No. S238941

IN THE SUPREME COURT OF CALIFORNIA

SUPREME COURT
FILED
JUL 25 2017
Jorge Navarrete Clerk
Deputy

SHARMALEE GOONEWARDENE,
Plaintiff and Respondent

vs.

ADP PAYROLL SERVICES, INC., ET AL.,
Defendants and Petitioners.

CRC 8.25(b)

After a Decision of the Court of Appeal,
Second Appellate District, Division Four Case No. B267010

Appeal from the Superior Court of the State of California
County of Los Angeles. Case No. TC026406
Honorable William Barry, Judge Presiding

APPLICATION FOR LEAVE TO FILE AMICUS CURIAE BRIEF IN SUPPORT OF PETITIONER; AMICUS CURIAE BRIEF

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APPLICATION FOR LEAVE TO FILE AM IC US CURIAE BRIEF I N SUPPORT OF PETITIONER

Pursuant to rule 8.520(f) of the California Rules of Court, TASLAR respectfully requests leave to file the attached amicus curiae brief in support of Petitioners ADP Payroll Services, Inc., ADP, LLC and AD Processing, LLC (hereinafter collectively referred to as "ADP") on the issue as to which the Court granted review: "Does the aggrieved employee in a lawsuit based on unpaid [wages] have viable claims against the outside vendor [i.e., the payroll service bureau] that performed payroll services under a contract with the employer?" (Order, Feb. 15, 2017.)

The TASLAR entities are each independently owned small businesses operating a payroll service providers. Some of these small businesses are located in California and others are located in sister states, and all process payroll checks for California employers. The TASLAR

entities seek to file their brief out of concern over the unprecedented imposition of liability by the appellate court upon payroll service providers under both contractual and tort theories to employees for violation of the duties imposed upon employers under Labor Code. The TASLAR entities believe the information and views provided in its brief will assist the court by addressing the scope and effect of the appellate decision as well as its unintended consequences.

The TASLAR entities have no interest in or connection to either side of this case. In fact, petitioners are in competitors with the TASLAR entities' businesses. No party or party's counsel authored the attached amicus curiae brief in whole or in part. Other than the TASLAR entities, no person or entity, including any party or party's counsel, made a monetary contribution intended to fund the preparation or submission of this brief.

Dated: July 20, 2017

Respectfully submitted,

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AMICUS CURIAE BRIEF

I

INTRODUCTION

In granting review, this Court will decide whether payroll service providers, which provide business services to employers, can be held liable under contract and negligence theories of liability to the employers' employees for violation of statutory duties imposed upon employers under the Labor Code in the payment of wages. The decision by the Court of Appeal extending such liability against payroll service providers is based on a misunderstanding of the role and the mechanics of the services provided by payroll service providers. The TASLAR entities are extremely concerned for the survival of their businesses which is threatened by such a drastic judicial extension of liability for employers' duties under the Labor Code to encompass vendors, i.e., payroll service providers.

In the present case, the Court of Appeal applied third party beneficiary concepts to extend an employer's statutory wage duties without a sufficient understanding of the services provided by payroll service providers. There has been no legislative change to the express provisions of Labor Code which limit liability to employers. The Court of Appeal did not hold that the requirements of the wages laws within the Labor Code were

intended to apply to, or encompassed the services provided to the employer by vendor payroll service providers. This brief explains, from the perspective of small independent payroll service providers, why the extension of liability to employees for the violation of an employers' statutory wage obligations bootstrapping contract and negligence theories is bad law, why this court should stop it and the financial effect of the concomitant litigations costs on small independent payroll service providers would drive thousands of payroll processors out of the market decreasing competition and consequently increasing the payroll processing costs to employers.

II

PAYROLL SERVICE PROVIDERS

The primary function of payroll service providers is the administration of payroll taxes for third party employers. While employers also utilize payroll service providers to assist them with some of their employee payrolls, that function is derivative of, and secondary to the calculation and assistance in satisfying employer employment tax requirements. Employers rely on payroll service providers to comply with complex federal, state and local tax deposit requirements, which vary significantly by jurisdiction and tax type in terms of deadlines, electronic

formats and filing requirements. Payroll service providers also typically handle quarterly state unemployment insurance wage and tax reporting and payment as well as annual W-2 filings and reconciliations. Absent payroll service providers, employers would otherwise have to make significant investments in legal assistance, technology and support staff to comply with frequent employment tax changes.[1] In this respect, the Internal Revenue Service (hereinafter "IRS") and most states require payroll taxes to be filed and paid electronically, in diverse formats and protocols which often change annually. The failure of an employer to comply with any one of its employment tax obligations may result in significant penalties.

