

AB 5: The Great California Employment Experiment— A Littler Workplace Policy Institute Report



August 2019

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I. Executive Summary

Sometimes, things are not as easy as A-B-C.

Assembly Bill (AB) 5, currently pending in the California legislature, would impose the “ABC” test on California businesses and workers, dramatically altering the legal standards applied in evaluating whether a worker is an employee or an independent contractor. If AB 5 is enacted in its current form, on January 1, 2020, approximately two million independent contractors in California could be considered employees under state law. The state’s workplace laws and regulations along with local city laws and rules will then apply to these newly classified workers, and give rise to potential back pay claims for misclassification. Employers will face very difficult choices, many of which are not appealing.

Employers doing business in California have expressed concern and anxiety about the future of AB 5, and the future of the Golden State’s economy should this bill become law. AB 5 has been aptly described as the most significant employment law issue facing California businesses today.

To provide guidance and assistance to employers that do business in California, Littler’s Workplace Policy Institute® (WPI™) has established an AB 5 Task Force (the Task Force) of employment law attorneys with subject matter experience in independent contractor, wage and hour, workers’ compensation, unemployment compensation, and employment tax law. This Task Force has undertaken an in-depth analysis of AB 5, evaluated its potential consequences, developed practical suggestions for our clients on potential compliance options and strategies, and brainstormed ideas and solutions to chart a better way forward.

While this report is one result of their efforts, it is only a start. WPI looks forward to participating further in the development of this critically important employment law issue.

II. Overview

The California economy—the fifth largest economy in the world—is at a crossroads. We are experiencing the longest period of sustained economic growth in several generations.

A substantial part of that growth is due to innovative business models that combine new ideas, technology and talent to invent something new. Many of these new business models did not exist prior to the recession of 2007-2009. The innovative environment in which California businesses operate played a large part in turning the state’s economy around, putting the state on the road to economic recovery and growth.

Virtually every segment of the economy in the Golden State has been transformed in the last 10 years. Businesses have rapidly adopted machine learning, artificial intelligence and robotics to increase efficiency and spur growth. Our modern economy is providing consumers with never-before-experienced convenience and on-demand functionality. In 2019, the world of work is profoundly different from that experienced just a few years ago. And that world of work is changing more and more each day.

Based on this description, it would seem that our economy is humming along on a super highway. But indeed we are, at this moment, paused at a crossroads: the intersection of our modern economy and AB 5.

AB 5, currently under consideration by the California legislature, seeks to answer a particularly complicated question with a test that is supposed to be as simple as A-B-C. *That question is—whether a particular person, doing a particular task, is to be classified as an employee, or as an independent contractor.* The question encompasses virtually every aspect of California labor and employment law: hours of work, wages, income tax, unemployment insurance, workers' compensation, mandatory sick leave, and more.

The question is of substantial importance not just to the novel business models of our modern, digital economy, but also to more traditional businesses and their workers: dance studios, interpreter services, real estate appraisers, freelance copywriters, and so forth. Further, the question obviously impacts those currently classified as contractors as well, individuals who value the freedom and entrepreneurial spirit that contracting brings, as well as more mundane aspects of the status, such as the ability to claim business expenses on their tax returns.

AB 5's approach is to take a wide swath of California workers and transform them, possibly retroactively, from independent contractors to employees. This would take our modern, digital economy and return it to a set of rules, many of which were developed at the beginning of the Industrial Revolution.

The consequences of this transformation are not wholly unknown. Lessons can be learned from other states that have adopted the ABC test. In those states, lawsuits have not gone away. They continue unabated, still asking the fundamental question: is this worker an employee or an independent contractor? Adoption of the ABC test in California will not be the end of the debate, but rather, the beginning of a new debate, which will be played out in our courthouses.

This transformation could also have a dramatic impact on the economic future of the Golden State. Our current period of sustained economic growth simply cannot last forever. In the past, growth periods have been halted by events such as the bursting of the dot-com bubble in 2000, or the subprime mortgage crisis of 2007. It is not beyond reason to suggest that passage of AB 5 and the sweeping uncertainty and litigation that invariably will result, could be a tipping point that may have a substantial impact on the California economy.

A more careful and measured approach to answering these far-reaching questions is called for. The complex legal and economic issues presented by the current independent contractor-employee debate simply are not subject to an easy solution. It is not as easy as A-B-C.

The challenge of maintaining modern employment laws is not new. In 2008, the California Labor Commissioner observed: "The technology explosion in the last 20 years has often outpaced the ability of federal and state governments to keep up with private industry advances in conducting business."¹ The observation was astute then, and remains equally so today.



1 DLSE Opinion Letter 2008.07.07, <https://www.dir.ca.gov/dlse/opinions/2008-07-07.pdf>.

This report will 1) review the history of California law regarding worker status; 2) review the key provisions of AB 5; 3) evaluate the ABC test; 4) discuss the possible impacts of adoption of the test in California; 5) provide practical suggestions and guidance for California businesses in adapting to the new test; and 6) conclude with the Task Force’s recommendations for a different path forward.

III. California Law: Independent Contractors

A. The evolution of the test used to determine worker status prior to April 30, 2018

To understand the significance of what AB 5 intends to do, it is instructive to examine the history of worker classification law in California.

In the agrarian economy that was quickly being left behind by the Industrial Revolution at the turn of the 20th century, status was perhaps self-evident based on longstanding social norms and the clear division of labor: everyone knew who was the master and who was the servant. Since master/servant law was being used to create employment laws for the newly forming industrial society, the differences between employers and wage earners might also have seemed self-evident.

It may be for this reason that there were no definitions of an “employee” in most of the employment laws that were enacted even as late as the 1930s. For example, the Social Security Act (SSA), National Labor Relations Act (NLRA), and the Fair Labor Standards Act (FLSA) all failed to define an “employee” when they were originally enacted. Rather, the term was colored by the organizational structures and philosophies of the times, as well as what the laws were attempting to achieve.

The United States Supreme Court noted in one early case that addressed whether “newsboys” were employees under the NLRA: “The word [employee] is not treated by Congress as a word of art having a definite meaning. Rather it takes color from its surroundings in the statute where it appears, and derives meaning from the context of that statute, which must be read in the light of the mischief to be corrected and the end to be attained.”² In reading the meaning of the word from the surroundings, the Court made the law regarding who is, and who is not, an employee.

Shortly after the SSA was enacted in 1935, the United States Treasury Department promulgated regulations that adopted the common-law control test to determine whether a worker was an employee or an independent contractor for Social Security tax purposes.³ Cases defining the contours of the definition of an employee under the SSA were found persuasive for purposes of the FLSA and other social laws.⁴ Despite the lack of any actual definition, “at the time the [SSA] was adopted there was no doubt or dispute or question that ‘employee’ in the [SSA] had its usual common-law meaning.”⁵

California’s governor approved the California Unemployment Insurance Act (CUIA) on June 25, 1935. This law anticipated and preceded the SSA (which along with Social

2 322 U.S. 111, 124 (1944) (internal quotations and citations omitted).

3 See 1 F.D. 1764 (1936) (reproduced and discussed in *United States v. Silk*, 331 U.S. 704, 714 n. 8 (1947)); see also *Illinois Tri-Seal Products, Inc. v. United States*, 353 F.2d 216, 224 (1965).

4 331 U.S. 722, 724-725 (1947).

5 S. Rep. No. 1255, 80th Cong., 2d Sess., reprinted in U.S. Code Cong. Ser., 80th Cong., 2d Sess., p. 1755 (1948).

Security enacted the federal unemployment system) by two months, and thus “the legislature took notice of the terms of the pending bill, generally, and caused state law to conform to the requirements of federal law if the same should be enacted.”⁶

Similar to the SSA, the CUIA did not originally contain a definition of an “employee.” The phrase “the usual common law rules” were not codified until 1971, but had the same meaning as used under federal employment tax law since inception. For example, in 1946 in *Empire Star Mines Co. v. California Employment Commission*,⁷ the California Supreme Court explained that, when determining if a worker is an employee or independent contractor for unemployment insurance tax purposes, “the most important factor is the right to control the manner and means of accomplishing the result desired. If the employer has the authority to exercise complete control, whether or not that right is exercised with respect to all details, an employer-employee relationship exists.”⁸

The common law control test remained the primary test used to determine worker status for all purposes in California from at least 1946 until 1989, when the California Supreme issued its opinion in *S.G. Borello & Sons, Inc. v. Department of Industrial Relations*.⁹ In *Borello*, the court explained, “the distinction between employees and independent contractors arose under the common law rules to limit one’s vicarious liability for a person rendering service to him.”¹⁰ This court pointed out that federal cases drew distinctions between tort policy and social legislation that justified “departures” from common law principles when dealing with statutes protecting “employees.”¹¹ Accordingly, the court found that “[w]here not expressly prohibited by the legislation at issue,” the federal courts had considered the social purpose of the legislation to expand the definition of an employee, and cited several federal cases for this proposition.¹² Therefore, because the Legislature had not limited and constrained the Worker’s Compensation Act to “the usual common law rules,” the *Borello* court was able to adopt additional factors from the “economic reality” test used under the Fair Labor Standards Act for purposes of the Workers’ Compensation Act.¹³

In adopting an expanded test under the concept of economic realities, the *Borello* court found that “the usual common law rules” “must be supplemented in compensation cases by consideration of the remedial purpose of the statute,” adding “We agree that under the Act, the ‘control-of-work-details’ test for determining whether a person rendering service to another is an ‘employee’ or an excluded ‘independent contractor’ must be applied with deference to the purposes of the protective legislation.”¹⁴ The *Borello* court did caution that “[w]e adopt no detailed new standards for examination of the issue [of a worker’s status].”¹⁵

Since *Borello*, California courts and various state agencies had applied the economic realities or “*Borello*” test to determine whether a worker is an independent contractor



6 *Gillum v. Johnson*, 7 Cal.2d 744, 755 (1936).

7 28 Cal.2d 33 (1946).

8 *Id.* at 43.

9 48 Cal.3d 341 (1989).

10 *Id.* at 350.

11 *Id.* at 352.

12 *Id.*

13 *Id.* at 354-355 (relying on *Real v. Driscoll Strawberry Assocs., Inc.*, 603 F.2d 748 (9th Cir. 1979)).

14 *Id.* at 353.

15 *Id.* at 354.



or employee for most purposes.¹⁶ As explained, the *Borello* test starts with the usual common law rules, but then supplements them by considering the remedial purpose of the statute along with a number of “secondary” factors, including whether the worker was engaged in a distinct occupation or business, or is integral to the business, the level of economic dependence the worker has upon the principal, the skill required in the particular occupation, and whether the worker or the hiring entity supplied the tools used to perform the work and the place where the work was performed.

B. *Dynamex* shifts the landscape of independent contractor law in California

The California Supreme Court on April 30, 2018, abandoned the *Borello* test in favor of the ABC test¹⁷ for purposes of the wage orders, which provide minimum wage, maximum hour, and working condition requirements for specific industries. The wage order at issue in *Dynamex Operations West v. Superior Court*¹⁸ imposes wage and hour obligations for non-exempt employees in California. Section 2 of the wage order contains the following definitions:

- (E) “Employ” means to engage, suffer, or permit to work.
- (F) “Employee” means any person employed by an employer.
- (G) “Employer” means any person as defined in Section 18 of the Labor Code, who directly or indirectly, or through an agent or any other person, employs or exercises control over the wages, hours, or working conditions of any person.

At issue in the case was the meaning of the term “employ,” and more specifically, what engage, suffer, or permit to work means. In seeking to define these terms, the court held that the broadest possible interpretation should be given, and thereafter adopted Massachusetts’ version of the ABC test. Under this ABC test, workers are presumed to be employees unless all three of the following conditions are met:

- (A) The individual is free from control and direction in connection with the performance of the service, both under his contract for the performance of service and in fact; and
- (B) The service is performed outside the usual course of the business of the employer; and
- (C) The individual is customarily engaged in an independently established trade, occupation, profession or business of the same nature as that involved in the service performed.¹⁹

¹⁶ There are several specific statutory tests for both employment and non-employment status, such as the statutory exemption for tax purposes for direct sellers. Cal. Unempl. Ins. Code, § 650. Nonetheless, other than a few limited statutory exceptions, the *Borello* test had been applied to most statutes to determine worker status for decades.

