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NEW LAW NEARLY ELIMINATES INDEPENDENT CONTRACTOR CLASSIFICATION IN CALIFORNIA

Last month, Governor Newsom signed Assembly Bill 5 (“AB5”) into law granting almost all California workers with employee status and the protections of its wage and hour and unemployment insurance laws. With this new law, only a select few can lawfully be classified as independent contractors.

You may recall our discussion of the California Supreme Court’s decision in *Dynamex Operations West, Inc. v. Superior Court* in our June 2018 Employment Law Bulletin. The *Dynamex* court held that all workers are employees unless the hiring entity can prove all conditions of “the ABC Test.” The *Dynamex* decision applied only to wage and hour claims under the Industrial Welfare Commission Wage Orders. AB5 was introduced to codify *Dynamex* and extend the ABC Test to California’s Labor and Unemployment Insurance Codes.

With the introduction of AB5, many industries lobbied for exemptions from the application of the ABC Test. Some of them were successful, while some were not. The end result is a 15 page, single-spaced detailed and complicated amended AB5 that nearly requires a law degree to wade through. As with any piece of complicated legislation, we anticipate there will be clarifying regulations and amendments to AB5 in the coming year, but for now, I’ve attempted to take you through the requirements in a step-by-step approach. After reading a few lines, you’ll see this is very complicated. Don’t be surprised if you need to get a cup of coffee, close your door, turn off the phones, and use a flow chart to follow this. Ok, here we go!

GENERAL RULE: All Workers Are Employees, Unless The Hiring Entity Can Prove Otherwise - and the Burden of Proof Is Very High.

Under the new law, a person providing labor or services for pay is automatically considered an employee, rather than an independent contractor, unless the hiring entity can either prove that ALL of the conditions of the “ABC Test” are satisfied OR the elements of an exemption from AB5 and that the worker meets the elements of the independent contractor test in *Borello & Sons, Inc. v. Department of Industrial Relations* (“the *Borello* Test”). To determine which independent contractor test applies and whether your business can meet it, follow the steps below.

STEP 1: The ABC Test. Can the hiring entity prove the worker meets the ABC Test? If not, go to Step 2. If yes, the worker is an independent contractor. (Note, independent contractor status will only very rarely be found under the ABC Test.)

(A) the worker is free from the control and direction of the hiring entity in connection with the performance of the work, both under the contract for the performance of the work and in fact;

(B) the worker performs work that is outside the usual course of the hiring entity's business; and

(C) the worker is customarily engaged in an independently established trade, occupation, or business of the same nature as that involved in the work performed.

STEP 2: Occupations Exempt From the ABC Test. Does the worker fall within one of the specified occupations specifically exempt from the application of the ABC Test? If not, go to Step 3. If yes, use the *Borello* Test in Step 6 to determine if the worker is an employee or independent contractor. (See AB5 for specific requirements for each occupation).

- licensed insurance agents;
- California licensed physicians, surgeons, dentists, podiatrists, psychologists & veterinarians;
- California licensed lawyers, architects, engineers, private investigators and accountants;
- securities broker-dealers, investment advisers or their agents and representatives registered with the Securities and Exchange Commission or the Financial Industry Regulatory Authority or licensed by the State of California;
- direct sales salespersons (as defined by Unemployment Insurance Code section 650);
- commercial fisherman working on an American vessel.

STEP 3: Contracts For Professional Services. Is the worker providing services under a contract for "professional services" that is exempt from the application of the ABC Test? If not, go to Step 4. If yes, use the *Borello* Test in Step 6 to determine if the worker is an employee or independent contractor.

For the Professional Services Contract exemption, the contract must be for one of the types of services listed in AB5 AND the individual worker must have an established business that meets five specific requirements:

Types of Services:

- marketing, provided that the contracted work is original and creative in character and the result of which depends primarily on the invention, imagination, or talent

of the worker or work that is an essential part of or necessarily incident to any of the contracted work;

- human resources administrator, provided that the contracted work is predominantly intellectual and varied in character and is of such character that the output produced or the result accomplished cannot be standardized in relation to a given period of time;
- some travel agent services;
- graphic design;
- grant writer;
- fine artist;
- services provided by an enrolled agent who is licensed to practice before the IRS;
- still photographer, photojournalist, freelance writer, editor or newspaper cartoonist who does not license content submissions to the hiring entity more than 35 times per year;
- licensed esthetician, electrologist, barber, or cosmetologist (provided the individual meets several requirements set out in AB5); or
- licensed manicurist (only until 12/31/2021).