Employers use payroll service providers to prevent costly IRS and state tax penalties. Statistically, each U.S. employer receives at least one IRS payroll tax deposit penalty every year, with an average penalty of nearly $700.[2] Payroll service providers are historically at least 10 times more accurate in tax filings than the employer population (i.e., incur less than one-tenth the number of penalty notices per return filed).

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1 According to the IRS, "there have been approximately 4,680 changes to the tax code since 2001, an average of more than one a day." *IRS National Taxpayer Advocate, Annual Report to Congress*, December 31, 2012, p. 6.

2 IRS Data Book FY2012, Table 17. Civil Penalties, Fiscal Year 2012.

Payroll service providers serve an important role in our nation's tax collection system as a conduit between employers and the IRS. Payroll service providers improve the efficiency of IRS tax collection and compliance assisting employers in making required tax deposits and tax information filings to the federal government and to state and local governments, greatly streamline business operations.

Payroll service providers are regulated by the Internal Revenue Service which defines these the scope of these businesses as follows:

1. A payroll service provider (PSP) is a third party that can help an employer administer payroll and employment taxes on behalf of an employer.

2. An employer may enter into an agreement with a PSP under which the employer authorizes the PSP to perform one of more of the following acts on the employer's behalf:

    - Prepare the paychecks for the employees of the employer.
    - Prepare Forms 940 and 941 for the employer using the employer's EIN.
    - File Forms 940 and 941 for the employer, which are signed by the employer.
    - Make federal tax deposits (FTDs) and federal tax payments and submit this information for the taxes reported on the Forms 940 and 941.
    - Prepare Form W-3 and Forms W-2 for the employees of the employer using the employer's EIN.

3. **A PSP is not liable for an employer's employment taxes as either an employer or an agent.**

4. **An employer's use of a PSP does not relieve the employer of its employment tax obligations or liability for employment taxes.**

Internal Revenue Manual 5.1.24, *Field Collecting Procedures, Third-Party Payer Arrangements for Employment Taxes* (Effective Nov. 6, 2015) (Emphasis added.).

Under the IRS regulations, the role of payroll service providers can best be described as mechanical in nature. The data for payroll processing is provided by employers. The role of payroll service providers is to perform the mathematical calculations for the payrolls, employment taxes and benefits from the data provided by the employers, and thereafter, printout the resulting payroll calculations for review and use by the employers.

Employers collect and supply all payroll data from their employees, and thereafter, convey that data, including wages and hours, to payroll service providers. Payroll service providers do no act as an audit of employers' payroll data. In most instances, employers perform their own data entry using on-line internet portals furnished via licensed computer software by which employers to input their payroll data using their own computers. After that payroll data is entered, licensed computer software is used to calculate gross wages, deductions and payroll tax liabilities, to draft

payroll checks and employee wage statements. make direct deposits, preparation of reports for employer management. The resulting product is then delivered to the employer. Employer are charged with reviewing and approving the work product received from the payroll service provider. In short, payroll service providers' work product is carried out for employers. Employers are responsible for providing the payment of their employees and supplying payroll statements to their employees.

A. <u>The Market Place</u>.

ADP dominates the payroll service provider industry commanding a thirty percent (30%) market share.[3] As of 2015, ADP had more than 610,000 business clients who employed roughly 24 million employees in the United States.[4] The next biggest payroll service provider is Paychex which has roughly a ten percent (10%) market share.[5] For added context, there are approximately 5900 payroll service providers in the country. In contrast to the services provided by the market share leaders, the monthly fee charged for payroll processing services by small independent payroll service providers is approximately four dollars ($4) per employee.

