

The Playbook:

Now That California Has Passed AB 5,
What Are the Options for Businesses
Using Independent Contractors?



The Law

On September 18, 2019, Governor Gavin Newsom signed Assembly Bill 5 (AB 5) into law. The law takes effect January 1, 2020, although some provisions may be applied retroactively.

AB 5 makes it harder to classify workers in California as independent contractors (ICs). Once it takes effect, it will instantly convert many thousands of independent contractors into employees for California-law purposes.

Here's how. AB 5 codifies the ABC Test adopted by the California Supreme Court in the *Dynamex* case and then extends it. In April 2018, the California Supreme Court ruled that a strict ABC Test would be used for determining whether someone is an independent contractor or an employee under California's Industrial Wage Orders, which cover minimum wage, overtime, meal and rest breaks, and a few other wage-related subjects. That's the *Dynamex* case.

Under AB 5, the *Dynamex* ABC Test will also be used to determine whether someone is an employee under all portions of the California Labor Code and the Unemployment Insurance Code. That means independent contractors in California will be presumed to be employees under these laws, unless the business benefiting from the worker's services can prove all three parts of the ABC Test:

- 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 involved in the work performed.

Unless all three requirements are satisfied, the workers will be considered employees of the hiring entity under California law, and all of the following state law requirements will apply:

- Minimum wage.
- Overtime, if not exempt, including daily overtime.
- Meal and rest breaks.
- Reimbursement of expenses.
- Paid sick leave.

- Paid family leave.
- Various notice, poster and wage statement requirements.
- Timekeeping record requirements.
- Unemployment coverage.
- Workers' compensation coverage.
- Paycheck timing requirements.
- On-call, call-back and standby pay requirements.
- Travel time payment requirements.
- Final paycheck requirements.
- Commission payment rules.

This is not intended to be a complete list of all California laws that apply to employees, but these are some of the most likely areas where businesses will find themselves to be in a state of noncompliance if their independent contractors are deemed to be employees under AB 5.

There are a number of exemptions to the bill. These are addressed separately at the bottom of the Playbook.

Assumptions for Use of the Playbook

For purposes of the Playbook, we assume that (i) AB 5 is applicable and no exemption applies, and (ii) Part B of the ABC Test is the obstacle to preserving independent contractor status. In other words, the Playbook assumes that the worker would be properly classified as an independent contractor under:

- Part A of the ABC Test;
- Part C of the ABC Test;
- The Right to Control Test (applicable to federal tax law and employee benefits law);
- The Economic Realities Test (applicable to federal wage and hour law); and
- The S.G. *Borello* balancing test (applicable to California labor laws other than the Industrial Wage Orders, before the advent of AB 5).

Part B is usually the most difficult requirement to meet.

For purposes of evaluating Part B, it does not make a difference whether the individual worker is a sole proprietorship or operates through an incorporated entity, such as a limited liability company. An individual worker's corporate status could be a factor in assessing compliance with Part A or Part C, but the corporate status of an individual worker is not a factor in assessing whether the work being performed is "outside the usual course of the hiring entity's business."

The Playbook is intended to provide a menu of options for situations in which the ABC Test described in AB 5 applies and Part B of the ABC Test is the only obstacle to maintaining independent contractor status.

The Playbook (or, What to Do About Part B)

Here are various options that can be considered by a business using independent contractors in California:

Option 1. The Complete Fold. Throw in all cards and concede defeat. Convert all 1099 workers to employees for all purposes, including under tax law and benefits law. Make them benefit-eligible, like all employees. Begin withholding. Onboard them as employees. If this strategy is adopted, the company can also begin exerting control over all aspects of how the work is done, since there is no longer a need to try to preserve contractor status. An added benefit of this strategy may be improved quality control. Another benefit is that the company can stop spending time and resources trying to preserve independent contractor status, especially in a political environment where the laws are likely to undergo further changes that will continue to make it more difficult to maintain a legitimate independent contractor relationship, even outside of California.

The obvious drawback is the cost. Employer-side employment taxes and benefits costs (depending on what the company would need to do) could add 30 percent or more to the company's labor costs for those workers. Adding new populations to a business's existing benefit plans can also create compliance headaches under ERISA and under federal tax laws that prohibit economic discrimination. These additions could also affect the pricing and enforceability of existing insurance plans and other contracts used to administer those plans.

Option 2. Partially Fold as to California Law Only and Make No Changes in Practices, Except as Needed to Comply with the California Labor Code and Unemployment Insurance Code. Treat workers as employees under California labor law only, but continue to treat workers as ICs for purposes of federal tax and benefits laws. Only change those practices needed to comply with California law. Changes that would be needed include:

- Track all hours worked.
- Pay overtime if not exempt, including daily overtime.
- Pay minimum wage.
- Provide meal and rest breaks.
- Provide sick leave and family leave.
- Reimburse all expenses.

