capacities for unpaid wages, arguing that the individuals were liable for the wages because each was covered by the IWC definition of employer. The *Reynolds* court refused to apply the IWC definition to the officer and director defendants, using instead a common law test of employment. Specifically, *Reynolds* held that directors and officers do not incur personal liability for the torts or breaches of the corporation merely by reason of their official position, and established that no such liability attaches when they are corporate agents acting within the scope of their duties. While this "safe harbor" from personal liability afforded to corporate agents remains intact after *Martinez*, its utility to individual defendants is more open to question, given the court's embracing of a broader employer definition.

In adopting the IWC's employer definition, the *Martinez* court stated that the purpose of the more expansive approach is, in part, to give courts power to reach through sham arrangements to impose liability on the "actual" employer. A person "suffers or permits" someone to work when he or she knows that the employee is working, and fails to prevent the work, despite having the power to do so. For example, in *Martinez*, several individual defendants were found not liable under the "suffer or permit" prong of the employer definition because they had no power to prevent the employees from working, despite their knowledge that the employees were going unpaid. One exercises control over an employee when he or she has the power to set the employee's wages, hours, or working conditions. Similarly, a court may determine that an entity or individual that directly or indirectly exercises control over any of these conditions of employment is an employer.

Finally, in reaching its decision, the *Martinez* court made additional observations that may be of relevance to California employers. After a lengthy analysis of the history of the IWC, the court stated that the IWC's wage orders and broad authority to make rules for employers are entitled to judicial deference. The court also expressly rejected incorporation of the "economic reality" test for employment developed in federal cases interpreting the Fair Labor Standards Act.

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Practical Impact of *Martinez*

As a result of *Martinez*, California employers must navigate more challenging waters when it comes to determining who exactly meets the definition of an employer under Labor Code Section 1194. The court's willingness to consider multiple entities or individuals as joint employers of the same employees dictates greater caution for employers that make use of employee sharing or leasing arrangements. While "co-employment" risks are not new, such risks are now greater for Section 1194 claims, e.g., failure to pay minimum wage or overtime. For example, when working with an individual improperly classified as an independent contractor as opposed to an employee, the employer may be held liable for the wages of all of the purported contractor's employees. ("[T]he determination that a purported independent contractor is in fact an employee raises the strong presumption, generally speaking, that the contractor and its employer jointly employ the contractor's employee.") Employers must also remember that on the question of who is an employer, and related questions of personal liability, *Martinez* underscores that federal and state law requirements differ—indeed, *Martinez* expressly rejects the federal "economic realities" standard. Since an action may be brought under either federal or state law, it is important that both standards be considered.

Perhaps of greatest significance to the officers and directors of smaller companies, those seeking funding, or those in financial distress, the safe harbor many believed *Reynolds* offered to those acting within the scope of their agency no longer seems that safe. Under *Reynolds*, even those plaintiffs alleging under Section 1194 that an officer or director defendant acted outside the scope of one's agency would nevertheless have the formidable task of proving that the defendant met the common law test for determining employer status. *Martinez* has arguably made it easier for a plaintiff to allege that officers or directors are personally liable for unpaid wages. If plaintiffs are permitted to "plead around" agency status (a safe harbor under *Reynolds)*, they may then utilize the expanded employer definition embraced by *Martinez*, and thereby improve their chances of defeating demurrers or summary judgment motions, and thus increase the risk of personal liability.

Finally, *Martinez* also serves as a reminder to companies, officers, and directors that diligence must be exercised in selecting appropriate insurance coverage. In particular, *Martinez*-type unpaid-wage actions against officers and directors may implicate a company's D&O or EPLI insurance coverage. Companies should ensure that any such policy selected provides adequate protection, including the ability to select counsel of their choosing.

For more information on the implications of *Martinez v. Combs*, please feel free to contact Fred Alvarez, Ulrico Rosales, Marina Tsatalis, Kristen Dumont, Laura Merritt, Alicia Farquhar, or another member of Wilson Sonsini Goodrich & Rosati's employment law practice.

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