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3 Morningstar.com

4 Fortune.com, Dec. 2, 2015

5 Morningstar.com

B. The TASLAR California Based Payroll Providers.

Pay-Net and Payroll World are both established payroll service providers, providing payroll services to small and mid-sized businesses throughout San Diego County. Pay-Net and Payroll World, which were both established in 1995, are family run small businesses. Pay-Net and Payroll World do not possess insurance which would provide coverage to lawsuits by its clients' employees relying instead upon contractual provisions limiting their liability to their employer clients.

HCM Centric and Promerio are located in Los Angeles County. HCM Centric services approximately 1600 employers with approximately 25,000 employees and Promerio processes payrolls for about 500 employers. The operator of HCM Centric has over 22 years experience as a payroll processing provider. Promerio has been processing third party employer payrolls for over 16 years and its two principals have over 45 years experience in payroll processing between them.

The operator of Payality has over 27 years experience as a payroll processing provider. Payality, which operates in Fresno County, services over 700 employer clients with approximately 20,000 employees combined. Of those employees data entry is performed by the employers for more than 92% of the employers' employees. As with Pay-Net and Payroll World,

Payality does not possess insurance which would provide insurance coverage for lawsuits by its clients' employees depending instead upon contractual limitations of liability with their employer clients.

C. **The TASLAR Sister State Based Payroll Providers.**

Erie Custom Computer Applications (hereinafter "ECCA") has been a family owned and operated payroll service provider since 1975. Located in Erie, Pennsylvania, ECCA processes payrolls for some 1,550 employers with approximately 75,000 employees. Of those, only some ten (10) employers for whom ECCA processes payrolls have offices and employees in California.

Task HR-VA has been a father and son owned and operated payroll service provider since 1985. Task HR-VA is based in Virginia processing payrolls for approximately 1,519 employers with combined employees of around 96,000. Of those employers fifteen (15) have a total of eighty (80) California employees. All of the payroll data processed by Tash HR-VA for those 80 California employees is entered on-line by the employers.

Adminasource has payroll processing operations in New Jersey and Texas. The operator of Adminasource has over 30 years experience as a payroll processing provider. Adminasource processes payrolls for 350 employer clients of which on one (1) has California employees.

QTS Payroll Services has been processing third party employer payrolls since 1986. QTS Payroll Services has operations in Nevada, Idaho and Arizona providing payroll services to more than 900 employer clients with some 20,000 employees. Of those employers and employees, approximately 50 have California operations with between 500-600 total California employees.

III

DISCUSSION

This brief argues that the Court of Appeal has made bad law from misunderstanding the function, economic role and mechanics of payroll service providers. The substance of the decision by the Court of Appeal is to expand liability for violation of employers' wage related duties under the Labor Code to encompass employers' payroll service providers. Without any legislative change, the Court of Appeal has countenanced litigation against payroll services providers for employers' infractions of the Labor Code under both contract and tort theories of liability. The result the Court of Appeal will inevitably be the reduction in competition through the withdrawal of payroll service providers from California, increased costs to employers for payroll processing services and increases in employment litigation.

A. Employees Are Not Intended Beneficiaries of the Services Provided to Employers by Payroll Service Providers.

In California, the rule permitting third party beneficiaries to a contract is codified. *Cal. Civ. Code* 1559 (Deerings 2017). The statute requires that unless a contract is made expressly for the benefit of a third person, no action may be brought by that third person. That is, a person who is only incidentally benefitted has not right of action.

In its decision the Court of Appeal clings to the antiquated concept of creditor and donee beneficiaries which are obsolete and deviate from the seminal issue: Ia a service provider agreement made *expressly* for the intended benefit of the employees? Unless the payroll service provider agreement is made for the intended for the benefit of an employee, no action for breach of contract can be stated.

In determining whether employees were intended beneficiaries, the appellate court focused on essentially two aspects of the alleged agreement, i.e., petitioner performed the mathematical calculations of respondent's wages for the employer and provided respondent's wage statement for her employer. The Court of Appeal did not look at the agreement as a whole, but only two of the alleged provisions. And, as set forth above the principal role of a payroll service provider is employment tax calculations, *et cetera*,

of which the payroll services are derived as a secondary function. The determination of whether a third party is an intended or incidental beneficiary must be made from the contact as a whole, and not merely from one or two alleged provisions.

Furthermore, the appellate improperly considered generalized advertising in reaching its conclusion. The Court of Appeal does not assert that the promotional materials to prospective employer clients were part of the agreement, but nevertheless, the appellate court based its decision that employees were intended beneficiaries in part on advertising, and did not instead of the alleged agreement as a whole.

