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Increasing Worker Classification Complexities

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1 Increasing Worker Classification Complexities

In recent years, employers have faced increased scrutiny regarding their classification of workers as independent contractors rather than as employees. The U.S. Department of Labor estimates that in 2017 employers classified nearly 15.5 million workers, representing 10.1% of the workforce, as independent contractors across a variety of sectors in the economy. Various federal and state laws and regulations apply only to workers classified as employees, and businesses bear the responsibility of making payroll tax withholdings and reporting those withholdings to governmental tax authorities, but not if the workers are classified as independent contractors. In response to the uptick in cases alleging misclassification of workers, courts and administrative agencies have developed or revised a series of tests to determine whether an employer has properly classified a worker as an independent contractor.

The law governing worker classification can be quite complicated, and the legislature and courts in California have now made the law even more challenging for employers. In April 2018, the California Supreme Court decided *Dynamex Operations W. v. Superior Court*, 4 Cal. 5th 903 (2018) and announced the so-called “ABC Test,” a legal standard for worker classification that significantly narrows an employer’s ability to classify workers as independent contractors. The Court’s holding in *Dynamex* applied only to worker classification under California’s so-called “Wage Orders” which set forth the state’s wage and hour rules. However, this year, the California Legislature enacted Assembly Bill 5 (“AB5”) which expanded the application of *Dynamex*’s ABC Test to classification of workers under the California Unemployment Insurance and Labor Codes. Although the bill exempts more than fifty professions and businesses from the new, more rigorous, standards, employers with operations in California may need to reassess classification of workers as independent contractors to ensure compliance with AB5.

In this article, we review California’s judicial shift to *Dynamex*’s more restrictive ABC test. Next, we review AB5 and its expansion of the ABC test to cases arising under the state’s Unemployment Insurance and Labor Codes. Finally, we offer some practical considerations for employers with operations in California, in light of the changing landscape for worker classification, as well as a look at some legislative initiatives in New York and New Jersey prompted by the recent activities in California.

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Background

If an employer classifies a worker as an employee, the employer assumes the burden of withholding payroll taxes and reporting those withholdings to governmental taxing authorities, and must abide by all the various state and federal regulations governing the employer-employee relationship. On the other hand, if a business classifies a worker as an independent contractor, the business generally will not bear those responsibilities. Courts and agencies have developed numerous tests, often varying depending on the type of claim a worker asserts, to determine whether an employer has properly classified workers.

Until 2018, California courts and agencies applied a multi-factor “economic realities” test to determine whether a worker was an employee or an independent contractor. For example, in *S. G. Borello & Sons, Inc. v. Dep’t of Indus. Relations*, 48 Cal. 3d 341 (1989), the California Supreme Court assessed whether a group of farmers were independent contractors, or whether they were employees, requiring the employer to secure workers’ compensation coverage under the Labor Code. The court determined the workers were classified properly as employees, concluding that classifying the farmers as independent contractors would “suggest a disturbing means of avoiding an employer’s obligations under other California legislation intended for the protection of ‘employees’” like the Agricultural Labor Relations Act, laws governing minimum wages, maximum hours, and Labor Code provisions regulating health and safety.¹ Applying the “economic realities” test, the Court asked whether the employer had the right to control the worker’s manner and means in accomplishing the desired result, and supplemented the inquiry with a set of secondary factors, including whether the employer had the right to discharge the worker at will, and whether the parties believed they were creating an employer-employee relationship.²

In April 2018, the California Supreme Court decided *Dynamex* and adopted the ABC test for worker classification in cases alleging an employer failed to

pay the mandated minimum wage under California’s Wage Orders. The court held that a worker is presumed to be an employee unless the employing entity can prove *each* of the following conditions:

- A. The person is free from control and direction in the performance of the work, both under the terms of the contract and in fact;
- B. The person performs work that is outside the usual course of the hiring entity’s business; and
- C. The person is customarily engaged in an independently established trade, occupation, or business of the same nature as that involved in the work performed.

This represented a much stricter classification test that would make it more difficult to classify a worker as an independent contractor. Because the ruling in *Dynamex* applied only to claims under California’s Wage Orders, California courts continued to apply the *Borello* test for claims arising under other state statutes.³

Legislative Expansion of *Dynamex*

On September 18, 2019 Governor Gavin Newsom signed AB5, codifying *Dynamex*’s ABC test and expanding its application beyond state wage and hour laws. Beginning January 1, 2020, a worker will be presumed to be an employee under the Unemployment Insurance and Labor Codes unless the employer can satisfy the ABC test and prove the worker is free from the employer’s control and direction in the performance of the work, the worker is performing work outside the normal course of the employer’s business, and the worker is customarily engaged in an independent trade or occupation. If the employer cannot satisfy all three criteria, then courts will find that the worker is an employee for purposes of the Unemployment Insurance and Labor Codes, even if the two parties have a written agreement stating the worker is an independent contractor.

