

PENNSYLVANIA BUILDERS ASSOCIATION

Detailed Explanation of New Pennsylvania Legislation Regulating Construction Industry Independent Contractors (October 2010)

I. INTRODUCTION

The Construction Workplace Misclassification Act (“Misclassification Act”), which was signed into law October 13, 2010 by Governor Rendell and becomes effective 120 days thereafter, on February 10, 2011, strictly regulates the use in Pennsylvania of individuals as independent contractors in the construction industry. It, as a practical matter, changes the traditional concept of weighing factual circumstances under what many PBA Members know as the “IRS Test” or the “ABC Test.” Under the new law it is still necessary to analyze and weigh on a case-by-case basis detailed facts about how much control the hiring party has over the individual, but on top of that there is now an additional specific list of “must haves.”

Due to lobbying efforts of PBA and other business groups aligned on the issue the final version of the Misclassification Act enacted into law is substantially less onerous than the initial version of the Bill pushed by various labor unions. Even in its watered down final version, however, the Misclassification Act represents another burdensome layer of governmental compliance obligations for Pennsylvania’s already battered construction industry. Unless all the technical requirements of the new law are strictly followed, individuals who were engaged as independent contractors may be automatically treated as the hiring party’s employees for unemployment compensation and workers’ compensation purposes. Non-compliance could also result in severe civil liability and criminal sanctions, including imprisonment.

II. GENERAL OVERVIEW OF NEW MISCLASSIFICATION ACT

A. Criteria for Being an Independent Contractor

For the purposes of the Misclassification Act, an individual engaged in Pennsylvania to perform services in the construction industry for remuneration will be automatically treated as an employee of the hiring party, and not as an independent contractor, unless all of several technical criteria set forth in the legislation are met.

The new statute begins by laying out the following three-part test that must be satisfied in order for an individual to be an independent contractor:

- (1) “The individual has a written contract to perform such services”; and
- (2) “The individual is free from control or direction over performance of such services under both the contract of service and in fact”; and
- (3) “As to such services, the individual is customarily engaged in an independently established trade, occupation, profession or business.”

While the Misclassification Act initially sets out a three-prong test that sounds much like a traditional “ABC Test” analysis, the law actually imposes at least eight distinct requirements that must be met because the Act further expands the third part of the general three-prong analysis into six additional absolute criteria that must be satisfied. In this regard, the new law provides that for the individual to meet the general requirement of being “customarily engaged in an independently established trade, occupation, profession or business with respect to the services,” and not be automatically classified for unemployment compensation and workers’ compensation purposes as an outright employee, the individual must also meet all of the following six technical requirements:

1. The individual must possess independent of the hiring party “the essential tools, equipment and other assets” needed to perform the services at issue.
2. The arrangement between the hiring party and the individual must be such that the individual “shall realize a profit or suffer a loss” as a result of the engagement.
3. The individual must be performing the engagement “through a business in which the individual has a proprietary interest.”
4. The individual must maintain an actual business location (*e.g.*, office or shop) separate from the location of the hiring party.
5. The individual must have either previously performed the same or similar services as an independent contractor or “hold[] himself out to other persons as available and able, and in fact [be] . . . available and able to perform the same or similar services” as an independent contractor.
6. The individual must maintain liability insurance during the term of the contractual engagement of at least \$50,000.

B. Penalties for Non-Compliance

The hiring party business, or “an officer or agent” of the hiring party business, is subject to penalties and liability for violations of the Misclassification Act if the hiring party business, or its officer or agent, “fails to properly classify an individual as an employee” for either Pennsylvania Workers’ Compensation Act or Pennsylvania Unemployment Compensation Law purposes. Each individual who is not properly classified as an employee is considered a separate violation.

A violation of the Misclassification Act has several potential implications. Aside from the possibility of the individual in question being reclassified as an employee for workers’ compensation and unemployment compensation purposes, the Pennsylvania Department of Labor and Industry may seek a “stop work order” in court to shutdown the project where the alleged violation is occurring, and may assess penalties of up to \$1,000 for the first violation and up to \$2,500 for each subsequent violation. In addition, violations of the Misclassification Act can be referred by the Department of Labor and Industry to the Attorney General for criminal

prosecution. The law subjects violators to possible fines and/or imprisonment, treating intentional violations as criminal misdemeanors, and negligent violations as summary offenses.