¹⁷ Please note that technically one should refer to the test adopted in *Dynamex* and carried forward in AB 5 as “a modified ABC test.” The California test, with its modification of the B Prong, deviates from the traditional ABC test used in many other states. We explain the “B” prong below. However, for the ease of the reader, in this report we will simply refer to the California test as “the ABC test.”

¹⁸ 4 Cal.5th 903 (2018).

¹⁹ See Mass. Gen. Laws c. 149, § 148B; *Dynamex*, Slip Op. at 68-69.

Under the first prong, it is the right of control rather than the exercise of control that is legally determinative. Further, the lack of control must exist both in contract and in practice.²⁰ To a large extent, this is the control aspect of the *Borello* test.

The second prong does away with the “place of business” exemption found in most ABC tests; one must show that the worker’s job is independent, separate and distinct from the company’s business, and not a regular or continuous part of the business.²¹ The court described this prong as addressing “workers whose roles are most clearly comparable to those of employees” It then provides the following examples:

Thus, on the one hand, when a retail store hires an outside plumber to repair a leak in a bathroom on its premises or hires an outside electrician to install a new electrical line, the services of the plumber or electrician are not part of the store’s usual course of business and the store would not reasonably be seen as having suffered or permitted the plumber or electrician to provide services to it as an employee. On the other hand, when a clothing manufacturing company hires work-at-home seamstresses to make dresses from cloth and patterns supplied by the company that will thereafter be sold by the company, or when a bakery hires cake decorators to work on a regular basis on its custom-designed cakes, the workers are part of the hiring entity’s usual business operation and the hiring business can reasonably be viewed as having suffered or permitted the workers to provide services as employees.²²

The last prong asks whether the person is the impetus for being self-employed, exhibiting indicia of a business such as incorporation, licensure, advertisements, or routine offerings to provide the services of the independent business to the public or to a number of potential customers.²³

Taking the three prongs together, the new standard means that a business cannot engage an individual as an independent contractor unless he or she has already established some kind of independent business to provide services to the general public that are unrelated to the firm’s own usual business.

C. *Dynamex* might be retroactive

On May 2, 2019, the U.S. Court of Appeals for the Ninth Circuit issued its opinion in *Vazquez v. Jan-Pro Franchising International, Inc. (Vazquez)*.²⁴ The Ninth Circuit concluded *Dynamex* applies retroactively. In reaching its decision, the Ninth Circuit expressly relied on the California Supreme Court’s “emphasis in *Dynamex*” that its holding was “a clarification rather than as a departure from established law.”

On July 22, 2019, however, the Ninth Circuit reversed course and issued a single-page order: (1) granting panel rehearing in *Vazquez*; (2) withdrawing the court’s previously published opinion; and (3) declaring the court’s intention to file “[a] revised disposition and an order certifying to the California Supreme Court the question of whether [*Dynamex*] applies retroactively.”²⁵

²⁰ *Dynamex*, 4 Cal.5th at 958-962.

²¹ *Id.*

²² *Dynamex*, 4 Cal.5th at 959-960 (internal citations omitted).

²³ *Id.* at 962 (italics in the original) (internal citation omitted).

²⁴ 2019 U.S. App. LEXIS 13237, 2019 WL 1945001 (9th Cir. May 2, 2019).

²⁵ Patrick Stokes, Bruce Sarchet, and Michael Lotito, [Ninth Circuit Withdraws Opinion Regarding Retroactivity of *Dynamex v. Superior Court, Will Certify the Question to the California Supreme Court*](#), Littler ASAP (July 24, 2019).



The Ninth Circuit's revised decision gives the California Supreme Court a second opportunity to address retroactive versus prospective application of its opinion in *Dynamex*. However, the Supreme Court may not act on this opportunity expeditiously. AB 5 as currently worded does not address the question of retroactivity. Until either the Supreme Court or the legislature acts, California businesses will have to look to the state's trial courts and appellate courts for clarification of this important question.

IV. AB 5

A. Basic provisions of the bill

AB 5 is a proposed legislative "fix" to *Dynamex*. The present text of AB 5 consists of three parts: (1) express adoption of the ABC test; (2) exceptions to the first part; and (3) a statement of intent to separately address workers' compensation issues by future amendments to existing law.

B. Adoption of the ABC test

The bill would add Labor Code section 2750.3, which expressly adopts the ABC test for purposes of the Labor Code, Unemployment Insurance Code, and California Wage Orders. The bill's statement of the three elements of the ABC test is identical to the language in the *Dynamex* opinion. Notably, the bill goes beyond the scope of the *Dynamex* decision, which applied the ABC test for purposes of the California Wage Orders only.

C. Exceptions

The bill creates a number of exceptions for certain workers and situations. For the vast majority of these exceptions, if the applicable criteria are met, the Borello test instead of the ABC test will apply. For a small number of the exceptions, meeting certain criteria will cause other tests to apply.²⁶

The proposed exceptions have been the most hotly debated aspect of the bill. The list has been amended numerous times to add new exceptions and to revise existing ones. Further amendments are expected. At present, the exceptions can be broken down into four categories, as follows:

1. *Specific occupations*²⁷

The bill lists seven occupations to which the *Borello* test will apply. Specifically:

- Insurance brokers;
- Physicians and surgeons;
- Securities broker-dealers, investment advisors, and their agents;
- Direct sales salespersons as described in section 650 of the Unemployment Insurance Code;
- Real estate licensees;

²⁶ For example, the current exception for real estate licensees provides: (1) if the licensee falls within the scope of section 10032 of the Business and Professions Code, then that section will apply; (2) if section 10032 does not apply, then: (a) for purposes of unemployment insurance, Unemployment Insurance Code section 650 will apply; (b) for purposes of workers compensation, Labor Code section 3200, *et. seq.*, will apply; and (c) for all other purposes under the Labor Code, the *Borello* test will apply.

²⁷ Under the current text of AB 5, these exceptions would be defined by Labor Code section 2750.3(b)(1)-(7).

- Hairstylists, barbers, electrologists, estheticians, and workers providing natural hair braiding;²⁸
- Workers performing repossession services for repossession agencies.

2. Service providers²⁹

The apparent goal³⁰ of this exception is to allow an individual or entity (the “contracting business”) to receive services from a worker employed by another individual or entity (the “service provider”), yet have the worker’s relationship with the contracting business be governed by the *Borello* test. In order to fall within the exception, the contracting business must demonstrate that 12 criteria³¹ are satisfied. Several of these criteria are problematic, for four reasons.

First, it will often be difficult for the contracting business to conclusively verify that the service provider actually maintains a separate business location, is “customarily engaged in an independently established business of the same nature as that involved in the work performed,” contracts with other businesses to provide the same or similar services, and maintains a clientele independent of the contracting business entity. On these issues, the contracting business must largely rely on the representations of the service provider. The bill does not address under what circumstances the contracting business may be held liable where the service provider’s inaccurate representations result in non-compliance with these criteria.

Second, several of the criteria are not within the control of the contracting business. The service provider controls whether it possesses a business license (if required by the jurisdiction in which the work is performed), advertises its services to the public, maintains a clientele independent of the contracting business entity, and maintains a separate business location. The bill does not specify under what circumstances the contracting business will be held liable where the actions or omissions of the service provider result in non-compliance with these criteria.



28 This is the only enumerated occupation that is subject to additional criteria. The five criteria are defined by 2750.3(b)(6)(A)-(E), as follows:

- (A) Sets their own rates for services performed, provided the rate is equal to or greater than two times the minimum wages for hours worked and is paid directly by their clients.
- (B) Sets their own hours of work and has sole discretion to decide which clients from whom they will provide services.
- (C) Has their own book of business and schedules their own appointments.
- (D) Uses their own funds to purchase requisite supplies used in connection with providing services.
- (E) Maintains their own business license in connection with the services offered to clients.

29 Under the current text of AB 5, this exception would be defined by Labor Code section 2750.3(b)(8).

30 The text of this portion of the bill is unclear, but the intent of this exception is apparent from legislators’ comments during the July 10, 2019, hearing of the CA Senate Labor, Public Employment, and Retirement Committee.

31 Under the current text of AB 5, these criteria are defined by 2750.3(b)(8)(A)-(J), as follows:

- (A) The service provider is free from the control and direction of the contracting business entity in connection with the performance of the work, both under the contract for the performance of the work and in fact; (B) The service provider is providing services to the contracting business rather than to customers of the contracting business; (C) The contract with the service provider is in writing; (D) If the work is performed in a jurisdiction that requires the service provider to have a business license or business tax registration, the service provider has the required business license or business tax registration; (E) The service provider maintains a business location that is separate from the business or work location of the contracting business; (F) The service provider is customarily engaged in an independently established business of the same nature as that involved in the work performed; (G) The service provider actually contracts with other businesses to provide the same or similar services and maintains a clientele without restrictions from the hiring entity; (H) The service provider advertises and holds itself out to the public as available to provide the same or similar services; (I) The service provider has no other financial relationships with the contracting business; (J) The service provider can negotiate its own rates, provided that the rate is equal to or greater than two times the minimum wage for hours worked; (K) The service provider can set its own hours and location of work; (L) The service provider is not performing the type of work for which a license from the Contractor’s State License Board is required, pursuant to Section 7000 and following of the Business and Professions Code.



Third, the criterion that the service provider have “no other financial relationships with the contracting business” is vague. The statute does not provide any guidance regarding which “financial relationships” would violate this criterion.

Fourth, several criteria are subject to change over time. The service provider may lose its business license, close its separate business location, cease advertising to the public, and lose its contracts with other businesses. These lapses may result in temporary or permanent failure to satisfy the corresponding criteria of the exception. These lapses may be inadvertent or occur despite the service provider’s best efforts (such as loss of other clients), or may be a deliberate lapse intended to fail the exemption under AB 5. The statute does not specify: (1) whether lapse of criteria will result in retroactive, temporary, or permanent loss of the exception; or (2) whether and to what extent the contracting business will be held liable.

3. *Contracts for professional services*³²

The apparent goal of this exception is to allow an individual or entity (the “hiring entity”) to receive “professional services” from an individual or entity (the “individual”) yet have the relationships with the persons and entities to whom they are providing services be governed by the *Borello* test. Notably, the reference to the professional as the “individual” does not mean the professional must provide services as an individual—the individual may provide the services through a sole proprietorship or business entity.³³

To fall within this exception, the services must first fall within the bill’s proposed definition of “professional services,” defined as “services that meet any of the following” four categories:

- The services require an active license from the State of California and involve the practice of one of the following recognized professions: law, dentistry, architecture, engineering, podiatrists, veterinarian, private investigation, or accounting.³⁴
- The services require possession of an advanced degree that customarily involves a prolonged course of specialized intellectual instruction and study in the field of marketing or the administration of human resources from an accredited university, college, or professional school, as distinguished from a general academic education.³⁵
- The services are performed by a freelance writer who does not provide content to any one publication more than 25 times per year. This item is subject to additional sub-criteria.³⁶
- The services are provided by “fine artists, professional grant writers, and graphic designers.” This item is also subject to additional sub-criteria.³⁷

32 Under the current text of AB 5, this exception would be defined by Labor Code section 2750.3(c).

33 The current text proposed Labor Code section 1750.3(c)(1) refers to the professional providing services as “the individual.” However, 1750.3(c)(2)(A) clarifies “For purposes of this subdivision ... An ‘individual’ includes an individual providing services through a sole proprietorship or other business entity.”

34 Current text of proposed Labor Code section 2750.3(c)(2)(B)(i)(I).

35 Current text of proposed Labor Code section 2750.3(c)(2)(B)(i)(II).

36 Current text of proposed Labor Code section 2750.3(c)(2)(B)(i)(III). The additional criteria applicable to a “freelance writer” are: (1) the worker must actually set their own hours, locations, and rate of pay; and (2) the worker’s rate of pay shall be equal to or greater than two times the minimum wage.

37 Current text of proposed Labor Code section 2750.3(c)(2)(B)(i)(IV). The additional criteria for “fine artists, professional grant writers, and graphic designers” are that the worker must actually set their own hours, locations, and rate of pay. Note the absence of any requirement that the worker’s rate of pay be equal to or greater than two times the minimum wage.

The current text does not expressly place the burden on the hiring entity to demonstrate that the services meet the criteria of these categories.³⁸

Notably, the bill currently states, “[p]rofessional services’ does not include professionals engaged in the fields of health care and medicine.”³⁹ This language is inconsistent with the provisions specifically including dentists and podiatrists within the scope of the first category of professional services, above.