- Comply with other pay requirements set forth in the Labor Code.
- Satisfy poster and notice requirements.
- Satisfy wage statement requirements.
- Satisfy timekeeping record requirements.

Treating workers as employees under California law but not under federal law could create new problems, however. Making the changes described in Options 2 and 3 could cause the relationship to more closely resemble employment under the Right to Control Tests used for federal tax and employee benefit law. Excluding these workers from benefits and not withholding could then have adverse consequences.

Option 3. Partially Fold as to California Law Only and Make Changes in Individual Worker Practices.

Assume California labor laws will now apply. Treat workers as employees under the California Labor Code and the Unemployment Insurance Code only. Continue to treat the workers as independent contractors for all other purposes, including under federal tax and benefits laws. Then, take action to minimize the effect and cost of compliance with California labor laws. Examples of such steps could include:

- Prohibiting workers from providing services for more than 40 hours a week.
- Prohibiting workers from providing services for more than eight hours a day.
- Prohibiting workers from incurring expenses over a certain threshold without prior approval.
- Requiring workers to track and report all hours worked.
- Imposing rules to limit travel time between projects, if the nature of the work involves driving between projects.
- Reducing pay or changing pay structure to account for the need to reimburse the worker for expenses.

Option 4. Partially Fold and Create a Subsidiary Employee Model. Create a subsidiary entity that will retain the contractors. The subsidiary would treat the contractors as its employees – either under all laws (as in Option 1) or under California law only (as in Options 2 and 3). The subsidiary can then follow Option 2 or 3. Using a separate entity won't make the tax and benefits concerns go away, but it could make compliance easier.

Option 5. Punt: Adopt Staffing Agency Model.

Concede that ICs must now be someone's employees under California law. Discontinue the practice of directly retaining 1099 ICs, and instead retain workers through a staffing agency that will be responsible for treating the workers as its employees under California law. Contract with the staffing agency to supply workers to perform the services formerly performed by the individually retained

independent contractors. Staffing agencies could be the biggest winners after the passage of AB 5, as many companies will rely on the fact that these agencies already have the infrastructure in place to deal with transient workers and to treat them as employees for all applicable state and federal law purposes.

Option 5 will eliminate the risk of independent contractor misclassification but will open the door to a finding of joint employment. The workers performing services through the staffing agency may be deemed joint employees of the companies benefiting from their services. Joint employment is not illegal, and if the staffing agency performs all the tasks it is supposed to perform as the workers' employer, then the existence of joint employment is not a problem.

Be sure to have a comprehensive contract in place with the staffing agency that (i) identifies the agency's specific obligations as the workers' employer (such as tracking hours worked, paying overtime, providing meal and rest breaks); (ii) includes indemnity by the staffing agency in the event it fails to comply with any of its legal or contractual obligations or in the event of a claim of misclassification or joint employment; (iii) requires adequate insurance coverage by the staffing agency so that it can pay out on any indemnity obligation; and (iv) deals with the benefits and benefit plan issues that are likely to arise since, in some cases, the workers could be treated as the recipient business's employees under employee benefit law, which could affect the benefit plans for both the benefited company and the staffing agency.

Option 6. Punt: Adopt a Large Contractor Model, Employees Only. Discontinue the practice of retaining individual 1099 ICs and instead contract only with sizable established companies (vendors) that perform the work desired. Contractually require the vendor to use only employees to perform the services, not IC subcontractors. This is important because under California Labor Code Section 2810.3 and common law, the contractor's workers may be considered joint employees of the company benefiting from the services. Be sure that the contract with the vendor requires it to perform all functions of an employer, and be sure to include the three main contract items listed in Option 5.

Note: If the vendor in Option 6 is permitted to retain 1099 IC subcontractors instead of using only W-2 employees, the company benefiting from the services may be worse off than if it did nothing and instead just continued to retain its own 1099 ICs directly. If the vendor retains 1099 IC subcontractors, the vendor will likely be misclassifying its 1099 ICs under AB 5

and, under Section 2810.3 and case law, the company benefiting from the services will likely be jointly liable along with the vendor for all of the vendor's labor law violations. The company will have all the exposure it had before, with less ability to control the facts. By adding this extra layer (the vendor) between the company benefiting from the services and the individual workers, it would also become more difficult to put in place an effective arbitration agreement with a class action waiver. For the Large Contractor Model to work after AB 5, the vendor needs to treat its individual workers as its employees, at least under California law.