Significantly, the Misclassification Act has a conspiracy liability concept, the full implications of which will not be known until case law develops in court regarding the interpretation of this provision, under which any third party who “intentionally contracts with an employer knowing the employer intends to misclassify employees” in violation of the Misclassification Act “shall be subject to the same penalties, remedies and other actions as the employer found to be in violation . . .”

The Misclassification Act also makes it unlawful for any person to require or demand that an individual enter into a contract “or sign a document” which results in the improper classification of that individual as an independent contractor.

In addition, the new law opens up construction industry businesses in Pennsylvania, and their officers and agents, to claims of “retaliation” against persons for allegedly exercising rights under the Misclassification Act, and creates a statutory “rebuttable presumption” that if any “adverse action” is taken by a hiring party against a person within 90 days of the person’s exercise of rights protected under the Misclassification Act such action has been done in retaliation for the exercise of those rights.

C. Miscellaneous Other Provisions

The law does provide a “good faith” defense for a company or person charged with violations of the law that is able to prove that they believed in good faith that the individual engaged to perform the services was qualified in accordance with the requirements of the Act to be an independent contractor at the time the services were performed.

The law includes a requirement that the Pennsylvania Department of Labor and Industry create a “poster for job sites which outlines the requirements and penalties” of the Misclassification Act and requires that the Department make the poster available on its website. The statute, however, does not require that any employer actually post the new poster.

III. COMMENTARY

A. Misclassification Act Criteria Presented as Absolute Requirements and Not Factors to be Weighed

Until now, the traditional legal analysis under Pennsylvania and federal law for determining whether an individual is an independent contractor or an employee has focused on the level of control by the hiring party over the individual and has taken into account, and reasonably weighed in light of the particular circumstances, various facts under analyses commonly referred to as the “IRS Test” or the “ABC Test.” The types of factual circumstances, or “factors,” analyzed and weighed under longstanding Pennsylvania and federal law did include, among other relevant facts, whether there was a formal contract between the parties and many of the same categories of facts that have now been elevated to statutory requirements in the Misclassification Act’s list of criteria. Until now, the absence of any particular factor did not

automatically mean the individual was not an independent contractor. It was just one of many circumstances to weigh.

The new Misclassification Act, read literally, makes the existence of a written contract and all six of the listed criteria, including the unique insurance requirement for individuals acting as independent contractors, absolute conditions for the individual to be treated as an independent contractor for Pennsylvania workers' compensation and unemployment compensation purposes. This makes the Misclassification Act different from other areas of Pennsylvania law and from current federal law, including federal tax and employment laws, so it is now possible that an individual working in the Pennsylvania construction industry may be classified as an independent contractor for federal law purposes (and even for Pennsylvania law other than specifically workers' compensation and unemployment compensation purposes), and at the same time be statutorily treated as an employee under the Misclassification Act for workers' compensation and unemployment compensation. For example, if an individual under traditional legal principles (*e.g.*, under the IRS Test) were unquestionably an independent contractor, but failed to have liability insurance, the individual would under the Misclassification Act be artificially classified as an employee.

B. Potential Constitutional Implications of Limiting Application of Misclassification Act Only to Construction Industry and Only to Individuals

The Misclassification Act, while on one hand purporting to simply defer to the definitions of "employee" in the Workers' Compensation Act and Unemployment Compensation Law, as a practical matter deviates from those definitions and artificially creates different statutory definitions of "employee" and, by negative implication, "independent contractor," adding the entirely new mandatory criteria, such as the written contract and unique insurance requirements. The Misclassification Act only applies to the construction industry in redefining who is an employee, and to make it even more narrow, only applies to individuals acting specifically as independent contractors. In contrast with the new Misclassification Act and its narrow requirement mandating insurance only for individuals, most laws mandating insurance, like the Pennsylvania Home Improvement Consumer Protection Act, apply requirements across-the-board to both sole proprietors and other types of businesses.

There arguably is no rational basis for requiring a sole proprietor who is acting as a subcontractor on a project to have mandatory insurance coverage while a two-person partnership or even a giant multinational corporation performing the exact same subcontract has no insurance requirement of any kind. It is similarly hard to make logical sense of how a general contractor on a project (if not an individual) can have no liability insurance requirement but the subcontractor has mandatory insurance requirements.

