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The Implications of *Dynamex Operations West v. Superior Court*: California's adoption of the ABC test for purposes of the Wage Orders

By William Hays Weissman, Esq.

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I. EXECUTIVE SUMMARY

The California Supreme Court's adoption of a strict ABC test for purposes of the wage orders is likely to cause significant problems for California businesses that use independent contractors. Of particular concern is the "B" prong of the test and the contours of the putative employer's business. While at present the ABC test applies only to the wage orders, which means that only non-exempt employees are subject, businesses may find it difficult to implement the ABC test without implicating other aspects of the relationship, such as taxes or workers' compensation, such that conversion for all purposes may be necessary. Nonetheless, there are many unresolved issues, and it remains to be seen how adoption of the ABC test will play out in California.

II. *DYNAMEX OPERATIONS WEST, INC. V. SUPERIOR COURT*[1]

California courts and state agencies had long applied what is known as the *Borello* test for determining whether a worker is an independent contractor or employee for most purposes.[2] The *Borello* test is a multi-factor test that looks primarily at whether the hiring entity had a "right to control" how services were performed, along with other "secondary" factors, such as whether the worker was engaged in a distinct occupation or business, 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.

On April 30, 2018, the California Supreme Court abandoned the *Borello* test in favor of the ABC test 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* 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.[3]

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.[4] 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.[5] The court described this prong as addressing "workers whose roles are most clearly comparable to those of employees ..." It then provides the following examples:

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1 4 Cal.5th 903 (2018).
2 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.
3 *See* Mass. Gen. Laws c. 149, § 148B; Dynamex, Slip Op. at 68-69.
4 *Dynamex*, 4 Cal.5th at 958-962.
5 *Id.*

> 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.[6]

Cases from Massachusetts 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 Div. of Empl. & Training*[7], 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).[8]

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.[9]

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.

III. ANALYSIS

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

The "A" prong of the new test is similar to the *Borello* test in looking 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 *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 or *Borello* test applies, and any failure to satisfy it should strongly suggest an employment relationship.

B. The "B" prong is unclear and likely very hard to satisfy

How a business is defined is not always clear. The business is often defined from a "production function" perspective—that is, what it makes. The court provides a couple of overly simplistic examples that belie modern business reality. For example, the court explains that if a retail store hires an outside plumber to repair a leak in a bathroom and an 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 as the store would not reasonably be seen

6 *Dynamex*, 4 Cal.5th at 959-960 (internal citations omitted).
7 439 Mass. 171 (2003).
8 *Id.*, at 179.
9 *Id.*, at 962 (italics in the original) (internal citation omitted).

as having suffered or permitted the plumber or electrician to provide services to it as an employee." This statement raises so many questions.

For example, what is the "usual course of business" of a retail store? The court does not say, and it is never 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 of course 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 what a business does.

Further, the court says plumber and electrician would "not reasonably be seen" as being in the usual business, but does not say by whom? Seen by the retail store, by the workers at issue or by the government? The answer would seem to be by the worker, insofar as he or she complains about the relationship, and next by the government, which generally gets the first pass at deciding how to characterize the relationship when there is a dispute. That the business and worker have a dispute, however, just demonstrates that the "seen" aspect of this factor is an entirely subjective standard.

Let's tweak the facts a bit. 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.

The court goes on to distinguish the plumber and electrician from the situation where "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 court find that in these cases "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." The court concludes that the seamstresses' and bakers' "role within the hiring entity's usual business operations is more like that of an employee than that of an independent contractor."

Once again, the court's conclusions lack any real analysis. What does it mean to say the cake decorators "work on a regular basis?" What work are they performing, and what does regular mean? What if the seamsters make dresses for dozens of companies, and market themselves to such companies, consistent with the "C" prong? Do those facts matter?

What is telling from the court's superficial examples is not what it says, but everything the court choses to omit that could make the question difficult to answer. By failing to address any complex modern examples, the court lets itself off the hook of having to apply its take to the real world.

Another area of concern in the modern economy are service referral agencies that facilitate the matching of independent contractors with client opportunities, or that provide independent contractors who engage the agency access to client opportunities. The courts in other states have reached different conclusions on these kinds of businesses, and it is now unknown how that will play out in California.[10]

In *Curry v. Equilon Enterprises*, LLC,[11] 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 case involved whether an employee of a company that leased services stations from

10 *Compare State of Nevada Department of Employment v. Reliable Health Care Services of Southern Nevada, Inc.*, 983 P.2d. 414 (Nev. 1999) (determining an agency that refers respiratory technicians to clients to be in the business of brokering workers, and the technicians to be in the different business of providing client care), *with Home Care Professionals of Arkansas, Inc., v. Williams*, 2007 Ark. App. LEXIS 339 (Ark. App. 2006) (determining a registry that refers caregivers who provide home care to be in the business of providing home care).

11 22 Cal.App.5th 772 (2018).

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 *92–93.)
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> 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.[12] (*Id*. at *22-23.)

This published opinion suggests that it is possible to draw distinctions between two businesses, and thus could support arguments for referral agency or platform-type businesses. It seems likely the lack of any control by Shell over the worker's job duties (the "A" prong) was likely significant in how the court evaluated the "B" prong as well. While that might bode well for referral-type businesses, this is only one appellate court opinion. Given the growing importance of such a business model to the modern economy, this area is likely to garner significant litigation over the next few years.

C. 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 (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. The court's reference to plumbers, electricians, and attorneys does little to aid in this analysis.

In *Curry*, 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.)
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> 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.[13]

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.

12 *Curry*, at *22-*23.
13 *Id*., at *23-*24.