While AB5 greatly expands the applicability of the *Dynamex* standard, the legislation exempts roughly fifty professions and industries from applying the ABC test for worker classification. For example, AB5 exempts physicians, surgeons, dentists, lawyers, architects, engineers, accountants, and registered

securities broker-dealers, as well as bona fide business-to-business contracting relationships. AB5 also exempts “professional services,” defined as individuals who maintain business locations, have a business license, set or negotiate their rates and hours, and customarily engage in the same type of work under contracts with other entities. Courts will not automatically regard workers within these exceptions as independent contractors, but rather will continue to apply the traditional *Borello* test.

AB5 also codifies stronger enforcement mechanisms to incentivize employers not to misclassify workers. The legislation empowers the California Attorney General, and city attorneys for cities with populations of more than 750,000, to pursue injunctive relief against employers who fail to properly apply the ABC test and continue to misclassify independent contractors. The California Labor Commissioner can assess an employer civil penalties of between \$5,000 and \$25,000 for each willful misclassification of an independent contractor. Misclassified employees can also seek back pay for unpaid wages or overtime, premiums for meal and rest breaks, or pursue a claim to enforce civil penalties under California’s Private Attorneys General Act.

Practice Pointers

Employers who contract with independent contractors in California should take steps to minimize AB5’s potential impact before it takes effect. Employers should assess carefully the job responsibilities of any independent contractors they engage, in order to determine whether they would meet all three prongs of the ABC test. Employers who improperly classify independent contractors may be liable for back pay, unpaid overtime, and meal and rest break premiums. The Labor Code further authorizes courts or agencies to impose civil penalties of up to \$15,000 per misclassified employee. As noted above, employers must also be aware of potential enforcement actions by state or local government agencies. Employers should also be mindful of ongoing litigation that may impact whether the ABC test is applied retroactively to pending litigation on wage and hour claims.⁴

Companies who engage in reclassification of employees and independent contractors also should

work with their California tax advisors to consider any potential tax implications. The California legislature stressed that one of AB5’s goals was to prevent revenue lost from companies misclassifying employees to avoid obligations like payroll taxes, workers’ compensation premiums, and other tax revenue. The California Franchise Tax Board (“FTB”) initially recommended amending AB5 to clarify the bill’s applicability to income and corporate franchise tax calculations, but the Board now indicates while AB5 will not change how those taxes are calculated, it could change the amount of income and expenses reported to FTB.⁵

Employers assessing worker classification should be particularly careful of the “B” prong of the ABC test, which requires that independent contractors perform work “that is outside the usual course of the hiring entity’s business.” AB5 does not define “business” in this context, thus requiring employers to interpret how the law should be applied.⁶

Other states are considering legislative changes following California’s lead. In New York, Senate Bill S6699A was introduced in November 2019 to adopt the ABC test for worker classification under the state’s labor law and workers compensation law, and the New Jersey State Senate introduced a bill to adopt the ABC test for the purposes of all State employment laws in the same month.⁷ Even under its current classification test, the New Jersey Department of Labor assessed Uber nearly \$650 million in past-due unemployment and disability insurance taxes and penalties for misclassifying drivers as independent contractors the previous four years.⁸ Within California, the contours of AB5 are yet to be determined, as Uber and Lyft may mount a ballot campaign to exempt their workers from classification under the ABC test.⁹ Employers engaging independent contractors, whether in California or elsewhere, certainly should monitor legislative changes and proactively assess how their independent contractors should be classified under the stricter test.

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¹ *Borello*, 48 Cal. 3d at 359.

² *Id.* at 351.

³ See, e.g., *Karl v. Zimmer Biomet Holdings, Inc.*, No. C 18-04176 WHA, 2019 WL 5677543, at *6 (N.D. Cal. Oct. 31, 2019) (applying *Borello* to determine a worker's classification for a claim arising under the Labor Code).

⁴ See *Gonzales v. San Gabriel Transit, Inc.*, 40 Cal. App. 5th 1131 (Cal. Ct. App. 2019) (finding *Dynamex* applicable to pending wage order enforcements in California's Second District).

⁵ State of California Franchise Tax Board, *Bill Analysis: AB5*, <https://www.ftb.ca.gov/tax-pros/law/legislation/2019-2020/AB5.pdf>.

⁶ See, e.g., *Dynamex*, 4 Cal. 5th at 959-60 (observing that while a plumber who services a leak at a retail store would not

be part of the store's usual course of business, a cake decorator who works on custom-order cakes for a bakery would be "part of the hiring entity's usual business operation").

⁷ See S. 6699A, 2019-20 Leg. (N.Y. 2019); S. 4204, 218th Leg. (N.J. 2019).

⁸ Chris Opfer, *Uber Hit With \$650 Million Employment Tax Bill in New Jersey*, Bloomberg Law (Nov. 14, 2019), <https://news.bloomberglaw.com/daily-labor-report/uber-hit-with-650-million-employment-tax-bill-in-new-jersey>.

⁹ See Sebastian Herrera, *Uber, Lyft Unveil Ballot Initiative to Counter California Gig-Economy Law*, The Wall Street Journal (Oct. 29, 2019), <https://www.wsj.com/articles/uber-lyft-unveil-ballot-initiative-to-counter-california-gig-economy-law-11572386291>.

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