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Client Alert

Employment Counseling & Litigation

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Is Your California Worker an Employee or an Independent Contractor?

By Julie Levinson Werner and Chandra K. Shih

What You Need To Know:

- **A bill is poised to become law in California that will shake up businesses' ability to treat workers as independent contractors.**
- **If a three-part test is not satisfied in full and the industry is not exempt under the law, the worker is presumed to be an employee.**
- **Compliance with the bill may reshape how investors and acquirors evaluate new opportunities in companies that rely on "gig workers."**

Assembly Bill 5 (A.B. 5) is poised to become law in California effective Jan. 1, 2020. If Governor Gavin Newsom signs this bill into law, A.B. 5 will significantly change the employment and business landscape in California for companies currently engaging workers as independent contractors.

Employee Classification Prior to A.B. 5

Prior to 2018, California courts and state agencies applied the common-law test that the California Supreme Court adopted in the *Borello* case to determine whether an individual was an independent contractor or an employee. In 2018, the California Supreme Court decided the *Dynamex* case and adopted a three-part "ABC Test" to determine a worker's classification. Following the Court's decision, the California Legislature has sought to codify the *Dynamex* standards and to exempt certain industries.

California is not the first state to implement the ABC Test. In 2015, the New Jersey Supreme Court, for example, applied the ABC Test and held that delivery drivers for Sleepy's, the mattress company, were employees and not contractors. And for many years, a Massachusetts statute has imposed the ABC Test upon businesses classifying their workers. From a tax standpoint, in 1987, the IRS implemented the "20-factor test," under which the evidence of the parties' situation tends to fall into three main categories: behavioral control, financial control, and the relationship of the parties. Over the years, businesses have preferred this 20-factor test to other tests, because no one factor is dispositive to a determination.

This past spring, two federal agencies under the Trump administration held that Uber and other app-based drivers are independent contractors and not employees. In April 2019, the United States Department of Labor, Wage and Hour Division, issued a 10-page opinion letter holding that the "gig workers" engaged by an online/smart-phone based referral service to connect service providers to end-market consumers were independent contractors. As well, the National Labor Relations Board (NLRB), a typically pro-worker agency, issued an advisory memorandum concluding that Uber drivers were not employees and therefore unable to unionize.

The ABC Test

California A.B. 5 codifies the three-part ABC Test, and says that a person providing labor or services for remuneration shall be considered an employee rather than an independent contractor unless the hiring entity demonstrates that all of the following conditions have been satisfied:

(A) The person 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 person performs work that is outside the usual course of the hiring entity's business; and

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

There are exceptions. Industries exempt from the law include, among others, licensed insurance agents, certain licensed health care professionals, registered securities broker-dealers, and investment advisers. Notably, driver-sharing businesses like Uber and Lyft would not be exempt. In addition, the law does not apply to *bona fide* business-to-business contracting relationships if multiple criteria can be satisfied demonstrating that the service provider is a genuine, stand-alone business.

Impact of A.B. 5 in California and Beyond

Increased litigation seems imminent as California courts, employers, and workers seek to more clearly define and refine the three-part ABC Test and the exemptions to that test. In addition to workers filing lawsuits, the California Attorney General is empowered to pursue injunctions against businesses suspected of misclassifying independent contractors. Beyond direct litigation costs and related judgments or settlements, businesses traditionally and lawfully engaging independent contractors in the state will face increased economic costs and administrative burdens to convert contractors to employees (or terminate those relationships entirely). Businesses may also face public relations and workforce culture issues following the bill's passage. High profile companies such as Uber and Lyft have faced public protests and mounting pressure to improve pay and working conditions for their workers.

Investors and acquirors also may require that target businesses adopt more conservative approaches with respect to classification of independent contractors and adherence to A.B. 5. Many businesses, particularly in the tech industry where the rise of the "gig worker" has been prevalent, rely on investment from venture capital firms and private equity firms to launch and grow. Further, a typical exit strategy for such businesses is a potential sale to an acquiror later in the company's life cycle. Each time a company undergoes an investment round or a proposed sale, investors and acquirors, respectively, conduct due diligence on the business and the company is asked to give standard representations and warranties in the transaction, which typically include representations regarding compliance with employment laws. Businesses that engage independent contractors in California will be forced to determine whether or not they are able to give such representations in light of A.B. 5. Further, investors or acquirors evaluating such business opportunities may seek to shift the cost of the risk of misclassification onto the target business by adjusting the valuation of the investment or the acquisition sale price to account for the financial impact misclassification may have on the business. Worse yet, if investors or acquirors are unable to quantify such impact or worker classification is a core feature of a company's business model, investors or acquirors may pass on the opportunity altogether in favor of less uncertain opportunities.

If enacted, A.B. 5 will impact companies of all sizes and industries. It is also expected that this bill will cause a ripple effect across the country, so all businesses should ensure misclassification issues are addressed early and reassessed often. Lowenstein Sandler's attorneys are available to answer questions and assist businesses seeking to assess the impact of A.B. 5 on their workforce.

Contacts

Please contact the listed attorneys for further information on the matters discussed herein.

JULIE LEVINSON WERNER
Partner
T: 212.419.5864 (NY) / 973.597.2550 (NJ)
jwerner@lowenstein.com

CHANDRA K. SHIH
Counsel
T: 650.433.5620
cshih@lowenstein.com