



Rewriting California's Independent Contractor Rules: A Business Survival Guide

Insights

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With his signature on AB 5 on September 18, 2019, California Governor Gavin Newsom has completed the year-long overhaul of the state's independent contractor test. What was once governed by a balancing test that provided breathing room for businesses to deploy contractors with relative ease has now been transformed into a bright-line standard that will challenge businesses across the state when it comes to compliance. Companies will soon face an increased risk of misclassification claims from workers unless they take immediate steps to get in line with the new law.

Introduction: What Changed?

For decades, the critical line between employee and independent contractor hinged on a flexible "control" analysis: if the independent contractor, rather than the hiring entity, controlled how the objectives of a particular assignment were accomplished, the worker could be properly treated as a contractor. But if the hiring entity controlled the means by which the contractor accomplished their duties, the contractor was deemed an employee, and entitled to all of the benefits that accompany employment. Scores of tests emerged from courts and governmental agencies to determine what amounted to sufficient "control" to trigger a misclassification finding: the IRS had a 20-factor test, the state of California had a 10-factor test, and the U.S. Department of Labor has a six-factor test at the moment. Each of these tests focused primarily, though not exclusively, on how much "control" the hiring entity retained over the contractor.

In 2018, however, the California Supreme Court adopted the rigid ABC test in *Dynamex Operations West, Inc. v. Superior Court*. While the decision marked California's first departure from the traditional control test, the decision was also limited to state Wage Orders, and left some room for interpretation (and argument) about its applicability to other claims, including statutory claims under the Fair Employment and Housing Act (the FEHA).

With AB 5, the California legislature took things one giant step further. The newly enacted legislation, set to go into effect on January 1, 2020, will solidify the ABC test for virtually all employment purposes (not just the Wage Orders), expand its reach (by making it potentially applicable in business to business relationships), and simultaneously grant exemptions to a limited number of industries.

The ABC Test

The ABC test reduces the “control” analysis to serve as only one part of – rather than the focus of – the independent contractor analysis. This means a contractor is deemed an employee under the law *unless* the hiring entity – not the contractor – can establish each of the following:

1. **Control.** The person is free from the control and direction of the hiring entity in connection with the performance of the work, both under contract and in fact.
2. **Usual course of business.** The person performs work that is outside the usual course of the hiring entity’s business.
3. **Established trade or business.** The person is customarily engaged in an independently established trade, occupation, or business of the same nature as that involved in the work performed.

The 800-pound gorilla in the analysis is the “B” factor: whether the contractor is performing work outside the retaining entity’s “usual course of business.” Shifting the analysis from one centered on “control” to an analysis that purports to measure how closely the contractor’s work relates to the hiring entity’s business is new.

It is no secret that the analytical change embodied in AB 5 amounts to a direct attack on gig economy businesses. Many gig economy businesses, in one form or another, link willing contractors to potential customers, with the matchmaking business receiving a slice of the fee in exchange for facilitating the connection. In practical terms, this means gig businesses will now grapple with the plaintiffs’ bar arguing that a contractor who agrees to perform work under the proposed matchmaking platform is performing work that is within the company’s “usual course of business.”

This argument will be made regardless of how much control the business does or does not have over the contractor’s work, and regardless of whether the contractor can simply decline any proposed assignment he or she does not wish to accept. Expect gig economy businesses, and others, to carefully define their actual business, and heavily litigate whether contractors who perform services are really acting in the company’s usual course of business (i.e., the matchmaking).

While the “usual course of business” factor is sure to be the most contested portion of the ABC analysis for many companies, it is worth emphasizing that it is not the only factor at issue. Companies retaining contractors must still also prove that they do not and cannot control the contractor’s performance of the work, either contractually or in actuality (prong “A”); they must also prove that the contractor is engaged in work in an independently established trade, occupation, or business while performing the work (prong “C”). Worker advocates are already lining up to argue that contractors in particularly low-skilled positions are always “controlled” if there is only one way to perform the job (this argument has been applied to agricultural workers), and may similarly argue that low-skilled work is not “an independently established trade, occupation, or business.”

