

## **Which Is More Important, Staying In Business Or Your Informal Relationship With Your Subcontractor?**

In the construction world the relationship between a contractor and subcontractor is sacred and not to be questioned. This is understandable because a contractor is in need of good reliable subcontractors who can perform quality work on a moment's notice with no questions asked.

This article is going to take a different approach to address why there needs to be a formal relationship by asking "Which is more important, staying in business or your informal relationship with your subcontractor?"

This is an open ended question with no right answer.

### **Hidden Financial Exposure – What?!?!**

Not following formalities between you and your subcontractor can lead to unintended yet costly financial exposure that affects the profitability of your business. The potential, yet very, real financial risks include:

- Suspension of your contractor's license;
- Loss of profit for work performed;
- Unemployment Insurance - Payment and penalties for your subcontractors and its employees;
- Employment Training Tax – Payment and penalties for your subcontractors and its employees;
- State Disability Insurance – Payment and penalties for your subcontractors and its employees;
- California Personal Income – Payment and penalties for your subcontractors and its employees;
- Triggering of Workers' Compensation Insurance for injuries caused to subcontractor and/or its employees;
- Increased Workers' Compensation Premiums;
- Triggering your general liability insurance if no workers compensation;

If you want to avoid these real possibilities continue reading to (1) see real life examples where the law is not followed, (2) learn what unintended financial consequences the contractors in these real life examples have endured and (3) understand the law.

### **Real Life Examples**

At this juncture you are probably saying, "that is nice, but this will *never* happen to me." Let's look at some real life examples.

### **Workers' Compensation Nightmare**

A general contractor has a long standing “working relationship” with a licensed subcontractor. The scope of work, price, etc. for each project is done on a handshake. The subcontractor always shows up for each project at the time specified by the general contractor. This subcontractor even brings along his brother when extra help is needed. The subcontractor pays his brother cash as he has certified to the CSLB that he has no employees.

This general contractor also sees no reason to insult his long time subcontractor/friend by asking him (1) to sign a written contract to formalize their relationship; (2) to check and see if his licensed subcontractor has a general liability policy for his work; and (3) workers compensation to cover his brother.

The subcontractor’s brother hurts himself on the job. The contractor does not know that the subcontractor’s brother works for the subcontractor let alone that he hurt himself on the job.

The contractor finds out this information when he receives notice of a claim on his workers’ compensation policy!

The policy is correctly triggered because the subcontractor’s brother by operation of law is an “employee” of the contractor. This was because there is no formal relationship between the contractor and the subcontractor. Thus, by law, subcontractor and subcontractor’s brother are deemed employees of the general contractor.

Note: At some point the contractor could be responsible for payment of the different taxes mentioned above and possibly loss of all profits on the project.

### **Lost Profits**

A licensed stucco contractor is trying to “get through” this tough economic downturn. As a means of staying in business he had to (1) formally lay off all his employees (2) not renew his workers’ compensation and (3) declared to the California State Contractor’s board that he is a sole-proprietor with no employees.

He took a job that required additional help. He hires back two of his former employees as “independent contractors”. Neither of these “independent contractors” have their contractor’s license.

The stucco contractor performs superior work. However, the homeowner is extremely unreasonable and does not like the work performed by the stucco contractor. The homeowner refuses to pay the contractor for the work completed. The stucco contractor sues the homeowner for monies owed under the contractor. The lawsuit backfires and the stucco contractor ends up paying back all the profit he earned on this project. Why?

California law states that any contractor who fails to maintain workers compensation insurance coverage shall have his license automatically suspended.<sup>1</sup> The law further states that a homeowner who hires an unlicensed contractor is entitled to recover all compensation paid to an unlicensed contractor.<sup>2</sup>

The stucco contractor inadvertently suspended his own contractor's license by hiring unlicensed independent contractors while not maintaining workers' compensation coverage. The penalty for working without a contractor's license is the forfeiture of all money received for work on a job. Thus, the contractor ultimately had to reimburse the homeowner all of the payments made by the homeowner.

### **The Law—Boring! Maybe??**

Ok, still not convinced? Let's look at the law. The law, in summary, states a person who is performing services in the construction industry without a valid contractor's license becomes an employee of the contractor who either holds a license or is required to be licensed.

The first question to be asked is who or what is legally defined as a contractor.

A contractor is defined as anyone person or legal entity that constructs, alters, repairs, adds to, subcontracts from, improves, moves, wrecks, or demolition...anything...<sup>3</sup>

Based on this broad definition *you* are a contractor and the laws below apply to you and your relationship with your subcontractor.

The next question then is who are *your* potential employees under the law.

In the eyes of the law, an employee is anyone (licensed or unlicensed) who is working for a contractor unless proven differently. This can be anyone from your subcontractor's unpaid brother (see example above) to your subcontractor himself. In this respect you are considered guilty until proven innocent.

There is a way to insure that your subcontractor stays an independent contractor and does not become an unintentional employee. This is by formalizing the relationship between you and your subcontractor.

California law has four factors<sup>4</sup> that must be adhered to prove your independent contractor is really an independent contractor. These four factors are:

- (a) The subcontractor directs and controls how the services contracted for are accomplished
- (b) The subcontractor is customarily engaged in an independently established business

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<sup>1</sup> Cal. Bus. & Prof. Code 7125.2

<sup>2</sup> Cal. Bus and Prof. Code 7031(b)

<sup>3</sup> Business and Professions Code 7026

<sup>4</sup> Labor Code 2750.5

- (c) The subcontractor's independent contractor status is bona fide and not a ruse to avoid employee status and
- (d) The subcontractor must have a valid state contractor's license.

There are a few documents that you should have in your file to show that your subcontractor is an independent contractor and not your employee. These documents include:

- Subcontractor's business license
- Subcontractor's Independent tax I.D.
- Subcontractor's workers' compensation
- Subcontractor's general liability insurance
- Written agreement formalizing the relationship between subcontractor and contractor
- Copy of subcontractor's license

At the end of the day the law is blind. It does not care (1) that you have a sacred relationship with subcontractor; (2) how long you have been working with your subcontractor; (3) that you are concerned about insulting your subcontractor with formalities; (4) etc. etc. The only way to keep your subcontractor from becoming an employee is to follow the required formalities set forth by California law.

This article starts and ends with the same questions, "Which is more important, staying in business or your informal relationship with your subcontractor?"

Maria Plumtree and David Tran are founding partners of Plumtree & Tran, LLP. Plumtree & Tran, LLP focuses their practice on the protection of contractors.