If the services fall within the above requirements, the hiring entity must demonstrate that nine criteria⁴⁰ are satisfied. Many of these criteria are also problematic, for the same reasons discussed above regarding the criteria for the exception for service providers.

4. Construction industry⁴¹

This exception appears calculated to allow an individual or entity (the “contractor”) to receive services from an individual performing work (the “individual”) pursuant to a contract in the construction industry, yet have the relationship between the contractor and the individual governed by the *Borello* test.

Unlike the other exceptions, described above, this exception does not specify whether the individual performing services may do so through a sole proprietorship or other business entity. However, the remaining text of the exception suggests this would be allowed. Specifically, the enumerated criteria for the exception refer to a “subcontractor.” If the individual and the subcontractor are construed as different persons/entities, then the exception allows the individual to provide services through a third party.

In order to fall within this exception, the contractor must demonstrate that eight criteria⁴² are satisfied. Many of these criteria are also problematic, for the same reasons discussed above regarding the criteria for the exception for service providers.



38 By contrast, the bill expressly places the burden of establishing all other criteria for the exception on the hiring entity.

39 Current text of proposed Labor Code section 2750.3(c)(2)(B)(ii).

40 Under the current text of AB 5, these criteria are defined by 2750.3(c)(1)(A)-(I), as follows:

(A) The individual maintains a business location, which may include the individual’s residence, that is separate from the hiring entity; (B) If work is performed more than six months after the effective date of this section, the individual has a business license, in addition to any required professional licenses or permits for the individual to practice in their profession; (C) The individual has the ability to use their own employees in the completion of the work, where reasonable, and has the authority to hire and fire other persons who assist in providing the services. Nothing in this section requires an individual to hire an employee; (D) The individual has the ability to engage in other contracts for services than with the hiring entity; (E) Both the individual and the hiring entity have the ability to negotiate compensation for the services performed; (F) Outside of project completion dates and reasonable business hours, the individual has the ability to set their own hours; (G) For services that do not reasonably have to be performed at a specific location, the individual can determine where to perform the services under the contract; (H) The individual is customarily engaged in the same type of work performed under the contract with another hiring entity or holds themselves out to other potential customers as available to perform the same type of work; (I) The individual customarily and regularly exercises discretion and independent judgment in the performance of the services.

41 Under the current text of AB 5, this exception would be defined by Labor Code section 2750.3(d).

42 Under the current text of AB 5, these criteria are defined by 2750.3(d)(1)-(8) as follows:

(1) The individual is free from the control and direction of the contractor in connection with the performance of the work, both under the contract for the performance of the work and in fact; (2) The subcontract is in writing; (3) The subcontractor is licensed by the Contractors State License Board and the work is within the scope of that license; (4) If the work is performed in a jurisdiction that requires the subcontractor to have a business license or business tax registration, the subcontractor has the required business license or business tax registration; (5) The subcontractor maintains a business location that is separate from the business or work location of the contractor; (6) The subcontractor has the authority to hire and to fire other persons to provide or to assist in providing the services; (7) The subcontractor assumes financial responsibility for errors or omissions in labor or services as evidenced by insurance, performance bonds, or warranties relating to the labor or services being provided; (8) The subcontractor is customarily engaged in an independently established business of the same nature as that involved in the work performed.

D. Intent to separately address workers' compensation laws

The bill contains only one very narrow provision directly addressing workers' compensation. Specifically, if real estate licensees are not subject to section 10032 of the Business and Professions Code, then their classification for workers' compensation purposes shall be governed by Labor Code section 3200, et seq.⁴³ This provision does not appear to alter existing law.

Rather, the bill amends Labor Code section 3351 to add the following statement: "It is the intent of the Legislature to amend the law to address workers' compensation and the holding in *Dynamex Operations West, Inc. v. Superior Court of Los Angeles* (2018) 4 Cal.5th 903." It appears those amendments, if any, will be made by legislation other than AB 5.⁴⁴

E. Status as of August 8, 2019

AB 5 continues to progress. It has made it out of the Assembly, into the Senate, and its next stop is the Senate Appropriations Committee. There are several possible further amendments to the bill that could result from the ongoing debate.

During the most recent committee hearing, on July 10, 2019, members of the California Senate Labor, Public Employment, and Retirement Committee (Committee) expressed several concerns regarding the current text of AB 5.⁴⁵ Committee Chair Senator Jerry Hill and Committee Vice Chair Senator Mike Morrell spoke on this subject in detail. Of particular note, the bill's author, Assembly member Lorena Gonzalez—along with members of the Committee—expressly contemplated extensive revisions to AB 5.

The Committee's concerns included:

Consideration of potential alternatives to the *Borello* test: The Committee's written analysis of the bill expressed sharp criticism of the AB 5's application of the *Borello* test to workers falling within the bill's various exceptions. The Committee wrote:

Essentially, the bill is saying, "if your workers were independent contractors before *Dynamex*, then they can continue to be independent contractors under Assembly Bill 5." That said, by retaining the *Borello* test, these occupations remain in the messy muddle of a failed employment test that met the needs of neither employers nor workers. Should Assembly Bill 5 become law, the Legislature will need to revisit the remnants of *Borello* in the future.⁴⁶

(Emphasis in original.)

Need for revisions to exceptions: Committee members claimed the business-to-business exceptions require additional work. Sen. Hill noted the temptation to ensure independent contractors are charging twice the minimum wage is understandable, but would be difficult to administer and enforce. He expressed concern that several criteria for the exceptions are outside the hiring entity's control. He proposed focusing not on

43 Current text of proposed Labor Code section 2750.3(b)(5).

44 Based on legislators' comments during the July 10, 2019, hearing of the CA Senate Labor, Public Employment, and Retirement Committee.

45 Bruce Sarchet, Patrick Stokes and Michael Lotito, *The Potential Effects Of Calif. Contractor Reclassification Bill*, Law 360 (July 19, 2019) <<https://www.law360.com/articles/1179532/the-potential-effects-of-calif-contractor-reclassification-bill>>.

46 Worker Status: Employees and independent contractors: Hearing on A.B. 5 before the S. Comm. On Labor, Public Employment and Retirement, 2019-20 Leg. Sess. (Ca 2019).

the rate paid, but on whether the person performing the work truly has the power to set his or her own rates. He opined that companies that allow “true” rate-setting should be allowed to continue contracting with workers as independent contractors.

Workers’ compensation: Sen. Hill also expressed concern regarding the workers’ compensation implications of AB 5. He opined that it would be illogical to apply wage and hour law, but not workers’ compensation law, to a worker. However, he recognized that any change to workers’ compensation laws would require careful consideration and time that may not be available during this legislative session.

Implementation: Committee members noted any legislative solution should avoid abrupt change. Sen Hill proposed that any major shift occur over time.

Trucking Owner-Operators: Nearly every member of the Committee commented on the plight of trucking owner-operators. All appeared to agree that the bill should contain explicit recognition of legitimate owner-operators.

Avoiding retroactive liability under *Dynamex*: The Committee expressed that the retroactive implications of *Dynamex* must be equitable and just. Sen. Hill stated that a legislative solution should protect businesses that were following the law as it existed at the time.

Transparency: Sen. Hill and Sen. Morrell requested increased transparency regarding selection of certain occupations and situations for exceptions.

In sum, most members of the Committee voted to pass AB 5, with the understanding that legislators would work with each other and stakeholders to resolve the above issues before the Senate votes on it. In her own closing comments, Assembly member Gonzalez acknowledged that the Committee probably would not address every situation in the time allotted, and anticipated the legislature would be working on this issue “for a few years.”⁴⁷

V. The ABC Test Is Unworkable

AB 5 is designed to codify, clarify and simplify the *Dynamex* decision. Despite those positive intentions, the test suffers from critical deficiencies. The legislation creates winners and losers without a rationale as to why some occupations and industries fall on one side of the equation or the other. Even when an exemption is crafted, definitional issues will arise as to whether a particular situation fits the exemption. Further, exemptions carry with them additional burdens of justifying the exclusion.

Moreover, the ABC prongs are anything but clear. The principal sponsor admits more years of work remain to refine the bill. Rushing to enact flawed legislation now will put jobs at stake in the interim.

AB 5, for the reasons discussed below, needs work.

A. Analysis of the A, B and C prongs

While under the ABC test an employer must demonstrate that the three prongs are met, each prong is not really capable of being reviewed in complete isolation. For example,

⁴⁷ Assembly member Gonzalez stated: “We probably won’t fix it for everybody this time. ... we will run out of time and I never worked harder on a bill, spent more hours on a bill. And, yet, we are not gonna get to every situation we dreamed of. And, I anticipate we’ll be working on this for a few years ... to get to those situations.”





whether control exists under the A prong is likely to be colored by both the B prong (service performed outside the usual course of business) and C prong (independent, established business). If the worker's business is really different from the principal's business, it may be difficult or impossible to actually control the manner and means by which services are performed. Further, if the worker has its own bona fide business, equipment, employees, etc., the work performed may be controlled more by the existence of such factors. Thus, contrary to claims that the ABC test is "easier" to use to establish an employment relationship, in reality, it suffers from the same kind of multi-prong analysis that exists under both the common law and Borello tests.

1. *The "A" prong is similar to the control factor of the Borello test*

The "A" prong of the new test is similar to the usual common law control test and the control aspect of the *Borello* test because it looks at whether "control" exists, both in contract and reality. In this sense, it is not particularly new or different from what already existed. If a business could not pass the control test or the control aspect of the *Borello* test, it would likely not pass the "A" prong of the ABC test either. So to some extent that "A" prong should be the threshold for determining status regardless of whether the ABC test, *Borello* test or usual common law rules control test apply, and any failure to satisfy it should strongly suggest an employment relationship.

2. *The "B" prong is unclear because it is difficult to define a "business"*

The crux of the problem with the ABC test's B prong is that it assumes everyone knows and can define the business. The *Dynamex* court described the B prong as addressing "workers whose roles are most clearly comparable to those of employees ..."

For purposes of tax law, whether a trade or business exists usually arises in the context of whether certain expenses are deductible as ordinary and necessary business expenses under IRC section 162, as opposed to personal expenses (or unnecessary and extraordinary expenses) for which no deduction is allowed. The Social Security Act, which created the federal-state unemployment system and imposes upon the states a number of requirements to receive federal funding, states "the term 'business' means a trade or business (or a part thereof)." The term "business" is not defined by the ABC test or in the *Dynamex* opinion. Defining a term with the term itself is not very useful.

The ordinary meanings of the term "business" are quite varied.⁴⁸

These different definitions are also not helpful, insofar as they do not tell us what the term means for wage and hour or unemployment purposes. Cases from

48 Merriam-Webster's Online Dictionary lists several definitions, only the first five of which are stated below:

- 1a: a usually commercial or mercantile activity engaged in as a means of livelihood: TRADE, LINE in the restaurant business
- b: a commercial or sometimes an industrial enterprise also: such enterprises the business district
- c: dealings or transactions especially of an economic nature: PATRONAGE took their business elsewhere
- 2a: ROLE, FUNCTION how the human mind went about its business of learning— H. A. Overstreet
- b: an immediate task or objective : MISSION what is your business here
- c: a particular field of endeavor the best in the business
- 3: AFFAIR, MATTER the whole business got out of hand business as usual
- 4a: personal concern none of your business
- b: RIGHT you have no business speaking to me that way
- 5a: serious activity requiring time and effort and usually the avoidance of distractions got down to business
- b: maximum effort

Massachusetts⁴⁹ have explained that in looking at how to define the usual business, how the firm defines its services may be important. For example, in *Athol Daily News v. Board of Review of the Division of Employment & Training*, the court found:

In light of the fact that the News itself defines its business as “publishing and distributing” a daily newspaper, we agree that the carriers’ services are performed in “the usual course of [the News’s] business.” See *Mattatuck Museum–Mattatuck Historical Soc’y v. Administrator*, Unemployment Compensation Act, 238 Conn. 273, 280 (1996) (art instructor services performed “on a regular or continuous basis” within art museum); *Bigfoot’s, Inc. v. Board of Review of the Indus. Comm’n of Utah*, 710 P.2d 180, 181 (Utah 1985) (musicians performed “usual and customary” activity of beer bar); *Yurs v. Director of Labor*, 94 Ill. App. 2d 96, 104 (1968) (organist played music as “usual part of” funeral home’s business).