The new law creates unique burdens on, and disincentives from using, small sole proprietor types of business in the Pennsylvania construction industry.

The unequal treatment of the construction industry and its sole proprietors potentially raises constitutional "equal protection" issues for the new Misclassification Act which may need to be sorted out in court in the future.

C. Miscellaneous Insurance Issues

The requirement of the Misclassification Act concerning insurance merely provides that the individual must maintain “liability insurance during the term of this contract of at least \$50,000.”

Although the insurer presumably would at least have to be an insurance company licensed in Pennsylvania, the law does not provide any minimum rating or any other standards for the insurer or required policy and, unlike the Pennsylvania Home Improvement Consumer Protection Act, does not specifically require that the liability insurance “cover property damage caused by the work.”

The new law also does not contain any exemption from the mandatory insurance requirement for Amish contractors or other religious objectors. (Even the Patient Protection and Affordable Care Act passed by Congress and signed into law by President Obama mandating health insurance beginning in 2014 contains an exclusion for religious conscientious objectors.)

D. Unclear Scope of “Officer” and “Agent” Liability

Section 4 of the Misclassification Act makes “officers” and an undefined class of “agents” personally liable and subject to criminal prosecution. In this regard, the Misclassification Act, in pertinent part, provides as follows:

“An employer, or an officer or agent of an employer, shall be in violation of this Act and shall be subject to the penalties, remedies and actions contained in this Act if the employer, officer or agent [fails to properly classify an individual as an employee].”

This personal liability provision is ambiguous on several levels. First, for example, it does not limit, or clearly define, exactly who is intended to be in the class of “officers” or “agents” subject to personal prosecution or liability.

Even with respect to actual “officers” in a formal corporate setting, the law is unclear whether anyone who has any paper title as a corporate officer is automatically and strictly liable for any violations of the Misclassification Act, or whether there are some reasonable limitations intended to apply. Many employment and tax laws establishing corporate officer liability limit such personal liability to circumstances where the individual has “policymaking authority” relevant to the matter that is the subject of the alleged violation, and has at least some proprietary ownership interest in the employer entity. Is a bookkeeper in a small corporate construction business who has no ownership interest in the company and no connection with or responsibility for classifying individuals as employees or independent contractors subject to criminal prosecution and personal liability simply because he or she is technically listed purposes as the “secretary” of the corporation? Does the innocent spouse who does not actively work in the business and owns none of the stock but who is listed as a corporate officer have personal liability and potential criminal responsibility if unbeknownst to the spouse the business, or another officer or agent of the business, misclassifies an individual?

The meaning of “agent” is even more wide open. It is not on its face even limited to employees of the business alleged to have violated the Misclassification Act. It is unclear what the implications are for multiple tiers of subcontractors.

On a whole other level, the provision is grammatically ambiguous about whether an innocent officer or agent with no knowledge of any potential violations is strictly liable and subject to prosecution for the actions or omissions by the employer entity, or by a different agent or officer. The way the vague provision is written the exact same rules must apply to mere “agents” as to “officers.” If an innocent corporate officer with no knowledge of a violation can be held liable for the actions of the corporate employer entity, the overbroad class of “agents” presumably must also be subject to such vicarious personal liability.

There appears to be much to be sorted out in litigation about the officer and agent liability provision of the Misclassification Act. PBA’s position is that an officer or agent (whatever that is) should only be subject to potential liability or prosecution if it can be proven that the individual officer or agent was actually responsible for causing the misclassification.

IV. SUCCESSFUL LOBBYING EFFORTS ELIMINATED MANY OF THE WORST ELEMENTS OF THE ORIGINAL VERSION OF THIS LEGISLATION

While PBA believes that even the final version of the Misclassification Act that became law is ill-conceived and does more harm than good, the original and various interim versions of the Bill pushed by the labor unions were dramatically worse. PBA and its allies were successful in lobbying to completely block several major particularly bad portions of the original proposed legislation and to have some favorable modifications made to several remaining provisions that could not be completely eliminated. For example, the mandatory “criteria” list that is the core concept of the Bill was successfully cut in half, from twelve down to six items. Some of the especially burdensome elements of the original Bill that were successfully resisted in lobbying by PBA and its allies include the following:

A. Standing of Labor Unions and Private Individuals to Bring Legal Actions

PBA and its allies were successful in lobbying to eliminate from the original version of the Bill provisions that would have given legal standing to individuals claiming to have been misclassified, and to labor unions and other non-attorney representatives, to bring lawsuits, including class actions, directly against construction industry employers for alleged violations of the Misclassification Act, and to seek attorneys’ fees for such actions.