Beyond The Gig Economy

But gig economy businesses will not be the only ones impacted by AB 5. In fact, most freelancers in the California economy work in industries that are *not* part of the technology-centered gig economy. Individuals involved in music writing and production, trucking, interpreters and translators, software developers, information technology professionals, video game developers, film producers, event planners, and videographers often gladly perform work as contractors. As another example, it is well publicized that even Google has more contractors than employees.

With the passage of AB 5, workers and businesses in all of these industries – which are collectively far bigger than the mere gig economy – will now be governed by the same ABC test applicable to the gig economy.

Retroactive Effect Appears To Be Codified

AB 5 is apparently intended to be retroactive, which is in line with a previously withdrawn 9th Circuit decision addressing the retroactivity of the *Dynamex* holding. Once the bill goes into effect on January 1, 2020, it will as of then have retroactive effect, at least as to the independent contractor misclassification analysis.

Businesses with potentially problematic relationships should act now, not later, to limit liability and avoid the potential impact of a lawsuit in January.

The Chosen Few

Some industries and businesses were able to secure an exemption from the legislature's sprawling reach under AB 5. In fact, the legislature granted specific exemptions to a laundry list of industries, including: (1) licensed insurance agents; (2) doctors and veterinarians; (3) lawyers, architects, engineers, private investigators, and accountants; (4) registered securities broker-dealers or investment advisers; (5) direct sales salespersons (provided that the salesperson's compensation is based on actual sales rather than wholesale purchases or referrals); (6) commercial fishermen working on an American vessel (but only until January 1, 2023); (7) workers performing work under contract for "professional services;" (8) realtors; (9) licensed repossession agencies (but only if the repossession agency is free from the control and direction of the hiring person or entity in connection with the performance of the work, both under the contract for the performance of the work and in fact); (10) subcontractors in the construction industry (subject to certain requirements); (11) tutors (provided they teach their own curriculum and are not public school tutors); (12) construction truck drivers (until January 1, 2022, subject to certain requirements); (13) tow truck drivers affiliated with the American Automobile Association; and (14) newspaper distributors and deliverers (though only until January 1, 2021).

AB 5 also exempts those providing "Professional Services" defined as (1) marketing services (provided that the contracted work is original and creative in character); (2) human resources administrators (provided that the contracted work is predominately intellectual and varied in character); (3), travel agents; (4) graphic designers; (5) grant writers; (6) fine artists; (7) enrolled tax agents licensed by the U.S. Department of Treasury or who practice before the Internal Revenue

Service; (8) payment processing agents (provided they are retained through an independent sales organization); (9) certain photographers (who do not license content submissions to a putative employer more than 35 times a year); (10) freelance writers, editors, newspaper cartoonist (provided that the individual contributes no more than 35 submissions a year to the hiring entity); and (11) licensed estheticians, electrologists, manicurists (until January 1, 2022), barbers, or licensed cosmetologists, subject to a number of additional requirements.

Beyond being included as a qualifying industry, the professional services exemption requires that the contractor; (a) maintains a business location that is separate from the hiring entity (including the individual's residence); (b) maintains a business license if the work is performed more than six months after the effective date of the bill; (c) has the ability to set his or her own hours and set or negotiate his or her own rates; (d) customarily engages in the same type of work performed under contract with another entity; and (e) customarily and regularly exercises discretion or independent judgment in the performance of the services.

In addition to the above exemptions, AB 5 exempts, subject to stringent requirements, the relationships between a referral agency and service providers and bona fide business to business contracting relationships from the ABC Test. As discussed below, however, these exemptions are nuanced and require meeting multiple stringent requirements for their applicability.

Not explicitly granted an exemption from the applicability of the ABC test under the new law are gig workers, truck drivers (except construction truck drivers for a brief period of two years), occupational therapists, speech therapists, language interpreters, optometrists, nurse practitioners, physician assistants, radiation therapists, licensed professional clinical counselors, marriage and family therapists, licensed clinical social workers, respiratory therapists, audiology, information technology employees, low-wage service workers ranging from janitors to home health aides, as well as unlicensed nail technicians, musicians, and rabbis.

Exemption For Business-To-Business Relationships?