The methodology of the appellate court presents the potential for widespread third-party impact that is *inherent* in the contractual relationship between employers and payroll service providers. Given the conceivably millions of potential of persons who could claim liability for any particular payroll service providers contract with their respective employers, additional factors must be present if persons from within this broad class will be contractually entitled to rely on the work product arising from a particular engagement for payroll services. That is, the class of *inherent* third-party beneficiaries is not the class of *express* third-party beneficiaries, or else the distinction between incidental and express beneficiaries would

lose all meaning in the payroll services context. As a matter both of policy and of reality there should be no "express third party beneficiaries" of an ordinary, standard payroll processing contract. The employer is the entity for whom the payroll calculations are generated and to whom those calculations are reported and approved. There are only incidental beneficiaries who have no legal rights arising from the contract.

By way of example, when a vendor of goods knows a buyer intends to resell the goods to a third party, that does not establish that the vendor intends to benefit the third party. The fact that vendor knows a buyer intends to resell to third party is not sufficient to make third party an intended beneficiary of the agreement between seller and buyer. The same rule should apply where the vendor provides services. In other words, there is an important difference between knowledge that a certain outcome will occur, and an intent to bring about that result. In order to establish third party beneficiary status, the contracting parties must have acted with more than the mere knowledge that a third party would derive benefit from the agreement. The benefit to the third party must have been a consequence which the parties affirmatively sought. The benefit to the third party must have been, to some material extent, a motivating factor in the decision to enter into the contract.

B. Important Policy Consideration Mediate in Against Extending Contract Liability to Third Party Employees.

First, breach of contract in this context is not an insurable occurrence under a Commercial General Liability (hereinafter "CGL") policy. That is, where, as in the case of a third party beneficiary action for breach of a payroll service provider agreement, the damages being demanded arise due to failure to meet an agreed upon obligation, there is no insurance coverage to provide a defense. Indeed, avoiding coverage for breach of contract claims is the very reason CGL policies first exclude all contractual coverage. Otherwise stated, claims for breach of contract to provide payroll services are not covered by CGL insurance.

Similarly, while errors and omissions insurance is designed to complement CGL Insurance to provide coverage for claims arising from the provision of "professional services," errors and omissions insurance likewise excludes coverage for breach of contract by a customer against an insured. Even though most companies sell their goods and services under a contract, errors and omissions insurance often excludes coverage for actions arising from breach of contract.

The result is that payroll service providers who are brought into wage disputes between an employee and employer will have to bear their

own defense costs which can be staggering for a small business. The litigation defense costs of only a few such lawsuits would be enough to cripple a small, independent payroll service provider such as one of TASLAR's ilk. Even where such a payroll service provider did have insurance coverage defending such actions, the deductible and the cost of the insurance would present a major financial drag on payroll service providers resulting higher costs, and higher service fees, in the industry.

There would necessarily be a loss of competition as the added costs to payroll service providers took a financial toll. Those payroll service providers unfortunate enough to service employers who have wage and Labor Code litigation will likely be forced out of business as the costs of defending 3 or more lawsuits at time would be financially prohibitive to the business model of TASLAR type payroll service providers.

There will be a loss of competition in the market. None of the sister state payroll service providers which have only a tangential, small number of employers with California employees can justify the risk of potentially devastating litigation costs for such a small amount of revenue in California.

This loss of competition will obviously result in increased costs to employers in California for payroll services.

C. The Decision to Allow a Claim for Negligent Misrepresentation Against Payroll Service Providers for Erroneous Wage Statements is Ill-considered.

The problem with the appellate ruling on negligent misrepresentation is two-fold. Payroll service providers play a "secondary" role to their employer clients and, by the express language of the statute, Labor code section 226 applies specifically to employers, and payroll service providers who are not liable under the statute for the alleged Labor Code violation.