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.*,[14] 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.[15]

D. Multiple tests now apply, which may not be practical for many businesses

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 any employee with reference to one statute but not another." Thus, while not explicit, the court appeared to endorse the *Borello* standard for various aspects of the Labor Code, including for worker's compensation purposes, even as it adopted the broader ABC test for the wage orders.[16]

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 did not seem to care about these inconsistencies, businesses may have a hard time operating, which in turn could trigger other disputes rather than resolve them.

IV. RECOMMENDED PRACTICES

In light of the substantial uncertainty surrounding worker status, there are a number steps that service recipients can take to address the uncertainty caused by the *Dynamex* decision.

- **Analyze whether the worker would be exempt**. Because the *Dynamex* decision applies only to the wage orders, as a practical matter that means it applies only to workers who are non-exempt employees. Independent contractors who would qualify as exempt if they were employees would fall outside the wage order's protections. Thus, even if the workers are "employees" under the ABC test, the wage order would not apply and the workers could still potentially qualify as independent contractors for all other purposes under the *Borello* test.

- **Analyze whether it matters if they are subject to the wage orders**. Because the wage orders impact only a limited number of issues, chiefly minimum wage, meal and rest periods, overtime, reporting time pay, payments for required uniforms, and rules relating to meals and lodging, it may be of little consequence if a worker is an employee for wage order purposes. For example,

14 2018 U.S. Dist. LEXIS 65009 (D. Mass. Apr. 12, 2018).

15 *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).

16 *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).

assume a business uses independent contractors to perform services a couple of days per week for four-hour shifts. Assume they are being paid at least minimum wage. Converting these contractors to employees subject to the wage orders is likely to have little impact. Because of the length of the shifts, meal and rest periods and overtime are not issues. With careful planning, reporting time pay could be avoided as well. Thus, an analysis of the nature of the services and work in the context of liability under the wage order may reveal that reclassification would not result in significant risk.

- **Recognize that the wage orders address limited issues**. As noted in the bullet above, because the wage orders address only a limited number of issues, a *Borello* analysis remains for most other purposes, including workers' compensation and state taxes. However, businesses should expect that there will be attempts to expand the definition of an employee using the ABC test to cover other aspects of the Labor Code and state taxes. While the court's own opinion appears to reject such expansion, that will not stop attempts to do so.

- **Recognize there are unanswered questions about the application of the ABC test**. There remain a number of unanswered questions. One is whether the opinion applies prospectively or retroactively. The California Supreme Court has agreed to decide whether to address this issue. Knowing whether the opinion applies only on a forward-going basis would provide at least some certainty that employers will not be liable for following the *Borello* test in the past.

- **Transportation businesses may have a unique exemption under the FAAAA**. Businesses engaged in the transportation industry may have a unique exemption under the Federal Aviation Administration Authorization Act of 1994 (FAAAA).[17] In *Massachusetts Delivery Association v. Coakley*.[18] the First Circuit held that the FAAAA preempts the "B" prong of Massachusetts ABC test.[19] The Western States Trucking Association already plans to challenge the ABC test under the FAAAA. Further, the "Denham Amendment," which has already passed the U.S. House of Representatives, would amend the FAAAA to clearly exempt carriers from complying with state laws that require employers to provide paid meal and rest breaks to employees. It also would preempt state rules on misclassification of truck drivers. Even if the amendment does not get enacted and the Ninth Circuit were to rule against FAAAA preemption, that would set up a circuit split that could get resolved by the United States Supreme Court (although any such resolution is probably a few years away at the earliest).

- **Carefully review the business**. Following the example in Curry, businesses should take care to define their business and how it relates (or better, does not relate) to the services being performed for purposes of the "B" prong. Further, as pointed out in *Athol Daily News*, businesses should carefully review the kinds of public statements made in marketing material and websites that describe the business and refine them as appropriate.

- **Ensure the business can meet the "A" prong**. Businesses should take steps to ensure they can meet the "A" prong of the test. If a business exhibits control such that the "A" test fails, then it likely fails the *Borello* test as well, and the workers would likely need to be classified as employees for all purposes. Review contracts to ensure they do not contain any suggestion of control.

- **Ensure the "C" prong is met**. Lastly, make sure that the worker is a bona fide independent contractor, has all required licenses and other clients, and holds himself or herself out to an appropriate market as being in the business of providing such services. While small businesses

17 49 U.S.C. § 14501 et *seq.*

18 769 F.3d 11 (2014).

19 *See* also *Mass. Delivery Ass'n v. Healey,* 821 F.3d 187 (1st Cir. 2016) (holding that the FAAAA preempts the "B" prong of Massachusetts ABC test for same-day delivery companies because application of it would require judicial determination of whether particular services fit within its usual course of business); *Schwann v. FedEx Ground Package Sys.* 813 F.3d 429 (1st Cir. 2016) (holding that the "B" prong as applied was preempted by the FAAAA because it sufficiently related to defendant's service in that it would prevent independent contractors from performing first-and-last mile pickups and therefore have a significant impact on the actual routes followed for the pick-up and delivery of packages); *Rice v. Diversified Specialty Pharm.*, LLC 33 Mass. L. Rep. 469 (1st Cir. 2016) (holding that driver's claims were facially preempted by the FAAAA in the delivery context because classification as an employee would have a substantial effect on defendant's routes, rates, and services).

are great, do not be someone's first customer, and gather appropriate documentation before the start of any engagement (business license, business card, advertising, references). A business could also consider establishing contracting standards and not contracting with any business that does not meet them. These standards could include contracting only with legal entities (whether C or S corporations or limited liability companies). Using bona fide corporations may add a further argument that the workers fall entirely outside the ABC test because they are not performing services as individuals.

Taking some of the above steps while recognizing that the contours of the ABC test are far from settled should help businesses deal with this significant change in California law. Businesses that have concerns about how to implement changes should consult counsel.

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