Not all courts have agreed with this approach. For example, in *Q.D.-A., Inc. v. Indiana Department of Workforce Development*, Indiana’s Supreme Court, recognizing that there is no definition of business in its own ABC statute, began its analysis of the B prong by borrowing a definition from other courts:

With no Indiana case clearly defining “course of business,” we adopt the definition applied by two of our sister states under their respective ABC Tests: “if an enterprise undertakes an activity, not as an isolated instance but as a regular or continuous practice, the activity will constitute part of the enterprise’s usual course of business irrespective of its substantiality in relation to the other activities engaged in by the enterprise.” *Appeal of Niadni, Inc.*, 93 A.3d 728, 732 (N.H. 2014) (alterations removed) (quoting *Mattatuck Museum v. Unemployment Comp.*, 679 A.2d 347, 351 (Conn. 1996)). In other words, if a company regularly or continually performs an activity, no matter the scale, it is part of the company’s usual course of business. And if a company regularly or continually performs activities showing it is “engaged in various separate and independent kinds of businesses or occupations,” it may have more than one course of business. *Scott v. Rhoads*, 114 Ind. App. 150, 150, 51 N.E.2d 89, 91 (1943).

The facts of the case are similar to many cases alleging worker misclassification. Q.D.-A. is a business that connects drivers with customers who need too-large-to-tow vehicles driven to them. Q.D.-A. contracted with a Driver to pair him with customers needing this driving service. The parties entered into a written contract that explicitly called the Driver an independent contractor and allowed him to choose his own hours and the routes he believed were safest and most direct, contract with Q.D.-A.’s competitors, decline any work offered by Q.D.-A., negotiate his pay for each trip, and hire other drivers to complete his deliveries if they were qualified under federal regulations.

Turning to the case at hand, the court noted that the parties agreed that the worker performed drive-away services, but disagreed as to what constituted the company’s “business.” The Department of Workforce Development argued that how a company markets itself should play an important role in defining its business. The court rejected this argument, noting that “marketing plays little, if any, direct role in analyzing the



⁴⁹ As discussed below, Massachusetts’ modified ABC test was the basis for the California Supreme Court’s reasoning in *Dynamex*. Accordingly, Massachusetts case law is now arguably persuasive in interpreting California’s ABC test.

activities Q.D.-A. performs on a regular or continual basis. To be sure, advertising can reflect services a company offers to its customers. But we cannot uncritically rely on that advertising to fully reflect the activities a company regularly or continually performs.” The court further added:

Instead, according to the panel’s “common-sense standpoint,” these customers would call the company to transport the RVs without caring how the company accomplished the task. [Citation omitted.] In other words, the panel supported its conclusion with speculative customer belief and facts not relevant to activities the company regularly or continually performed. By leaving the company’s activities unexamined, [its] reasoning did not answer the statutory question of whether its usual course of business included delivering RVs.

Ultimately what the Indiana Supreme Court did was reject what is far too common in worker classification cases—reaching a conclusion based on assumptions and “common sense” rather than a reasoned decision based on application of the law to the actual facts. But this raises the issue of whether the definition of the term “business” is clear, articulable and knowable, or, as is so often the case, based upon what the trier of fact thinks a business does, such that any “rule” can be objectively applied to facts.

In *Curry v. Equilon Enterprises, LLC*, a published opinion rendered only a few weeks after the California Supreme Court’s *Dynamex* opinion, the appellate court addressed the ABC test in the context of a joint employer case. The matter involved whether an employee of a company that leased service stations from Shell was also an employee of Shell under a joint employment theory. Applying the *Dynamex*’s court analysis of the ABC test, the *Curry* court stated:

The “B” factor requires an examination of whether “the worker performs work that is outside the usual course of the hiring entity’s business.” (See *Dynamex, supra*, 2018 Cal. LEXIS 3162, *90.) For example, if a bakery hires cake decorators to work on a regular basis, then those cake decorators are likely working within the bakery’s “usual business operation,” and thus would be employees. Whereas an electrician hired to work at a bakery would likely be viewed as not working within the bakery’s usual course of business and therefore would not be viewed as an employee. (*Id.* at pp. *92–93.)

We concluded *ante* that Curry was engaged in the distinct occupation of an ARS station manager. We also concluded *ante* that Curry’s “management of two gas stations was part of ARS’s regular business because ARS’s business involved operating gas stations.” We explained that “Shell was not in the business of operating fueling stations—it was in the business of owning real estate and fuel.” Thus, there is not a triable issue of fact as to the “B” factor because managing a fuel station was not the type of business in which Shell was engaged.⁵⁰

However, in *Vazquez v. Jan-Pro Franchising International*, the Ninth Circuit, which held that *Dynamex* applied retroactively, states that “the ABC test is conjunctive, so a finding of any prong against the hiring entity directs a finding of an employer-employee relationship.⁵¹ Prong B may be the most susceptible to summary judgment on the record

50 While never stated, it seems likely the lack of any control by Shell over the worker’s job duties (the “A” prong) was significant in how the court evaluated the “B” prong as well.

51 For additional information on this topic, see James A. Paretti, Jr. and Michael J. Lotito, [Franchising and California at a Crossroads: the Dynamics of Dynamex and the ABC Test](#), Littler Insight (July 18, 2019).

already developed.” The opinion then notes, “courts have framed the Prong B inquiry in several ways. They have considered whether the work of the employee is necessary to or merely incidental to that of the hiring entity, whether the work of the employee is continuously performed for the hiring entity, and what business the hiring entity proclaims to be in.” The *Vazquez* court curiously also cites the *Mattatuck Museum* case.

In discussing these approaches, *Vazquez* focuses in part on economics. Citing an Illinois case,⁵² it found that carpet measuring was necessary to a carpet retailer, and so the workers were in the same business as the carpet retailer, but a person who performed “highly specialized restoration work” was not a “key component” to a general contractor, and thus in a different business. Further, it distinguished cab leases, where the lessor’s revenue did not vary based on the services of the drivers, from the situation where the drivers paid a percentage of their earnings to a limousine company. *Vazquez*, citing the *Athol Daily News* case, also looked at how the business holds itself out to the public.

Turning back to the *Dynamex* opinion, what is the “usual course of business” of a retail store? The court does not say, and it is not defined anywhere in the opinion. If we do not know what that business is, how can anyone know whether a service is or is not in the usual course of such business? The answer, presumably, is we just assume we know or get to guess based on the description “retail store” that its business is “selling” some kind of tangible goods. The court’s analysis now suggests that the “B” prong is based on assuming someone knows what a business does.

What if the retail store is part of a large chain that has its own maintenance staff that includes plumbers and electricians? Are maintenance and repairs then part of the usual business of the retail store? If so, if it still hires an outside plumber or electrician, does that create an employment relationship under the “B” prong? What if that outside plumber has his own truck, tools, advertising, and other clients? Is he then in business for himself as a “traditional independent contractor” under the “C” prong, particularly if the retail store does not “control” him under the “A” prong? What if the electrician is a retired electrician that happens to be a friend of the store manager, and offers to fix whatever electrical issue exists for a small fee? Is he an employee because the “C” prong is not met or because the “B” prong is not met, or both? These kind of practical questions have no answer in the court’s opinion.

In summary, what is telling from the court’s bare and incomplete examples is not what it says, but everything the court chooses to omit that could make the question difficult to answer. By failing to address any complex, modern, real-world examples, the court leaves unanswered several critical questions and provides little meaningful direction for courts, agencies, businesses or workers.⁵³

3. The “C” prong

The “C” prong is also potentially problematic for many businesses. Although arguably the “C” prong was previously a factor to consider under the *Borello* test, the new test appears to require that the individual (1) was already in business for him- or herself and



⁵² *Carpetland U.S.A., Inc. v. Ill. Dep’t of Emp’t Sec.*, 201 Ill.2d 351 (2002).

⁵³ Interestingly, Massachusetts, Indiana and Ninth Circuit courts all rely upon the *Mattatuck Museum* opinion from the Connecticut Supreme Court to support their view of how to define a business. That two state supreme courts and a federal court of appeals rely upon the same opinion to define *business* in a nebulous way and then still apply it in such different manners highlights the problem with defining a business in the first place: it is a subjective test based on how one views activities, which in turn makes it more or less an arbitrary determination.



(2) works in a customarily independent profession. This latter requirement is less clear than the former, and whether new professions—work that does not yet exist—could ever become “customarily” independent is open for debate.

In *Curry* (the California decision that addressed the impact of *Dynamex* in a joint employer context), the court explained the “C” prong as follows:

The “C” factor requires evidence “that the worker is customarily engaged in an independently established trade, occupation, or business of the same nature as that involved in the work performed.” (See *Dynamex*, supra, 2018 Cal. LEXIS 3162, *88.) This factor can be proven with evidence that the worker has “take[n] the usual steps to establish and promote his or her independent business—for example, through incorporation, licensure, advertisements, routine offerings to provide the services of the independent business to the public or to a number of potential customers, and the like.” (Id. at *97.)

As explained ante, in the policy section of this discussion, the “ABC” test is directed toward the issue of allegedly misclassified independent contractors. Trying to apply the “C” factor in a joint employment case will lead to an analysis that is a blend of the “A” and “B” factors, e.g., whether *Curry* was engaged in an occupation independent from the alleged secondary employer.⁵⁴

What the “C” prong allows is for either a worker or trier of fact to argue that not enough was done to establish a business. For example, if individuals do not incorporate and rely upon word-of-mouth advertising, have they taken the “usual steps to establish and promote” the business? These questions make the “C” factor an easy target for failure to meet the burden of proof arguments without ever having to articulate what evidence would be sufficient to meet it. Moreover, the “C” prong raises serious questions about how anyone starts a business. For example, an individual may not want to incur, nor be able to incur, the costs of incorporating or engaging in substantive marketing and advertising. Every new business has a first customer, but if the worker fails in his or her efforts to obtain other customers, does that put the first customer at risk? In a way, the “C” prong appears to require some kind of implicit guarantee that individuals will be successful in their entrepreneurship, because if they fail early, those first few customers may now be at risk of claims of misclassification (likely through unemployment claims). If all service recipients will then shy away from new businesses, how can they ever get off the ground and be successful?

In *Cook v. Estes Express Lines, Corp.*,⁵⁵ a federal court recently found that under Massachusetts’ ABC test, an individual who had incorporated, owned several trucks, and had workers who performed services for him, was not an “individual” for misclassification purposes. While noting that incorporation itself was not a strict bar to recovery, the court held that when the “individual” spends his time managing his business rather than performing services in an individual capacity, he falls outside the scope of the ABC test.⁵⁶ But is this a new definition of the C prong, or the B prong? If I work in my business and hire someone else to manage it, does that qualify under *Cook*? Maybe I don’t like doing

⁵⁴ *Curry v. Equilon Enterprises, LLC*, 23 Cal.App.5th 289, 315 (2018).

⁵⁵ 2018 U.S. Dist. LEXIS 65009 (D. Mass. Apr. 12, 2018).

⁵⁶ See also *Michael v. Pella Products, Inc.*, 14 N.E.3d 533 (Ill. 2014) (bona fide corporation not an individual for purposes of the Illinois’ Employee Classification Act); *Resilient Floor Decorators Vacation Fund v. Contract Carpet, Inc. et al.*, 1993 U.S. Dist. LEXIS 18768 (E.D. Mich. 1993) (rejecting that court could pierce the corporate veil to hold corporations were actually individuals); *Sargent v. Commissioner*, 929 F.2d 1252 (8th Cir. 1991).

paperwork, but like driving. What are the implications? Arguably having employees that perform administrative functions demonstrates indicia of a bona fide business under the C prong, but it does little to address the B prong implications.