The Court of Appeal acknowledges that those who provide financial reports and opinions to clients, i.e., employers, based upon information provided by the clients, including its agents, are deemed to have played a "secondary" role. (Decision of the Court of Appeal, at p. 30.) And, that those who play a "secondary role" are not subject to an action for negligent misrepresentation unless the claimant is a "specifically intended beneficiary." (Decision of the Court of Appeal, at p. 31.) The Court of Appeal also recognizes that the employer and its agents, i.e., its employees, provided the data, i.e., information, to the payroll service provider. (Decision of the Court of Appeal, at p. 32.) Thus, under *Bily v. Arthur Young & Co.*, 3 Cal.4th 370 (1992), payroll service providers would be deemed to play a "secondary" role as it relates to third party employees.

However, the Court of Appeal views the allegations that the payroll service provider mathematically miscalculated respondent's wages from the data and information supplied to the payroll service provider by the employer as transmuting the role of the payroll service provider from secondary to primary. (Decision of the Court of Appeal, at p. 32.) In essence, the mere allegation, which would likely be present in every action for negligent misrepresentation, that the professional made a mistake with the data it was provided effectively engrosses the entire distinction. An alleged mathematical mistake from data supplied by an employer and its agents should not change the "secondary" role of a payroll service provider.

D. Payroll Service Providers Should Not be Liable for Professional Negligence to Third Party Employees.

The Court of Appeal relies upon the three factors in *Bily v. Arthur Young & Co.*, *supra*, 3 Cal.4th at p. 398 to impose professional liability upon payroll service providers to third party employees. The appellate court's reliance is misplaced. In *Bily* the California Supreme Court declared that because the imposition of professional liability for auditors to third parties against auditors would likely increase costs and reduce the availability of auditors, that professional liability should remain confined to auditors' clients. Citing no statistics or other evidence, the Court of Appeal

blithely declared that in its view the imposition of professional liability upon payroll service providers to third party employees would not result in either a reduction of available service or an increase in the costs of those services. The Court of Appeal could not be more wrong. There are a plethora of employee wages cases in California every year. In fact, California wage claims make up more than half of the employment wage claim settlement dollars in 2014.[6] The litigation cost exposure presented by even a small fraction of those cases is sufficient to drive small providers, such as the sister state providers out of California's market. For in-state providers, some would go out of business and while other would have to increase their prices to account for the probable litigation costs. Those litigation costs would also be expected to reduce or preclude new payroll service providers from entering the California market. The decision to impose professional liability to third party employees by the Court of Appeal represents a change to entire payroll processing industry in this state.

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6 *NERA Economic Consulting, Trends in Wage and Hour Settlements: 2015 Update* p. 14.

IV

CONCLUSION

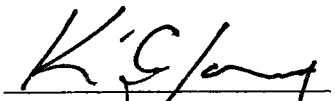
In rendering its decision, the Court of Appeal deviated from *stare decisis* declaring rights of action by third party employees against payroll service providers where none had before existed. The appellate decision before this Court has created instability where there had been stability, inconsistency where there had been consistency and unpredictability where there had been predictability within out judicial system. The consequences to the payroll services market and California's economy in permitting contract and negligence actions against payroll service providers by third party employees should be a matter for our legislative process, and not the result of an appellate court's decision on a narrow set of facts. The appellate decision before this court involves significant legal issues having a wide-reaching effect on the rights and obligations of thousands of businesses and their payroll costs.

Over the last fifteen years, nine states (Alabama, Arizona, California, Minnesota, Nevada, New York, Oklahoma, Utah & Virginia) have considered and rejected new legislation over the payroll service provider industry. This Court need not blaze a new trail. TASLAR urges the Court reverse the extension of liability imposed b the Court of Appeal.

Payroll service providers are rightly concerned about being named as defendants in the numerous wage cases filed every year in California and the litigations costs they will incur, whether they will be able to pass those costs on to employers, the effect on competition with the larger market share payroll service providers and whether they will be able to remain in business.

Dated: July 20, 2017

Respectfully submitted,



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CERTIFICATE OF COMPLIANCE

(Cal. Rules of Court, rule 8.520(f))

Pursuant to California Rules of Court, the foregoing Brief of Amicus Curiae in Support of Petitioner contains 3,749 words, including footnotes, but excluding the Application, caption page, and tables. This is fewer than the 14,000-word and 8,400-word limits set by rule 8.520(c)(l) of the California Rules of Court. In preparing this certificate, I relied on the word count generated by Corel WordPerfect version 12 word-processing program used to generate the brief.

Dated: July 20, 2017

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