Although much of the publicity surrounding AB 5 has rightfully centered on individuals working as independent contractors, businesses have also expressed concern that legitimate "business-to-business" relationships could be swept up in the ABC test as well. The new law attempts to address this issue, but likely does not go far enough to address all of the concerns of the business community.

Specifically, the statute identifies "business service providers," who provide business services to "contracting businesses," as exempt from the ABC test's reach. To satisfy the exemption, however, a contracting business bears the burden of establishing that each of its "business service providers" satisfy each of 12 factors:

- **Control.** The business service provider must be "free from the control and direction" of the contracting business entity, both under the contract and in fact.

- **Services must be to the business, not customers.** The business service provider must provide services directly to the contracting business rather than to customers of the contracting business.
- **In writing.** The contract with the business service provider must be in writing.
- **Properly licensed.** The business service provider must have required business licenses and business tax registrations.
- **Separate location.** The business service provider must maintain a business location that is separate from the location of the contracting business.
- **Independent, established business.** The business service provider must customarily engage in an independently established business of the same nature as that involved in the work performed.
- **Other clients.** The business service provider must *actually* contract with other businesses to provide the same or similar services and maintain a clientele without restrictions from the hiring entity.
- **Actively advertises.** The business service provider must advertise and hold itself out to the public as available to provide the same or similar services.
- **Provides own equipment.** The business service provider must provide its own tools, vehicles, and equipment to perform the services.
- **Negotiate rates.** The business service provider must be able to negotiate its own rates.
- **Set own hours and location.** Consistent with the nature of the work, the business service provider must be able set its own hours and location of work.
- **Not applicable to construction.** The business service provider must not perform the type of work for which a license from the Contractor's State License Board is required, pursuant to Chapter 9 (commencing with Section 7000) of Division 3 of the Business and Professions Code.

The factors that are most likely to create angst for businesses are vendors that have only one client in actuality (regardless of whether the vendor is or is not prohibited from having other clients); vendors that do not advertise their services; and vendors that have no independent location outside of their one client. Businesses will also want to carefully consider adding indemnity clauses in each of their contracts, and potentially even audit rights to ensure vendors are paying their employees correctly.

Business groups have expressed concern that a “business-to-business” relationship that fails to meet these 12 specific factors would automatically come within the gambit of the ABC test. However, in a “Letter to the Journal” expressing her legislative intent, the author of AB 5 stated, “Importantly, while this provision exempts certain bona fide business-to-business contracting relationships from the holding in *Dynamex* if the criteria are satisfied, [it] is not intended to suggest, by negative implication, that the business services provider is necessarily an employee if those criteria are not satisfied.” This language may prove useful for the proposition that there are other legitimate

business relationships (besides those that satisfy the criteria set forth in AB 5) that nonetheless fall outside the reach of *Dynamex*.

What's Next?

Several companies have pledged to support a ballot initiative to repeal, at least in part, AB 5. Unless and until then, AB 5 will go into effect on January 1, 2020 and it will do so with retroactive applicability as of that date. In the meantime, we recommend the following four-step plan:

1. Assess any potential exposure. Companies with independent contractor relationships will want to immediately assess the number and extent of their independent contractor relationships, while also being mindful of the exemptions.
2. Make corrections quickly. Companies with problematic independent contractor relationships will want to correct those relationships now, not later, given the statute's retroactive effect.
3. Ensure your contracts contain an arbitration agreement. Companies not explicitly exempted by AB 5 will want to have a written agreement with contractors containing an indemnification clause and an arbitration agreement with a class action waiver. Such arbitration agreement should be different than the arbitration agreement used by the company for its employees.
4. Evaluate vendor relationships. Companies with business-to-business and vendor relationships will want to ensure that those relationships comply with the law. The most potentially problematic issues will be found with vendors that either have no other clients, or do not have a separate location. Businesses may also wish to revise their vendor agreements to build in the AB 5 factors, and to include additional provisions such as indemnity and audit rights to ensure compliance.

We recommend you get in touch with your California counsel as soon as possible to begin work on your compliance strategy. For more information, contact your regular Fisher Phillips attorney or one of the attorneys in any of our California offices:

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