4. *The problem with multiple tests*

The petitioner *Dynamex* argued to the California Supreme Court that having two separate tests—one for the wage orders and one for other aspects of the Labor Code (not to mention for other purposes, such as state taxes)—would create confusion and be unworkable in practice. The court rejected this argument, stating that the wage order “purposefully adopts its own definition” of who is an employee “to govern application of the wage order’s obligations that is intentionally broader than the standard of employment that would otherwise apply.” The court went on to state that “any potential inconsistency” arises from the wage order’s broad definition, and that “it is possible under *Borello* that a worker may properly be considered an employee with reference to one statute but not another.” Accordingly, while not explicit, the court appeared to endorse the *Borello* standard for various aspects of the Labor Code, including for workers’ compensation purposes, even as it adopted the broader ABC test for the wage orders.⁵⁷

The question, of course, is how practical it is to have a person deemed an “employee” for purposes of minimum wages, but not for other purposes, such as expense reimbursements, wage statements, workers’ compensation or state taxes. For example, the requirement to pay “wages” to employees under a wage order could be inconsistent with the determination that no wages are paid for tax purposes. Even if the court in *Dynamex* did not seem to care about these inconsistencies, businesses may have a difficult time operating, which in turn could trigger other disputes rather than resolve them.

Indeed, AB 5 in its current form does not completely address this issue. It leaves untouched the question of which test should apply for purposes of workers’ compensation. Employers have been faced with the challenges of multiple tests since the publication of *Dynamex*, and those challenges will likely multiply if AB 5 is signed into law.

B. Impact on the franchising industry

To date, discussion of AB 5 has focused primarily on the question of whether a given worker is properly classified as an employee or an independent contractor, and the bill’s impact on segments of the “gig” economy. What has received far less attention is the broader reach of AB 5 generally and its potentially devastating effect on business models in wholly different contexts. One such industry is franchising. Indeed, if AB 5 is adopted and applied as broadly as some are already arguing it should be, the bill could seriously threaten franchising in California.

As discussed above, under the three-prong ABC test, a worker is presumed to be an employee of a hiring entity unless that entity can prove: (a) the worker is free from its control and direction; (b) the worker is performing work outside the usual course its business; and (c) the worker is engaged in an independently established business, trade,



⁵⁷ See, e.g., Cal. Lab. Code, §§ 201, 202, 203, 203.1, 203.5, 204a, 206, 206.5, 208, 209, 212, 218.6, 221, 226(a), 226.8, 227, 227.3, 227.5, 230.5, 230.7, 230.8, 231, 232, 233, 240, 243, 351, 353, 2082, 2800, and 2810.5 (all Labor Code provision that are not covered by the Wage Orders).

or occupation. The Ninth Circuit in *Vazquez* went as far as to suggest it is possible that in most, if not all instances, a franchisor will be unable to satisfy the B-prong of the ABC test, because it will be unable to show that its franchisee’s workers are doing work “outside the usual course” of the franchisor’s business. This is hardly surprising, given the franchising model by definition involves a franchisor licensing other companies to use its name, branding, and business model to offer its products and services.

Moreover, as a matter of state and federal franchising law, a franchisor is required to exercise a certain amount of direction and control over a franchise’s operations, so as to maintain the integrity of its brand, protect other franchises, and ensure that the public can rely on the brand to provide quality and consistency across all franchise locations.⁵⁸ Some have argued that this legally required control over certain aspects of a franchise’s business should be sufficient to trigger franchisor liability under the A-prong (“direction and control”) of the ABC test.

While the *Vazquez* decision has been withdrawn pending an opinion from the Supreme Court of California as to whether *Dynamex* and the ABC test should apply retroactively, efforts to apply the ABC test to the franchising model and adopt it as a broad standard of joint employment are far from dead. Indeed, the argument that a franchisor may be found to be a joint employer of its franchisees’ employees is currently being pressed in the Ninth Circuit Court of Appeals in *Salazar v. McDonalds*.⁵⁹ In that case, the plaintiffs—employees of a McDonald’s franchise—are seeking to use the ABC test to hold McDonald’s USA (the national franchisor) jointly liable for alleged wage and hour violations committed by the franchise owner. There is no allegation in the *McDonald’s* case that the franchisee employees were classified (or misclassified) as independent contractors—they have always been classified (and protected under wage and hour law) as employees of the franchisee. The plaintiffs do not dispute this fact, but rather argue that *Dynamex* should be read broadly as a standard of joint employer status to encompass not only the franchise owner but also the national franchisor itself. They ask the court to find that McDonald’s USA was an employer of its franchisees’ workers under the ABC test and is accordingly jointly liable for any wage and hour violations.

AB 5 codifies the ABC test, and at present contains no implicit or explicit exception for franchising. Proponents of the law are likely to press for its broad interpretation (as advocates of the ABC test have already done in the judicial context). If courts are receptive to these arguments, franchisors will potentially face exponentially increased financial exposure, as they might now be held liable for violations of wage, hour, and other labor laws committed by their franchisees arising from practices over which the franchisor has no direct influence, oversight or control. If that happens, we can safely predict the franchising model will face near limitless liability.⁶⁰

C. The problems with “exceptions” to the ABC test

In response to criticism that the ABC test is too sweeping and broad, the “solution” often floated is to carve out specific tasks, or industries, and not use the ABC test for those endeavors. Indeed, the current wording of AB 5 provides for a number of exceptions

⁵⁸ The Lanham Act, 15 U.S.C. § 1064(5)(A).

⁵⁹ Appeal No. 17-15673 (9th Circuit).

⁶⁰ As noted, the discussion of AB 5 has, to date, been focused on independent contractors and ride-sharing or Transportation Network Companies. It may be that the expansion of liability and the potentially devastating effect on the franchising model under the ABC test is an unintended consequence of AB 5. If that is the case, the legislature would do well to consider amending the bill to make clear that its reach is not so broad.

for hairdressers, private investigators, and so on. A more broadly worded “business to business” exception has also been proposed.

There are at least four concrete problems with this approach.

First and foremost, from the worker’s perspective, if the ABC test is so important to social justice, and so fair to workers, then why should *any* workers be deprived of the “benefits” of the test? Why should the legislature be allowed to choose winners and losers amongst its citizens? Does this create equal protection problems, as less-favored industries can rightly ask why they are excluded from the “benefits” of AB 5 exclusion for no seemingly compelling reason?

Second, how does one business qualify for an exception, while another does not? A skeptical observer might note that particular industries, with particular legislative clout, were able to get their exceptions written into law, while less influential industries failed to achieve that same success. Indeed, at the July 10, 2019 hearing, Senator Mike Morrell, Vice Chair of the Senate Labor Committee, asked the sponsor of AB 5: “In all of these carve-outs you are picking winners and losers, so, can you walk me through the process of why you are doing it that way and how you process, who wins, and who loses. Who gets favoritism and who loses out?”

Third, the exceptions will need to be defined. The devil will be in the details—does a specific type of work fall within the exception, or must it be covered by the ABC test? If we craft definitions of excepted work, then inevitably lawyers will argue over whether particular endeavors do or do not fall within the exception. So adopting the ABC test will only be the beginning of a multitude of new debates.

Also, there is no guarantee that the exceptions to the ABC test that are crafted in the current legislative session will be the end of the debate. The sponsor of AB 5 admitted as much in her closing remarks to the Senate Labor Committee on July 10, 2019.⁶¹ Indeed, the impact of the ABC test on potential new business models and industries is wholly unknown. While the legislature can carve out exceptions for *existing* businesses and industries, it cannot predict what developing industries or business models might come into existence in the future. One obviously cannot write an exception for a business that has not yet been imagined. California might be legislating its way out of the next generation of innovative business models.

D. Lessons from Massachusetts

Dynamex borrowed the ABC test from Massachusetts. Indeed, the Massachusetts Independent Contractor Act was the inspiration for the *Dynamex* decision. This law has had a significant impact on the Massachusetts labor market.

The Massachusetts Independent Contractor Act was passed in 2004.⁶² Ironically, the bill’s sponsors only intended the law to apply to the construction industry, but due to a mistake in how the bill was drafted, it applied to all industries. No one corrected the mistake, and it has been on the books ever since.⁶³

61 See *supra* note 47.

62 M.G.L.A. c. 149 § 148B.

63 See Alexander Klibaner, *Will independent contractors become extinct in Mass.?*, Mass. Lawyers Weekly, Oct. 9, 2006.





The Massachusetts Independent Contractor Act is an ABC test, with a B prong that is identical to the one contained in AB 5—that is, to be considered an independent contractor, a person must perform work that is “outside the usual course of the business of the employer.” The practical effect of this statute is that it can be challenging to argue that workers are independent contractors in Massachusetts.

Our Task Force members observed that industries that have traditionally used independent contractors, and that use independent contractors throughout the country, were hit with a wave of litigation in the Bay State not long after this law went into effect. Given the inflexible and unforgiving language of the statute, these companies—which had been operating lawfully for years—had to pay multi-million dollar judgments or settlements. Some companies that predominantly engaged independent contractors converted them to employees, with the associated costs and administrative burdens that go with such a conversion; other companies found that they could not bear those costs and remain profitable, and simply closed.

Likewise, our Task Force members noted that businesses that use independent contractors as temporary or supplemental labor also found themselves sued, with equally negative results. As a result, most companies found engaging independent contractors was too risky. A common response is to engage temporary workers through staffing agencies—which incurs additional costs to the business.

Finally, anecdotal evidence shows that some businesses have chosen to reduce their operations in Massachusetts, or to engage independent contractors in other states (or even other countries), to avoid this onerous restriction.

In short, it is exceedingly difficult for a business to engage independent contractors in Massachusetts, foreclosing a common business model for many industries, and imposing substantially greater costs on companies throughout the state.

VI. Potential Impact of the ABC Test on the California Economy: the Law of Unintended Consequences Unleashed

California is famous for its progressivism in both politics and in business. When embarking on progressive ventures, however, attentiveness to the economic realities of one’s situation cannot be ignored. The ABC test flatly ignores the economic realities present in California today. The consequences for our state’s economy could be sizable.

Even if California’s economic health appears rosy, underlying trouble spots abound, including a severely underfunded public pension system, unaffordable housing, the volatility of a state revenue stream heavily dependent on personal income taxes tied to capital gains, weakened infrastructure, declines in our system of public education, and on and on.

Full employment in California makes it easy to mask many of these underlying challenges. But the longest economic expansion in our history must certainly come to an end; many believe that will be sooner rather than later. The current state budget-operating surplus could easily disappear in the wake of a single economic shock, such as a wholesale change in how hundreds of thousands of workers are classified. There is little room for error.



In this section of the report, we discuss the current employment law environment in California, the potential economic impacts of the ABC test, and potential impact that California’s adoption of the ABC test will have on other states and the nation as a whole.

A. The employment law environment in California may well be at a tipping point

As outlined above, there are multiple problems with the ABC test. If that test is imposed on our modern economy in California, the consequences could be dire. It is simply not rational to think that all of the businesses impacted by the test could comply overnight and still survive. Some have speculated that reclassification will add 20-30% in operating costs for some very substantial businesses in California. Such an increase in costs would pose an existential threat to those organizations.

The ABC test, if adopted, would be added to a growing list of employment law issues and concerns confronting California employers today. Now, many have pointed out that California is the fifth largest economy in the world, and the economy here has continued to grow despite what some describe as an “over-regulated” environment for businesses. This is true. However, it is equally true that employers in the state do face significant challenges in complying with state laws and local ordinances regulating the workplace. The list of such laws and regulations continues to grow.

1. *Litigation: Wage and hour class actions, PAGA*

Every employer in California today knows that a “part of doing business” is the threat of employment litigation. Full compliance with all of the technical requirements of the California Labor Code and the Wage Orders is a challenge, to say the least. As unhappy employees find their way to attorneys, typically through an internet search, the first thing they are likely to be asked is whether they received all of their meal and rest breaks. Next, the attorney will want to take a look at the employee’s wage statement, to be sure that the 10 required elements are present.

In the last few years, there has been a tremendous growth in the number of employment lawsuits filed in California. Of particular note are class action lawsuits alleging wage and hour violations, along with Private Attorney General Act (PAGA) lawsuits, seeking penalties on a per-paycheck basis for labor code violations.

According to the State of California, Department of Industrial Relations website, in 2015, there were 4,218 PAGA notices filed with the state’s Labor and Workforce Development Agency.⁶⁴ The number has steadily grown since then, with 5,730 notices filed in 2018. Based on data through June 30, 2019, it is projected that another 6,372 notices will be filed this year. That’s a total of more than 26,000 notices filed in the last five years. The time and expense of litigating these claims is taking its toll. Anecdotally, our Task Force members have observed that the impacted workers often see little monetary benefit from these claims, with the bulk of the fees collected going to trial attorneys and/or to the state.

