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Employee vs. Independent Contractor: A Distinction with Huge Differences

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Few areas of labor and employment law are more misunderstood and wrongly decided by companies than the decision to classify a worker as either independent contractor or employee. This determination is fraught with subjective analysis and uncertainty. California recently enacted one of the most restrictive tests in the nation for making this determination. As California is often a bellwether for social and legal trends across the nation, a discussion of California's new law can be instructive for those in other states as it can be anticipated that other states will follow California's lead.

The Costs of Misclassification

Correct classification of workers, especially in California, is crucial for employers. California wage order requirements (such as setting requirements for meal/rest breaks, overtime, pay reporting, etc.) apply to employees but not independent contractors. As a result, workers classified as employees are significantly more costly to the employer than those classified as independent contractors.

An employer's failure to abide by these requirements as to their employees can result in hefty cumulative penalties under the recent wave of more protective wage and hour provisions. Worse yet, many cases of misclassification involve classes of employees that ultimately could cost an employer in the six- or even seven-figure range in the form of class action or other collective lawsuits. Therefore, wrongly classifying an employee as an independent contractor creates a real risk of extraordinarily large judgments against an employer.

Defining the Working Relationship

Until recently, California courts analyzed the correctness of this determination largely by reference to California case law. The standards were fact-specific and subject to multifactor tests set forth in Supreme Court decisions such as the well-known *S.G. Borello & Sons, Inc. v. Dept. of Industrial Relations*, 48 Cal. 3d 341 (1989), the longtime standard test for classification, and the more recent *Martinez v. Combs*, 49 Cal. 4th 35 (2010). Many states have a variety of similar tests, depending on the reason for which the independent contractor/employee determination must be made. These tests generally consider specific factors to ultimately determine the degree of control the employer exercises over a worker given the totality of circumstances of the working relationship

(see, for example, the tests/factors set forth in *Cantor v. Cochran,* 184 So.2d 173, 174-75 (Fla. 1966) in Florida; *Carter v. Reynolds,* 175 N.J. 402, 409-10 (203) in New Jersey; Colo. Rev. Stat. Ann. Sec. 8-70-115(1)(c) in Colorado). The more control the employer exercises over the worker, the more likely the worker will be considered an employee.

Further, many states may apply different tests depending on whether the issue involves workers' compensation, unemployment insurance, wage and hour law, state tax laws, whistleblowing, specific industries or job categories, or employer liability (discrimination, harassment, retaliation, etc.). Many evaluations are made pursuant to specific statutory schemes. In other cases, a "common law" test may apply. Some states use federal law to make this determination. To further complicate matters, an individual can be considered an employee under one test but an independent contractor under another test, depending on the issue involved. Hence, advising companies regarding worker classification is challenging, and attorneys should consider the narrowest test in a particular jurisdiction when advising their employer clients.

California's Narrow Definition of Independent Contractor

Current California law, codifying the California Supreme Court's 2018 decision in *Dynamex Operations West v. Superior Court,* 4 Cal. 5th 903 (2018), is one of the most restrictive tests in the country. Under *Dynamex,* workers are presumed to be employees unless the employment relationship meets certain specific criteria. *Dynamex* provides that a worker is an independent contractor only if the hiring entity establishes (except in a few circumstances):

> **A.** The worker is free from the control and direction of the hirer in connection with the performance of the work, both under the contract for the performance of such 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 the work performed for the hiring entity.

This three-prong *Dynamex* test is also called the ABC test. California codified this decision into law under Assembly Bill 5 (AB5) effective January 1, 2020. Massachusetts has a similar test as set forth in M.G.L. c. 149, Sec. 148B.

However, the ABC test does not apply for certain individuals, including medical and other professionals (e.g., lawyers, architects, engineers, private investigators, or accountants), insurance and real estate agents, registered stockbrokers and investment advisors, and certain commercial fisherman. (Cal. Lab. Code Sec. 2750.3(b).)

There are some other exceptions to AB5 for other occupations so long as the working relationship meets certain strict criteria. These requirements may not be attainable by many of the individuals working in the field due to the nature of the engagement (e.g., services provided by a freelance writer, editor, or newspaper cartoonist may provide only up to 35 submissions per year and remain an independent contractor). (Cal. Lab. Code Sec. 2750.3(c)(2)(B).)

In these cases, the looser multi-factor test of the *Borello* case applies. (Cal. Lab. Code Sec. 2750.3(c)(1).) However, most other occupations are not exempt.

The Effect of California's Law

For employers, the second requirement of AB5, which requires that, to be considered an independent contractor, the worker must perform work outside the usual course of the hiring entity's business, is most problematic. Contracted workers who provide services comparable to services provided by an employee are unlikely to be deemed to perform work outside of the hiring entity's business. It means that, for example, a house painting company may not be able to hire freelance painters. And surprisingly, Uber and Lyft may

not be able to engage drivers as independent contractors. Food delivery companies such as DoorDash may not be able to engage delivery persons as independent contractors.

This law has the effect of potentially obliterating "gig" economies. Gig occupations, also known as "side hustles," offer flexibilities not found in the traditional employer/employee relationship, such as the ability to choose one's own hours and not have to work in an office. As a result, many gig workers find these jobs ideal to earn extra money given their circumstances. These workers may work these jobs as second or third jobs or as a side job for parents with young children while the kids are at school. Uber, Lyft, and DoorDash are examples of these services. Many other types companies and work relationships also depend on the use of independent contractors in certain situations, such as media companies and freelance content providers. These employees value the independent nature of this work. They do not want to be tied to scheduled hours and other job requirements associated with classification as an employee. However, other workers and certainly legislatures around the country have taken the position that the conditions of these business relationships are oppressive and unfair. These legislative bodies have passed a bevy of laws designed to "protect" workers from being classified as independent contractors.

California's law may essentially end this gig economy and other businesses that use independent contractors within California's borders. Therefore, many affected companies might curtail operations in, or consider moving their business out of, California. Many have done so already.

Further, the flexibility that both workers and companies enjoyed in the past decades is being eroded in a manner that some believe is detrimental to the ability of business to operate profitably while also complying with the laws as they relate to traditional employees.

The Current State of Affairs

Some of these app-based companies are suing the State of California to overturn AB5. They offer several arguments including, generally, that they are merely in the business of licensing software and not providing driving, delivery, or other services. Hence, the "employer" is not truly an "employer" but more akin to a licensor, and the worker is more akin to a licensee. These app-based companies also argue that this legislation is unconstitutional in having the effect of punishing a specific industry and/or business model.

However, a federal judge recently denied an injunction to stay the application of AB5 to these companies while the companies fight this law in court. The federal judge noted that though the companies proved the irreparable harm entitling them to an injunction, setting a living wage and regulating employment were more important to the public interest. These companies are also pushing for a November 2020 state ballot measure that would exempt them from AB5.

Also, many workers are trying to find their way around AB5 by setting up and providing their services through limited liability companies and obtaining a business license. This might work for certain occupations, so long as they can meet the criteria for a business license, but not for others that do not require a business license.

Only time will tell the ultimate fate of AB5 in California and the future of worker classification legislation across the country.

For more information regarding the determination of whether a worker is an independent contractor or an employee in light of California's AB5, see the publication by the State of California Labor Commissioner's Office, Independent Contractor Versus Employee.

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