

Employee or Contractor? What California's AB5 Means for Workers and Businesses

A new California law could reclassify independent contractors as employees and set a new precedent for defining employment.

On September 18, California Governor Gavin Newsom signed into law Assembly Bill 5, which establishes a three-part test that a business must satisfy to maintain that a worker is an independent contractor for employment purposes in the state. Some professions — including certain licensed physicians and licensed insurance agents — are exempt, with some conditions, from AB5, which takes effect January 1, 2020. But transportation network company drivers and potentially other marketplace contractors are not exempt.

The law establishes stricter criteria to be met, known as the ABC test, to maintain a worker as an independent contractor. A business must establish that:

- A. The worker is free from the company's control.
- B. The duties performed by the worker are outside the usual course of the company's business.
- C. The worker is customarily engaged in an independently established business, trade, or industry.

Workers that do not meet all three criteria will be classified as employees, which could allow them to start earning a minimum wage and qualify for overtime pay and paid leave, among other benefits.

AB5 codifies the 2018 California Supreme Court decision in the case of *Dynamex Operations West, Inc. v. Superior Court of Los Angeles*, which established a more onerous ABC test



(encompassing the above criteria) to determine whether an individual is an employee or an independent contractor. The *Dynamex* criteria replaced a test that had been applied since 1989 following the *S.G. Borello & Sons, Inc. v. Department of Industrial Relations* case. The *Borello* test looked at a number of factors to determine whether an individual was an independent contractor, although not all factors had to be met.

New Challenges for Gig Platform Companies

AB5 could make it more difficult for some gig platform companies to classify individuals who offer services on their platforms as independent contractors.

The second part of the ABC test requires companies to demonstrate that their core business differs from the services that any independent contractors offer on their platform. This can be more of a challenge for homogeneous gig platforms, such

as those that offer only one service, as opposed to platforms that offer multiple services that could range, for example, from photography to moving services to driving. This is because many courts could use an “economic means” test to evaluate like activities.

For example, prior to AB5’s passage, a ride-share platform could argue that its core business was not transportation services, but rather matchmaking, routing, and payment technology that empowers others to offer rides. Under the new law, if a court applies an economic means test, that platform might need to succeed in arguing that a substantial amount of its income does not come from transportation services.



The first part of the ABC test provides platforms and workers with a clearer path, although still fact-driven. Activities held by courts to be “bright line” signs of an employment relationship include being required to:

- Report to work at certain times.
- Wear a company logo or uniform.
- Complete certain training.

While foregoing these requirements could mean passing Test A, all three tests must be satisfied for a worker to remain classified as an independent contractor.

The effect of this new law on gig economy platforms is unclear. Some gig economy companies have expressed confidence that AB5 will not affect their business models and that they can rely on the economic means test. Several gig platform companies have committed to pushing a ballot initiative in 2020 to overturn the law.

New Pressures on Trucking Owner-Operators

Transportation companies using an owner-operator model are also potentially affected by AB5 as owner-operators provide services that are central to trucking companies’ core business and thus may fail the second part of the ABC test.

The nature of trucking operations may make it more challenging for owner-operator models to clear the ABC test. After the *Dynamex* decision, many trucking companies began evaluating alternative business structures, including a settlement carrier model whereby an owner-operator would be required to obtain its own operating authority and a motor carrier acting under a brokerage model.

This model could create significant disruption for owner-operators as they will be required to secure insurance on their own. Given the current state of the insurance market for truck liability, the cost of insurance could force many owner-operators out of business, creating additional shortages in capacity.



New Costs and Liabilities

For employers, AB5 could represent a costly change and expansion of risk profiles. Among other areas, AB5 will affect:

- **Workers' compensation programs.** Beyond the fact that more individuals will now be eligible for statutory workers' compensation benefits in the event of work-related injuries, the reclassification of independent contractors will almost certainly increase insurance purchasing costs for many employers. If premiums increase to an extent that businesses will no longer be able to absorb their costs and instead pass them on to customers, revenues and margins could be adversely affected.
- **Employment practices liability and wage and hour risks.** Misclassification of workers who are eligible for overtime could result in significant legal exposure in a state that was already at the forefront of costly wage and hour litigation and well known for the broad protections provided to its workers. California's expansive workplace protections will also now apply to a much larger population of workers, providing protections for oft-filed claims of harassment, discrimination, and retaliation. Any company with operations in California that uses independent contractors can expect to face more frequent wage and hour and employment litigation.

Of particular note is that AB5 empowers California's already-active attorney general and certain city attorneys to issue injunctions against businesses suspected of misclassifying independent contractors. To date, it was up to individual workers to take action if they believed they had been misclassified as contractors and should be considered employees.

Employers will also need to contribute to unemployment insurance for these newly reclassified workers.

Take Action Now

There is still debate on the effect the new legislation will have on workers themselves, and not all have endorsed it amidst fear that new regulations will prompt the companies they work for to restrict their working hours or, worse, cut them off completely. Some workers for app-based businesses worry that the new law will take away their flexibility.

Although AB5 is expected to face legal challenges and some questions remain unanswered, including whether *Dynamex* applies retroactively, businesses should begin preparations to adapt to the new law. Businesses should take steps now to carefully review the classification of any independent contractors in California, in consultation with their legal counsel. They should also consider how the reclassification of workers — including the potential for employee status to be awarded retroactively — could affect:

- Insurance programs, including workers' compensation, employment practices liability, and wage and hour liability.
- Human resources.
- Payroll.
- Benefits.

While AB5 is restricted to California, the Golden State is known as a workplace protections trailblazer, and lawmakers in other states have expressed interest in passing similar legislation, as have labor groups. That means even businesses not directly affected by the new law should keep an eye on its progress and consider how similar legislation elsewhere could affect their organizations.



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