Efforts at PAGA reform have, to date, been unsuccessful.

2. *Explosion of state laws*

Compliance with employment laws has become more challenging in California. In the last five years, we have seen exponential growth in the number of state laws that impose

64 California Dep’t of Indus. Relations, [Private Attorneys General Act \(PAGA\) – Filing](#) (Jan. 2019).

obligations on employers. No doubt, the measures were passed with the best of intentions. But the sheer volume of new requirements makes it challenging for small and large businesses alike to keep abreast and up to date.

The overwhelming majority of California employers sincerely wish to fulfil their legal obligations. But at some point, the number of such obligations can overwhelm a business. Most California employers would say we are at least approaching that point; indeed, some would say we have surpassed it.

3. *Explosion of municipal ordinances*

In addition to the ever-growing list of state employment laws, cities often regulate the workplace. For example, since January 1, 2018, new minimum wage ordinances have been enacted in San Diego, Alameda, Berkeley, Daly City, Emeryville, Fremont, Mountain View, Oakland, Pasadena, Redwood City, San Francisco, Sonoma and Sunnyvale. There are now 21 separate minimum wage rates in the San Francisco Bay Area alone. Several California cities have also adopted paid sick leave ordinances, with the result that employees may accrue sick leave at different rates depending on the city in which they work. “Predictable scheduling” ordinances, requiring that employers provide advance notice of work schedules or pay a penalty called “predictability pay,” also have been adopted in several California cities.

These enactments have been referred to as the “municipalization” of employment law. California seems to be leading the way, but other cities across the country have also joined the trend. Historians note that the unification of Germany and Italy in the late 1800s led to the opening of trade and the growth of national economies. We are witnessing in California today the opposite—the “deunification” of California, as the rules change when workers cross city limits. Many in the business community have expressed extreme frustration with this trend, which makes it even more challenging for businesses to operate in the Golden State.

4. *The role of organized labor*

It is common knowledge that the percentage of the American workforce that is unionized has been declining over the past decades. The U.S. Supreme Court’s ruling in *Janus v. AFSCME*⁶⁵ could also have an impact on union membership in California. As reported by the U.S. Bureau of Labor Statistics, union membership in California in 2018 stood at 14.7% of persons employed.⁶⁶ Ten years earlier, union membership stood at 17.2%.

Despite the decline in membership, organized labor continues to play an important role in shaping state workplace policy in California. Labor unions and their Political Action Committees regularly contribute to the political campaigns of candidates for state office. Members of the business community report that when they ask state legislators for assistance with employment law reform, they are told: “go work out a deal with labor, and then come back to me.”

Unfortunately, it is not as simple as that. Organized labor does not always speak with one voice. As reported recently, talks between employers and organized labor to address AB

65 585 U.S. ____ 138 S. Ct. 2448; 201 L. Ed. 2d 924 (2018).

66 U.S. Dep’t of Labor, Bureau of Labor Statistics, Economic News Release, Table 5. Union affiliation of employed wage and salary workers by state (last modified Jan. 18, 2019).

5, "... have created deep rancor within the labor ranks and set unions against one another."⁶⁷ However, that time of division may have passed. More recently, on July 24, 2019, the State Building and Construction Trades Council of California sent a letter to the governor and legislative leaders stating: "Our Executive Board voted unanimously to oppose any legislative proposal allowing technology platform companies to exploit workers by treating them as independent contractors with substandard protections." The International Brotherhood of Teamsters is listed as a signatory to the letter.

Indeed, organized labor appears to have little to gain from participating in meaningful discussions regarding the ABC test. As noted by respected Capitol columnist Dan Walters, the sponsor of AB 5 "... has a powerful lever because if the Legislature doesn't act, the Supreme Court ruling's three-factor test for who's an employee and who's not remains in effect."⁶⁸

Unfortunately, the business community's efforts to partner with organized labor to find a solution that makes sense for our modern California economy have not yielded positive results.

5. *Prop 11: A case study*

Many in the employer community have repeatedly expressed frustration with an inability to influence effectively workplace policy in Sacramento. Taking the message directly to the voters has proved to be a successful but very expensive alternative, at least in one example.

In last year's midterm elections, the California ballot contained a number of statewide propositions, addressing such topics as the issuance of state bonds for various projects, limitations on farm animal containment, rent control, repealing the gas tax, revisiting daylight savings time, property tax breaks for seniors, and rest breaks for ambulance drivers employed by private companies. As the last example shows, California voters have been asked to weigh in on discrete employment law matters affecting only a small number of the state's employees.

Arguing in favor of the rest break issue, Proposition 11, the proponents noted as follows:

Prop. 11 establishes into law the longstanding industry practice of paying emergency medical technicians (EMTs) and paramedics to remain reachable during their work breaks in case of an emergency—just like firefighters and police officers.

Prop. 11 is needed because a recent California court ruling could stop this longstanding practice and require EMTs and paramedics to be completely unreachable while on break. This means if the closest ambulance to your emergency is on break when you call for help, 911 dispatchers would have NO WAY to reach the ambulance crew because all communications devices would be turned OFF.⁶⁹

Not all Californians saw it this way. The California Labor Federation, for example, stated:

First responders work pressure-filled, grueling schedules and often deal in matters of life or death. Stripping them of guaranteed rest and meal breaks does nothing to



67 Noam Scheiber, *Debate Over Uber and Lyft Drivers' Rights in California Has Split Labor*, N.Y. Times, June 29, 2019.

68 Dan Walters, *Commentary, New state budget a windfall for unions*, CalMatters (July 4, 2019).

69 Arguments concerning Cal. Proposition 11, approved Nov. 6, 2018.

improve public safety. In fact, it makes their jobs even more difficult. The measure also sets a terrible precedent that could be used to take away meal and rest breaks from other workers.⁷⁰

In the end, voters approved the initiative, with 59.63% of voters in favor.⁷¹ A committee called Californians for Emergency Preparedness and Safety spent over \$29 million in support of the measure. A single private ambulance company in the state donated over 99% of those funds.⁷²

Prop. 11 shows just how far we have come in the Golden State in our struggles to find some balance in the regulation of the workplace. The time and resources expended to achieve just one small modicum of reform, for a discrete category of workers, should cause all of us to pause and reflect.

B. Impact of the ABC test on employment litigation

Many in the business community have asserted that adoption of the ABC test in California will lead to more employment litigation. Adoption of the test will open up the possibility of hundreds of thousands of new plaintiffs with wage and hour claims potentially stretching back four years. Misclassification lawsuits typically involve claims for minimum wage, meal and rest breaks, leave of absence, wage statement violations, waiting time penalties, and so on. As discussed above, the floodgates of employment litigation in California are already opened. Adoption of the ABC test will likely make a difficult situation even more challenging for California businesses.

C. Economic Impact of the ABC test

As with many matters in economics, it is not possible to put an exact dollar figure on the economic impact of the adoption of the ABC test in California.

Much of the current debate centers on the tax impact of AB 5. On the one hand, proponents argue that reclassifying contractors as employees will garner payroll tax revenue to the state. On the other hand, income tax revenue could actually drop following adoption of the test, should businesses react to AB 5 by closing up shop and leaving the state.

1. Payroll tax impact

With regard to payroll taxes, an overly simplistic approach to calculating a dollar cost associated with the ABC test would be to take the total compensation paid to independent contractors who would be reclassified as employees, and increase that amount by a certain percentage, to reflect the “driven payroll costs” of hiring an employee. Federal and state payroll taxes in California amount to about 12% of wages—

⁷⁰ Steve Smith, [California First Responders Say “No on Prop 11.”](#) Cal. Labor Fed’n, Labor’s Edge: Views from the Cal. Labor Movement (Sept. 10, 2018).

⁷¹ See Ballotpedia, [California Proposition 11, Ambulance Employees Paid On-Call Breaks, Training, and Mental Health Services Initiative](#) (2018).

⁷² FollowTheMoney.org, [Californians for Emergency Preparedness & Safety, Committee Major Funding from Am. Med. Response \(AMR\)](#) (showing contributions received by industry sector).

for every dollar of wages, the employer's cost actually is \$1.12.⁷³ Other benefits drive the cost even higher, but substantial variations exist in the actual cost of such benefits from employer to employer.

However, even if one were to identify a precise "driven benefit" cost for contractors—25%, for example—identifying the total compensation paid to "misclassified" workers remains an insurmountable challenge. As mentioned earlier, the ABC test does not yield predictable results. Nobody can predict what the total dollar "wages" of misclassified workers might be. As noted in one study:

Any analysis of the costs associated with re-classifying workers from independent contractors to employees is clouded by the fact that it's not possible to predict how courts will interpret the status of workers on a case-by case or industry-by-industry basis.⁷⁴

Accordingly, estimates of the payroll tax impact of the ABC test, either in terms of the cost to businesses, or revenue that might have otherwise been collected by the state, will necessarily be imprecise.

However, it certainly does not require much imagination to speculate that companies facing a substantial increase in the costs of securing labor will have few, if any, options. California businesses facing such an increase will face an existential crisis.

2. State income tax impact

The sponsor of AB 5 has estimated that the state would earn an additional seven billion dollars in taxes should AB 5 be adopted. But that estimate must be tempered by a consideration of the other, broader impacts of adoption of the ABC test. Businesses facing an existential threat in California may well decide to leave the state. The trend is nothing new—news reports abound discussing the challenging business climate here, and the defection of companies to other states. One auto company recently announced a relocation from California to Tennessee.⁷⁵

The Nashville Business Journal recently reported that, a tech company founded in 2017 with 75 employees in San Francisco, will be opening its next office in Nashville, with 450 employees there. The report noted:

Pilot.com is the latest in a long line of San Francisco tech firms that have looked to Nashville as a lower-cost option to expand operations in recent years. Ridesharing service Lyft opened its Second Avenue office in 2015 and now employs more than 750 people, while online ticketing and registration company Eventbrite has 220 Nashville employees, making it the second-largest office in the company. Postmates Inc. recently

⁷³ The revenues that would be collected from state payroll taxes would just go to the Unemployment Insurance Fund and State Disability Fund. The UI Fund has been bankrupt since 2009 and additional revenues might shore up the UI Fund, but this could easily be offset by another downturn in the economy. The financial challenges faced by the California Unemployment Insurance Fund were recently noted by Dan Walters: "California's other fiscal crisis." <https://calmatters.org/commentary/californias-other-fiscal-crisis/>. On top of the underlying problems facing the fund, by suddenly sweeping into employment thousands of workers for whom no taxes had been paid, the UI Fund is likely to get devastated if numerous workers who had previously been treated as independent contractors are suddenly "unemployed" and granted benefits. Since *Dynamex* does not apply to unemployment taxes, and AB 5 should likely be prospective only, this leaves a potentially huge mismatch between funding for unemployment benefits and workers' rights to such benefits that may bankrupt the UI Fund beyond recovery.

⁷⁴ Christopher Thornberg et al., *Understanding California's Dynamex Decision*, Beacon Economics (2018).

⁷⁵ Jamie McGee and Emily R. West, *Mitsubishi North America to move headquarters to Nashville area*, Tennessean, June 25, 2019.



signed a lease to occupy 100,000 square feet at MetroCenter that could bring as many as 1,000 new jobs. KeepTruckin, GoCheck Kids and Greenlight Medical are also San Francisco companies that have either opened offices or moved their headquarters to Music City.⁷⁶

Texas is another attractive option for California businesses seeking to relocate. As noted in the recent special report published by *The Economist*:

Last year McKesson, a medical-supplies company, and Core-Mark, a supplier to convenience stores, shifted their headquarters from California to Texas, as did Jamba Juice, a smoothie company. Many Californian firms are also adding jobs outside the Golden State. Charles Schwab, a financial-brokerage firm based in San Francisco, received more than \$6m in incentives from Texas, and by the end of this year will have more employees there than in California.⁷⁷

According to CNBC's "Best States For Business" Report, in 2018, California ranked number 48 in the category "Cost of Doing Business."⁷⁸ According to the Tax Foundation's State Business Tax Climate Index, California ranks 49th.⁷⁹

Many employers in California have asserted that adoption of AB 5 will make an already unattractive business climate in California even less so. The state clearly loses tax revenue for every business that deserts the state. This very real possibility must be part of the equation, and the dialogue, as we consider the potential income tax and other ramifications of AB 5.