B. Elimination of Applicability of New Law to Pennsylvania Minimum Wage Act and to Wage Payment and Collection Law

The original version of the Bill would have had the Misclassification Act apply for the purposes of Pennsylvania’s Minimum Wage Act and to Wage Payment and Collection Law in addition to the Workers’ Compensation Act and Unemployment Compensation Law. The ultimate version is limited solely to workers’ compensation and unemployment compensation.

C. Removal of Provision Causing Debarment from Public Works

Also successfully eliminated from the earlier versions of the Bill were provisions that would have resulted in construction employers being debarred from eligibility to perform public works for a period of up to three years for certain intentional violations.

D. Reduction of Insurance Requirement from \$1M to \$50K

The original version of the law would have required any independent contractor to have general liability coverage of at least \$1M. Although PBA and its allies were unable to have the requirement completely removed from the list of criteria, it was substantially softened to a mere \$50K level of coverage in the ultimate statute.

E. Miscellaneous Other Provisions Successfully Affected

- The requirement regarding possession of necessary tools and equipment that ended up in the enacted law was substantially softened as a result of lobbying. The original version of the Bill would have required the hiring party to be able to prove that any tools or equipment used by the independent contractor were actually titled to, or leased under a written lease agreement from a third party by, the independent contractor. Under this initial rule pushed by the labor unions, equipment, such as scaffolding and ladders, could not even be shared among multiple subcontractors. This was substantially cut back in the final enacted statute, which merely requires that the individual possess the requisite tools and equipment independent of the hiring party.
- Provisions in the original Bill that would have allowed the Department of Labor and Industry to administratively issue “stop work order” shutting down all work sites of the hiring party were successfully eliminated. Under the final version, only courts have the power to issue stop work injunctions for alleged Misclassification Act violations. It is now limited solely to the specific site where the alleged violation is occurring.
- A provision that would have extended the reach of the new law to “maintenance work” was successfully blocked in lobbying and eliminated from the definition of construction work subject to the law.
- Also blocked from inclusion in the final enacted law were proposed provisions which would have artificially classified any independent contractors who were violating immigration laws as employees.
- A mandatory requirement that the hiring party be able to prove that the individual “includes income and losses from the services rendered on federal income tax schedules” was also successfully eliminated prior to the final enactment.
- Other criteria eliminated as mandatory requirements for independent contractor status included such things as being able to prove that the individual incurred the “main expenses related to the work,” and that the individual was responsible for the satisfactory completion of the work and liable for any failures.

V. WHAT PBA MEMBERS MUST DO TO COMPLY WITH THE NEW LAW

Prior to the February 11, 2011 effective date, PBA Member construction businesses who engage individuals as independent contractors should, with the guidance of their legal counsel, carefully review all existing independent contractor relationships that are currently in place and make sure it is possible to qualify the individuals as independent contractors under the new law given the actual level of control and other circumstances. If it is not possible, the individual may need to be made an actual employee or the relationship would need to be terminated. If the engagements would otherwise qualify as independent contractor relationships as long as the new insurance and other technical requirements are put into place, steps should be immediately taken to restructure and properly document the engagements consistently with the new law.

Independent contractor agreement forms and practices for use in future engagements should also be carefully reviewed and revised to ensure ongoing compliance with the new legislation. At a minimum, the following steps should be taken with the guidance of legal counsel:

- Procedures should be established to require that any individual independent contractor arrangements have written executed contracts with the essential terms of the engagement and with appropriate requirements for the individual to maintain insurance and provide certifications and proof of meeting all of the above-described criteria. Any agreement forms should be carefully reviewed and updated.
- Procedures should be put in place to require the independent contractor to furnish proof of insurance prior to commencing the engagement.
- As a practical matter, if the individual is being engaged to perform services in connection with home improvement contracts regulated under the Pennsylvania Home Improvement Consumer Protection Act, the individual should be required to demonstrate compliance with that Act prior to the engagement, including providing proof of registration as a contractor, if applicable.
- Practices and procedures should be established to obtain from the individual, and keep on file, proof of the individual's having performed the same type of work in the past for other hiring parties and/or proof of the individual's advertising or otherwise marketing such services generally. This should include such things as gathering copies of any newspaper, Penny Saver, yellow pages or other written advertisements; printouts of website advertisement; copies of letterhead; photos of truck signage; business cards, etc.
- Individuals should be required to formally invoice the hiring party for payments.
- To the extent possible and appropriate, payment arrangements between the hiring party and individuals should be structured so that it is clear that the individual has a risk of profit or loss. Particular care will need to be taken with respect to the use of hourly type arrangements and legal counsel should be consulted in structuring the compensation models to be used by the business.