Worker’s Business Requirements:

Even if the worker provides services that meet the definition of “professional services”, the worker must perform those services in connection with an established business that meets ALL of the following requirements:

- the worker must maintain a business location, which may include the individual’s residence, that is separate from the hiring entity;
- the worker must have all required professional licenses and permits to practice their profession (if work is performed after July 1, 2020);
- the individual must have the ability to set or negotiate their own rates for the services performed
- outside of project completion dates and reasonable business hours, the worker must have the ability to set the individual’s own hours;
- the individual must be customarily engaged in the same type of work performed under contract with another hiring entity or must hold themselves out to other potential customers as available to perform the same type of work; and
- the individual customarily and regularly exercises discretion and independent judgment in the performance of the services.

STEP 4: Business-To-Business Exception. Is the worker providing services under a contract that fits the Business-To-Business exception? If not, go to Step 5. If yes, use the *Borello* Test in Step 6 to determine if the worker is an employee or independent contractor.

The Business-To-Business exception applies when a business entity (“business service provider”) contracts to provide services to another business (“contracting business”) and all of the following criteria are met:

- the business 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;
- the business service provider is providing services directly to the contracting business rather than to customers of the contracting business;
- the contract with the business service provider is in writing;
- if the work is performed in a jurisdiction that requires the business service provider to have a business license or business tax registration, the business service provider has the required business license or business tax registration;
- the business service provider maintains a business location that is separate from the business or work location of the contracting business;
- the business service provider is customarily engaged in an independently established business of the same nature as that involved in the work performed;
- the business service provider actually contracts with other businesses to provide the same or similar services and maintains a clientele without restrictions from the hiring entity;
- the business service provider advertises and holds itself out to the public as available to provide the same or similar services;
- the business service provider provides its own tools, vehicles, and equipment to perform the services;
- the business service provider can negotiate its own rates;
- consistent with the nature of the work, the business service provider can set its own hours and location of work; and
- the business service provider is not performing the type of work for which a license from the Contractor's State License Board.

STEP 5: Other Exceptions. Is the worker providing services that meet one of the following exceptions? (See Labor Code section 2750.3 for the specific detailed requirements of each exception). If not, use the *Borello* Test in Step 6 to determine if the worker is an employee or independent contractor. If yes, apply the test listed next to the exception.

- Construction Subcontracts (Labor Code section 2750.5 and the *Borello* Test)
- Referral Agency contracts (*Borello* Test)
- Motor Club worker (*Borello* Test)
- Real Estate Licensees (Business & Professions Code section 10032)
- Repossession Agencies (Business and Professions Code section 7500.2)

STEP 6: Does the Worker Meet the Independent Contractor Status Test Announced In *Borello*? If not, the worker is an employee. If yes, the worker is an independent contractor. (Note, independent contractor status is also rarely found under the *Borello* Test).

The *Borello* Test examines the total circumstances of the relationship between the hiring entity and the worker performing the work, in light of the 11 factors listed below. While

easier to meet than the ABC Test, the *Borello* Test also strongly favors a conclusion that a worker is an employee, rather than an independent contractor.

1. whether the worker is engaged in an occupation or business that is distinct from that of the hiring entity;
2. whether the work is part of the hiring entity's regular business;
3. whether the hiring entity or the worker supplies the equipment, tools, and the place for the person doing the work;
4. the worker's financial investment in the equipment or materials required to perform the work;
5. the skill required in the particular occupation;
6. the kind of occupation, with reference to whether, in the locality, the work is usually done under the hiring entity's direction or by a specialist without supervision;
7. the worker's opportunity for profit or loss depending on his or her own managerial skill (a potential for profit does not include bonuses);
8. how long the services are to be performed;
9. the degree of permanence of the working relationship;
10. the payment method, whether by time or by the job; and
11. whether the parties believe they are creating an employer/employee relationship.

Although no single factor in the *Borello* test is determinative, the first one—whether the individual's work is the service or product that is the hiring entity's primary business—is given the most weight.

Conclusion

Congratulations on making your way through the AB5 requirements! If you're confused, you're not alone. AB5 clearly shows California's strong public policy in favor of protecting workers. While the least risky and most conservative approach is to hire every worker as an employee, the AB5 exceptions are there to be used, but applying them won't be easy. With AB5, you can expect the Labor Commissioner, the Employment Development Department and attorneys who represent employees to be laser-focused on this issue, which means high risk and potential liability for hiring entities that don't classify workers as employees.

If you're thinking of hiring an independent contractor, contact an SMT employment attorney for help with the detailed analysis AB5 now requires.

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