3. *Impact on decisions made by private equity firms*

Much of the capital for business ventures in California comes from private equity firms. Those firms currently are undertaking due diligence on a variety of investment options across the country and around the world. Of course, these investors are used to uncertainty, and to taking risk. But uncertainty about material costs in the future, for example, is one thing. Uncertainty that could lead to the demise of entire business models is another. In evaluating business opportunities in the Golden State today, investors are focused on the ABC test, and whether individuals in particular industries might be subject to claims of misclassification.

4. *Impact on innovation*

The ABC test, if adopted in California, also could slow the pace of innovation in the Golden state, in at least two fundamental ways. First, if the flight of businesses from California is exacerbated due to the passage of AB 5, talent will flee as well. Second, the ABC test will be restrictive—any platforms for delivering new products and services to consumers will need to comply with the overarching employment law standard of the ABC test.

5. *Impact on other states*

California is rightfully perceived as a leader in employment laws. California was the first state with an Equal Pay law—passed in 1949 in the wake of World War II. California's

76 Joel Stinnett, [San Francisco company to bring division HQ, 450 jobs to Nashville](#), Nashville Bus. J., June 25, 2019.

77 The Economist, Special Report: California & Texas, [Many people are moving from California to Texas](#), June 20, 2019.

78 CNBC, [America's Top States for Business 2018](#) (updated June 7, 2019).

79 Jared Walczak et al., [2019 State Business Tax Climate Index](#), Tax Foundation (Sept. 26, 2018).

Family Leave Act (CFRA) predated the Federal Family and Medical Leave Act (FMLA). California has a Private Attorney Generals Act; other states are considering similar laws.

The Economist captured this concept well in its recent special report on California and Texas: “California ... frequently creates political winds that sweep across the country.”⁸⁰

Based on this history, should the ABC test become the law in the Golden State, it is likely that other states will follow suit. Indeed, the ABC test is a component of the PRO Act (“Protecting the Right to Organize” Act), which has been introduced in the House of Representatives (HR 5718).

VII. Practical Suggestions While AB 5 Is Still Being Debated

A. Create a task force

The ABC test represents an existential threat to many California businesses. For them, we suggest the immediate creation of a task force of your own, reporting to the CEO, to study the practical impact AB 5 will have on your unique operations. The task force should have active participation of key functions including: Legal (inside and outside), Human Resources, Communications (inside and outside), Governmental Relations (including state and federal, inside and outside), Investor Relations, Operations, Site Placement and the Chief Financial Officer. As the discussions of this group will involve consideration of legal risks, strategies and options, they should be undertaken utilizing the attorney-client privilege.

B. Develop a public relations plan

AB 5 is generating significant publicity, not only in the legal press, but in the popular media as well. The Sacramento Bee has published numerous articles and columns as the bill has worked its way through the legislature. The San Francisco Chronicle, the Los Angeles Times and other California newspapers have weighed in as well. The AB 5 debate has also been the subject of articles in the New York Times and other out-of-state publications.

Business leaders, such as the CEOs of major transportation network companies, have published editorials explaining their point of view. Organized labor has countered, with editorials and columns of their own.

Contractors have held public demonstrations, touting the flexibility and independence offered by their current status, and asking to remain independent contractors. Other contractors have engaged in counter-demonstrations, complaining about their situation, and asking to be classified as employees.

The media coverage of AB 5 is eclipsing coverage of other important bills that also would dramatically change the employment law landscape in California. The list of potential new employment laws is staggering, including currently pending bills that would:

- Triple the statute of limitations for bringing employment discrimination claims (AB 9).
- Make the requirements of the California Consumer Privacy Act applicable to employment records after January 1, 2021 (AB 25).
- Limit the use of arbitration agreements in employment (AB 51).
- Create liability for “labor contractors”—a new term in the Labor Code—for sexual harassment (AB 170).



⁸⁰ The Economist, Special Report: California & Texas, *California and Texas have different visions for America's future*, June 20, 2019.



- Create a rebuttable presumption of retaliation if an employer takes adverse action against an employee within 90 days of a complaint of sexual harassment (AB 171).
- Establish an evidentiary privilege for communications between a union business agent and a represented employee (AB 418).
- Expand the ability of employees to recover penalties for labor code violations (AB 673).
- Prevent “no-rehire” provisions in employment severance agreements (AB 749).
- Provide unemployment insurance benefits to striking workers (AB 1066).
- Impose joint liability on grocery stores for the wage and hour liability of food delivery services (AB 1360).
- Require large employers—even those without employees in California—to provide an annual pay data report to the California Department of Fair Employment and Housing, with data broken down by race, ethnicity and gender (SB 171).
- Expressly permit local governments to adopt their own employment discrimination ordinances and establish city government agencies to enforce those laws (SB 218).

This intense news coverage of AB 5 shows no signs of slowing down. When the California legislature reconvenes on August 13, and the legislative timeline becomes more condensed, there is no doubt that AB 5 will again make headlines.

Faced with such a daunting list of potential new laws and regulations, employers may feel overwhelmed and conclude that it is pointless to respond. Further, employers may fear that if they do speak out, repercussions will follow. For example, in response to the editorials from the CEOs identified above, proponents of AB 5 issued counter-editorials, which included attacks on those individuals as earning exorbitant salaries while their workers struggled to make ends meet.

Nevertheless, California employers should not delay in evaluating possible communications strategies with regard to independent contractor status. Careful consideration should be given to each audience: employees, contractors, customers, and the public at large. Simple and consistent messages are best. Each business in California has a story to tell; each story is different. Many employers will choose to remain quiet in public, but may be willing to be more outspoken among their own employees, contractors and customers.

A solid communication strategy also anticipates the counter-messages that the supporters of AB 5 may employ. When businesses tout the flexible work schedules afforded to independent contractors, a response has been that many workers classified as W-2 employees also have flexible schedules. Businesses should be ready with a response. On this point in particular, some employers have responded that California state law makes it extremely difficult for an employer to engage “on-call” workers. For example, in one recent California appellate court decision, it was found that employees needed to be paid for making a quick phone call to work to learn whether or not they were scheduled for the day.⁸¹

Employers should also actively consider participation in communications by trade associations or professional groups. Participation in such an association can go far

81 *Ward v. Tilly's, Inc.* 31 Cal. App. 5th 1167 (2019).



beyond the mere paying of dues. The messages developed by trade groups can and should be heavily influenced by the members themselves.

C. Engage in the political process

California employers have already undertaken traditional political strategies in response to AB 5. Meetings have been held with legislators. Lobbyists have been retained. Private and public overtures have been made to organized labor, seeking compromise. Nevertheless, efforts by business groups to influence the legislative process with regard to AB 5 so far have been largely unsuccessful.

Of course, if the legislature passes AB 5, it will end up on the governor's desk. What might he do with the bill? Attempts to seek some sort of a sign from Governor Newsom have been unsuccessful. He did, however, make a few sweeping statements in a recent San Francisco Chronicle "It's All Political" podcast, including:

I'm worried about their current classification because there's not the commensurate benefits of all that time and energy. That's going to be a majority of our workforce in a few decades, so we're going to have to address this issue . . . And remember, in 10 years, [companies] aren't going to care about this because the vast majority of their business model is going to be automated, so this is an interim conversation.⁸²

The governor also commented:

I'm into compromise. I've been trying to seek it for many many months. You can't have a dominant workforce that provides no workers comp benefits, no unemployment insurance, no stability. Why are we living in a society that's never been more abundant, where wealth is just dominant, and people feel worse than ever? It's because people are working harder than ever but they're running in place. The gig leaders get that — but it's just, how do we get that done without the traditional model being stuffed on top of a dynamically new economy? And so therein lies the vexing question: How do we balance on that?⁸³

When asked directly if he had a position on AB 5, the Governor responded: "I have a deep position to advance the conversations. If my position was explicit, those conversations would end."⁸⁴

Based on the scant results that have come from attempts to influence the legislature and the governor so far, employers may conclude that any further efforts will be futile.

However, now is the time to act; realistically now is the only time to act.

The following is a 10-step "all in" political strategy to address AB 5:

1. Urge associations to have fly-ins in August to meet with legislators and to voice concerns.
2. Meet the governor. Meet him in person, or meet his staff members in person, or at least communicate in writing. Littler's Workplace Policy Institute will be providing this Report to his office, and will also provide further correspondence to him voicing the concerns of the business community.

82 Joe Garofoli, [Gavin Newsom dodges taking a stand on California's gig-worker bill](#), S.F. Chron., June 25, 2019.

83 *Id.*

84 *Id.*

3. Find legislative champions for the business community and support them.
4. Perform an economic analysis of the impact of the ABC test on your business.
5. Ask your trade association to participate as an *amicus* before the California Supreme Court on the retroactive impact of *Dynamex*.
6. Establish coalitions of like-minded companies and experts such as economists and site selection personnel to assist in analysis and communication.
7. Consider legal challenges. If AB 5 is given retroactive effect, a challenge may be possible.
8. For multi-state employers, realize that the ABC test will spread beyond California. Develop an offensive strategy to enact favorable legislation in select states and consider establishing more operations in favorable jurisdictions. Draft model legislative language, find state champions and support them with sound communication assistance.
9. Engage in serious discussions about reforming our employment laws to permit more flexibly in the workplace, at both the state and federal levels.
10. Consider a longer-term strategy. If the country is in a recession and the ABC test has contributed to high unemployment, reform may be more appealing. Should this come to pass, it is not beyond the realm of possibility that the worker classification issue embodied in the ABC test might have to be taken directly to the voters, as was the case last year with Proposition 11.

Even if, however, all employers faithfully adhere to all 10 suggestions, California employers should be clear-eyed about the very real possibility that AB 5, in some shape or form, will become the law in California as of January 1, 2020. The WPI Task Force's suggestions for dealing with that reality are below.

VIII. Practical Suggestions Should AB 5 Become Law

Compliance with AB 5 will be a significant challenge for many employers in California. Several approaches are possible, but few seem to be ideal. WPI's Task Force has identified five primary options for moving forward, should AB 5 become the law of the state.

A. Make everyone an employee

First, businesses that are using independent contractors and may face challenges complying with the "B" prong could simply reclassify all of their contractors as employees. For businesses with only a handful of contractors, this may be an attractive option. For businesses that primarily rely on independent contractors, this option simply may not be viable. Regardless of the number of contractors used by a business, this option presents immediate fiscal challenges.⁸⁵

In addition, once the potential legal challenges are addressed, this option will present substantial operational hurdles. California employers know how difficult it is to police meal and rest breaks, on-call status, work schedules, and so on. Adopting this approach

⁸⁵ There is perhaps a possibility that any "self-correction" could be used as evidence of improper classification in the past. See, e.g. *Sav-On Drug Stores, Inc. v. Superior Court*, 34 Cal. 4th 319, fn 4 (2004). However, the doctrine of "subsequent remedial measures," (California Evidence Code section 1151) may ameliorate such arguments. If in fact contractors are misclassified, this can be alleged in a lawsuit whether or not reclassification to employee status has occurred.



will impact workers, as well. Workers who tout the flexibility that their independent status affords may need to accept less flexibility when classified as employees.

Finally, with the requirement of compliance with the labor code and the wage orders, comes the specter of PAGA liability. All of these considerations must be factored into any decision to reclassify contractors as employees.

B. Outsource employment to a third party

As discussed above, this is the response that many employers in Massachusetts adopted in the wake of adoption of the ABC test there. The essence of the ABC test, and *Dynamex*, is that every worker should get a W-2. There typically is no further inquiry once this is done.⁸⁶ Utilizing a staffing agency allows for that third-party provider to assume the responsibilities of the employer of record.

Presumably, the third party is not in the business of “x” (driving cars, delivering items, etc.), but rather is in the business of providing workers who are the W-2 employees of the agency.

Of course, this comes with an additional cost. Staffing agencies typically charge for not only the cost of labor, but also insurance, taxes, and a management fee. Other legal risks may emerge such as joint employment liability. WPI’s recommended task force should be directed to weigh the cost-benefit analysis of such a third-party “solution.”

C. Subscription-based platforms

A number of technology platforms have been developed in recent years that allow consumers to link up with service providers, but with the providers themselves setting their own fee. This ability to set a price may be a key consideration in preserving arguments that a worker is an independent contractor.