- If the hiring party has a practice of providing essential tools and equipment that traditionally in the trade would be expected to be possessed by the independent contractor, such practice would need to be terminated prior to the effective date of the law.
- All other terms of the company's contract forms and practices relating to individual independent contractors should also be carefully reviewed with legal counsel to ensure that there is not a level of control and direction regarding the means and methods of how the work is performed that would cause the engagement to fail to meet the independent contractor definition of the new law. (An arrangement structured to have an individual build a porch within certain specifications for a flat fee of \$20K plus materials is very different from an arrangement under which an individual is required to work under close supervision from 7 a.m. to 3 p.m. on an hourly basis with tools and materials being ordered and provided by the hiring party.)

It is important to understand that there is not a simple one-size-fits-all contract form that can be used to guarantee that an individual will be treated as an independent contractor. As has always been the law, the individual must genuinely be free from the level of control that would traditionally make the individual an employee and must otherwise continue to meet all of the same requirements that have always applied for independent contractor status in addition to maintaining the new required level of insurance, having a written agreement, and meeting the rest of the listed criteria in the new law.

PBA members who do not act as hiring parties, but who regularly function as single-person independent contractors for construction businesses, should also consider taking proactive steps, with the guidance of their legal counsel, to make sure they will be able to solidly document for general contractors their ability to qualify as independent contractors (assuming the level of control is not too great to make it a legal impossibility).

Practical steps that such sole proprietor businesses may begin taking include contacting insurance brokers to make arrangements to be able to quickly put in place the required \$50K general liability insurance at the point of any engagements after the new law goes into effect; having an established business address, business cards, formal invoice forms, and letterhead; acquiring or making arrangements to be able to use all essential tools and equipment of the trade without relying upon the hiring party; registering under the Pennsylvania Home Improvement Consumer Protection Act, if appropriate (which will bring in its own overlapping insurance requirement); taking steps to advertise and market at a level appropriate for the size of the engagements, and keeping copies of any such advertising and marketing materials in packet that can be provided to hiring parties; assembling proof (without divulging any confidential information) of engagements by other customers; and creating and using truck signage, if appropriate. Depending upon the circumstances, individual independent contractors may also wish to consider, with the guidance of legal counsel, whether it might be appropriate and cost effective to set up a more formal entity structure for the business, like a corporation or limited liability company, and/or whether it is appropriate to register a fictitious name with the Pennsylvania Department of State.

VI. RECAP

Under Pennsylvania's new Misclassification Act, an individual who is engaged to perform services for remuneration in the residential or commercial construction industry will be automatically treated as an employee, and not an independent contractor, for Pennsylvania workers' compensation and unemployment compensation purposes unless (1) the individual is free from the hiring party's control or direction over the performance of the services and (2) all of the following requirements are satisfied:

1. There is a written independent contractor agreement between the hiring party and the individual.
2. The individual possesses the essential tools necessary to perform the services.
3. The arrangement between the hiring party and the individual is structured so that the individual may realize a profit or suffer a loss from the engagement.
4. The individual has an ownership interest in his or her business that is contracted to perform the services for the hiring party.
5. The individual must have a physical business address separate from the hiring party's location.
6. The individual must have either previously performed the same types of services for other parties or must hold himself out to other potential customers as being able and available to perform such services.
7. The individual must maintain for the duration of the contract liability insurance of at least \$50K.

The hiring party business, and its officers and agents, may be civilly liable, may face criminal prosecution, and may be subject to stop work orders on projects for misclassifications of employees as independent contractors in violation of the new law.

*This summary prepared by
Loudon L. Campbell, Esq., and James A. Diamond, Esq.,
ECKERT SEAMANS CHERIN & MELLOTT LLC, Legal
Counsel to the Pennsylvania Builders Association*

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