In a recent opinion letter, the U.S. Department of Labor evaluated virtual marketplace companies (VMCs) and applied its six-factor test to conclude that workers were contractors, not employees. Particularly important was the independence of the workers from the VMC, including their freedom to accept or reject jobs, and their ability to set their own prices.⁸⁷

The use of such platforms, and the development of potentially even more revolutionary platforms in the future, may be one way for businesses to be creative and still preserve contractor status. For example, a platform that allows for actual back-and-forth bargaining between parties, and eventual mutual agreement on a fee, may strengthen the argument that the worker is truly an independent contractor.

D. Continue to use contractors and hope for relief elsewhere

This option might be described as “whistling past the graveyard.” Many contractors are happy with their arrangements and actually do not want to be classified as employees. As long as these persons remain happy, there are no issues, right? Well, everything is great, until it isn’t. If one of these workers becomes upset for some reason, then the liability of continuing to operate with contractors could prove to be crushing.

⁸⁶ See, however, the discussion of the application of the ABC test to franchisors, Section V.B.

⁸⁷ U.S. Dep’t of Labor, Wage & Hour Div., Op. Ltr. FLSA2019-6 (Apr. 29, 2016).



E. Minimize the number of actual workers in the state

Again, drawing from the lessons in Massachusetts, one option is to relocate work over state lines. The relatively small size of the New England states, and their proximity to one another, make this a possibility. In California, the sheer size of the state makes this option a challenge.

Members of our Task Force have been consulted by interested parties regarding whether moving some or all operations to a venue outside of California should be considered. Indeed, economic development agencies of other states may utilize adoption of the ABC test in California as yet another reason businesses should consider looking to their home states, rather than California, as a good place to set up shop.

Businesses are evaluating automated systems, replacing workers with robots and learning computers. This is a trend that is occurring right now, without the impact of the ABC test. Companies evaluating their options certainly can and will consider further automation as a solution to the compliance challenges presented by retaining employees. The cost-benefit analysis of deciding whether to use an employee, or a robot, could be heavily influenced by adoption of the ABC test.

The WPI Task Force predicts that full-scale adoption of the ABC test will cause some businesses to completely pull up stakes and leave California. Such defections have taken place in the past in response to the burdensome regulatory climate in the state. AB 5 could accelerate the pace of such departures and act as a disincentive to come to California.

IX. A Different Way Forward

The challenges the ABC test presents are daunting. It seems that our business climate and economy likely will not react well to the mandates imposed by the ABC test. In a recent editorial by the *Los Angeles Times*, the board concluded that AB 5 is “overkill.”⁸⁸

The Harvard Business Review echoed this concern: “...the debate over how to classify workers, as either employees or freelancers, is a red herring. The larger issue is how to modernize employment and labor protections to fit with the realities of work today.”⁸⁹

It seems equally daunting to alter in any significant way the current arc of AB 5. The outlook in California for meaningful reform of our employment laws seems bleak. Our barriers to real reform were well-expressed by *The Economist* in its recent special report on Texas and California:

California’s politicians are not blind to their state’s problems, but they seem unpragmatic. They are also encumbered by structural issues, such as the entrenched interests of unions, bureaucracy and laws allowing voters to approve major decisions in ballot measures. All this means it is much harder for the state to make the big changes required. They may also be less receptive to moderation and pressure to change because they have no fear of losing power to the Republicans in the near future.⁹⁰

88 Times Editorial Board, [Editorial: California legislators could save gig workers — or ruin the part-time economy](#), L.A. Times, July 6, 2019.

89 Orly Lobel, [The Debate Over How to Classify Gig Workers Is Missing the Bigger Picture](#), Harv. Bus. Rev., July 24, 2019.

90 The Economist, Special Report: California & Texas, [Texas seems better placed to adapt than California](#), June 20, 2019.



Perhaps the California political climate for meaningful reform has changed completely in just the past few years. Just 10 years ago, business leaders, disability rights advocates and trial lawyers reached a compromise on SB 1608, which took steps to increase access to facilities by persons with disabilities, while decreasing the number of lawsuits required to enforce access laws. Perhaps the days of such compromise are over.

Nevertheless, we still must seek a different path forward, through the legislative process, in the executive branch, and in our society as a whole.

A. A call for legislative action

In the early days following the issuance of the California Supreme Court's *Dynamex* decision, many in the California employer community complained that the court was doing the job of the legislature—creating new law. There was hope that real reform was possible, to replace *Dynamex* with something more progressive and attuned to the realities of our modern economy. Business leaders, organized labor and politicians met and discussed options.

Indeed, then-Governor Brown vetoed a bill last year that would have codified the ABC test for employees in the janitorial industry. In his veto message, he noted:

I share the Author's concern about protecting the most vulnerable workers as well as the general concern about providing clarity regarding worker classification. The California Supreme Court recently issued a significant decision establishing a new test to determine whether a worker is properly classified as an employee or an independent contractor, *Dynamex Operations West, Inc. v. Superior Court* (2018) 4 Cal.5th 903. The Administration and the Legislature are still reviewing this decision and any statutory changes to such tests would be premature.

While many found a hopeful tone in the then-governor's message in 2018, and shared his "general concern about providing clarity regarding worker classification," it appears that no relief is in sight. As discussed above, the ABC test is far from clear. It becomes even more blurry when it is inflicted upon a modern economy that is reinventing itself with increasing frequency.

There simply must be a better path forward for California.

As many noted in response to *Dynamex*, it is the job of the legislature to legislate. One legislative approach could include a return to *Borello* in the short term. The *Borello* test was far from perfect, but it was stable and established. Our modern economy grew and business innovation continued apace while this test was in effect.

Moving forward, one legislative option would be to temporarily revert to *Borello* while longer-term solutions are crafted. Such solutions could include such concepts as:

- Create a third category of workers. For example, "The Independent Worker," as advanced by former Deputy Secretary of Labor Seth Harris and economist Alan Kruger. It is notable that they assert that wage-hour laws should not apply to this new third category of workers.⁹¹ As a further example, Ontario, Canada recognizes "dependent contractors," who are provided pre-termination notice rights, as are regular employees, but who are not afforded the same legal status for other employment laws.

91 A Proposal for Modernizing Labor Laws for Twenty-First Century Work: The "Independent Worker," Dec. 7, 2015 https://www.hamiltonproject.org/papers/modernizing_labor_laws_for_twenty_first_century_work_independent_worker.

- Replace the current system of employment taxation with a new funding system for “Universal Protections” for workers, so that all workers, regardless of whether they are contractors or employees, have access to minimum compensation, protection from discrimination, leaves of absence, unemployment insurance, medical coverage for illness and injury incurred while working, and so on. Create the system without the need for a presumption of “employee” status requiring compliance with wage and hour laws.
- Create a new system of protections for independent contractors. The Editorial Board of the Los Angeles Times recently asserted: “Rather than expanding the definition of who is an employee, a better approach would be to give more wage and labor protections to independent contractors.”⁹²
- Create a “portable safety net” for contractors. This was articulated recently as follows: “Each contractor-worker would have an Individual Security Account into which any business that hires that worker would contribute an amount pro-rated to the number of hours worked for that business. Those funds then would be used by that worker to pay for her or his safety net needs.”⁹³
- Create a new test, utilizing parts of the common-law test, and/or parts of the FLSA’s “economic realities” test, to determine independent contractor status.
- Reestablish the Industrial Welfare Commission, or a more modern version of it, to assess and make recommendations about the 21st century workforce.
- Meaningful reform of wage and hour laws, to remove the disincentive that those laws impose on hiring W-2 employees; such reforms could include the following.
 - Truly flexible scheduling options—as just one example, many employees have expressed that they would like the ability to choose to work through their breaks in order to leave work earlier and spend more time at home with their families.
 - Allow employers and employees to more freely utilize incentive pay plans.
 - Allow employers and employees to more freely utilize “on call” employment.
 - Allowing employers to cure labor code and wage order violations within a reasonable time of awareness of the problem, without the imposition of excessive penalties.
 - Limiting the ability of municipalities to regulate employment law issues; reserve such authority to the state.
- Other “outside the box” approaches could include:
 - Revise the state minimum wage to allow for regional differences in the cost of living.
 - Create a statewide advisory committee, similar to the Cal-OSHA Advisory Committee (with participation by employers and employees), to provide advice and input to the labor commissioner.

92 Times Editorial Board, [Editorial: California legislators could save gig workers — or ruin the part-time economy](#), L.A. Times, July 6, 2019.

93 Steven Hill, [Opinion: 21st century California workers need portable safety net](#), Mercury News, July 18, 2019.

- Allow employers to self-insure for all medical benefits (work-related claims, as well as non-work related claims) in a single insurance plan. Expand access to association-based health-insurance and retirement plans. This would help decouple access to these benefits from traditional employment and address one of the most common concerns about independent contracting.
- Incentivize companies to use employees instead of independent contractors. For example, the state could provide tax incentives to companies that convert independent contractors into employees, or that maintain a high employee-to-independent-contractor ratio. This approach would encourage businesses to use employees when they can, but would avoid crippling them when they cannot.

Of course, any such changes, should they be adopted, should be prospective only.

In essence, the WPI Task Force asserts that now is the time to pause and reflect, and develop a solution that adequately takes into consideration the complexity of our diverse, modern and ever-changing economy. A temporary reversion to the *status quo ante Dynamex* would allow for a more meaningful and measured approach to our current workplace legal challenges.

B. Larger questions: TIDE and the future of work (The Emma Coalition)

In closing, all Californians must acknowledge that the outcome of our current debate over the ABC test will have dramatic and sweeping effects on life in the Golden State. There is a tangible connection between the classification of workers and the future of work in the state.

We all must take responsibly for the multitude of issues that are around the corner, particularly those relating to Technology-Induced Displacement of Employment (TIDE).

In Darrell West's book, *The Future of Work*, he cites two examples of the erosion of jobs taking place today. Restaurants are using tablets for ordering. Quick service restaurants use digital ordering Kiosks. At one chain, 2,500 jobs have been replaced, and the prediction is that the stock value of the company will increase by 17.5% as a result. One California warehouse introduced robots costing \$30,000 to \$40,000 that can handle 30 to 50% of all shipments a day, in half the time that would be required for humans to complete the tasks. Foxconn, which makes the phone in your pocket, has 10,000 Foxbots, which have eliminated 60,000 jobs.

Why does replacing human jobs with digital kiosks or robots make sense today? It eliminates worries about staffing; it eliminates the need for recruitment and retention initiatives; it eliminates the need to evaluate such things as compliance with meal and rest breaks, whether a wage statement has all required information, whether sick leave, ADA leave, workers' compensation, FMLA, state FMLA and city paid leave laws are all properly integrated, and on and on.

As unit labor costs increase, the cost difference between humans and alternate task performers decreases. The creation of task performers is decreasing while the cost of human capital is increasing. The end result is not hard to predict.

To help outline the key discussion points that must take place surrounding TIDE, the National Restaurant Association and Littler's Workplace Policy Institute have partnered to create





the Emma Coalition. The Coalition is actively grappling with the challenges that will be presented as our modern economy continues its current revolution.⁹⁴

Such efforts, and others, work for the betterment of all in our community, including workers, employers, business investors and citizens at large.

X. Concluding Remarks

The workplace of the industrial revolution was based on a paternalistic concept: the employer takes care of its employees. But the paternalistic model is outmoded as an exclusive model today. Many workers do not want to be treated like they are in the care of their employers, but rather would prefer something different. In Europe, the concept of “Flexicurity” has been introduced as a way to address issues confronting workers in a modern economy. The four basic components of flexicurity are: 1) flexible and reliable contractual arrangements; 2) comprehensive life-long learning strategies; 3) effective active labor market policies; and 4) modern social security systems providing adequate income support during employment transitions.⁹⁵

AB 5 should force us to engage in serious discussions. This is California’s Sputnik moment—we can and should come together for meaningful change. *Dynamex* and AB 5 are creating a workforce crisis. A crisis is a terrible thing to waste. We invite you to join us as we work to ensure the 21st is the next American century, as we reinvent the workforce in a deliberate and thoughtful manner.

94 The Emma Coalition, <https://www.littler.com/service-solutions/wpi/emma-coalition>; Michael J. Lotito, et al., *The Future Is Now: Workforce Opportunities And The Coming TIDE, WPI Report* (June 2018).

95 European Comm’n, Employment, Social Affairs & Inclusion, *Flexicurity* (last visited Aug. 5, 2019).

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