Option 7. Fight, Version 1: Full-Scale Combat Through Class Action Litigation. Maintain the status quo and argue that the work is not within the usual course of the business. This is a high-risk strategy. Penalties for noncompliance can be substantial and may include criminal liability. Set aside significant monetary resources for attorneys' fees, win or lose. Expect to defend the IC status of the workers through class action litigation. In preparation for battle, bolster defenses and facts that would support this claim. Alter the company's website to show the limits of the company's usual course of the business. In other words, show that the ICs perform a service that the company does not offer. Create other documents, both internal and public-facing, that demonstrate the limits of the usual course of the company's business in a way that supports the contention that work performed by the ICs is outside that scope.

Option 8. Fight, Version 2: Hand-to-Hand Combat Through Arbitration. Maintain the status quo and argue that the work is not within the usual course of the business. Fight all misclassification disputes through individual arbitration cases. Acknowledge the risk of continued exposure to Private Attorneys General Act (PAGA) claims, which are not subject to arbitration. Also acknowledge the risk of mass arbitration claims that could be filed by a sophisticated plaintiffs' firm with ample resources. As noted in Option 7, this is a high-risk strategy, but perhaps less risky than Option 7 since the only avenue for class liability is through PAGA. This option requires three actions: **First**, ensure that all contractors have signed individual arbitration agreements with class action waivers. **Second**, ensure that anyone retained by a contractor to perform services (e.g., a contractor's employees and subcontractors) has also signed an arbitration agreement with a class action waiver that covers claims against the contractor and against the company for which the contractor is performing services. **Third**, in preparation for battle, bolster defenses and facts that would support this claim. See Option 7.

Option 9. Restructure and Fight. Make structural changes to the company to bolster the company's position that the work being performed by ICs is outside the usual scope of the business. While Options 7 and 8 involve making changes that are somewhat superficial and clarifying, Option 9 involves making actual structural changes in the company to ensure that the usual business of the company does not include the kind of work the ICs perform. The fight aspect of this option can be undertaken through class actions (as in Option 7) or arbitration agreements with class waivers (as in Option 8). As noted in Option 7, this is a high-risk strategy.

Option 10. Run. Businesses with operations in multiple states may decide that the costs of compliance are too high, as are the potential costs of noncompliance. For those businesses, the best option may be to discontinue operations in California that involve the use of independent contractors.

Exemptions to AB 5

AB 5 does not apply to the following situations.

Category 1: Specified Professions and Certain Types of Professional Services (new Sections 2750.3(b), (c)).

The bill exempts a specified list of occupations, and for these occupations, the *S.G. Borello* balancing test will continue to be used instead for determining whether a worker is an independent contractor or an employee.

The list of exempted professions includes California-licensed insurance brokers; certain types of California-licensed medical professionals, lawyers, architects, engineers, private investigators, and accountants; securities broker-dealers; direct salespeople; commercial fishermen (until 2023); and individuals working under some types of contracts for professional services.

The exemption for contracts for professional services applies only to specified professions and requires compliance with a set of requirements. The specified professions are marketing, human resources administration, travel agent, graphic designer, grant writer, fine artist, enrolled tax agent, payment processing agent, photographer, freelance writer and some cosmetology positions.

The additional requirements are that the individual (a) maintains a business location (which may be the individual's residence); (b) has a business license and any other required professional license (if work is to be performed after July 1, 2020); (c) has the ability to set or negotiate rates; (d) has the ability to set hours of work, outside of project completion dates and reasonable

business hours; (e) is customarily engaged in the same type of work for other entities or holds himself/herself out to potential customers as available to perform the same type of work; and (f) customarily and regularly exercises discretion and independent judgment in the performance of the services.

Category 2: Real Estate Agents and Repossession Agents (new Section 2750.3(d)).

The bill also exempts from the ABC test real estate agents and repossession agents, who are instead subject to the Business and Professions Code.

Category 3: Business-to-Business Contracts with an Entity That Does Not Require a License from the California Contractors State License Board to Perform the Work (new Section 2750.3(e)).

The bill likewise exempts from the "ABC" test a "bona fide business-to-business contracting relationship," as defined below, under the following conditions:

- 1) If a business entity formed as a sole proprietorship, partnership, limited liability company, limited liability partnership, or corporation ('business service provider') contracts to provide services to another such business ('contracting business'), the determination of employee or independent contractor status of the business services provider shall be governed by *Borello*, if the contracting business demonstrates that all of the following criteria are satisfied:
 - a) 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.
 - b) The business service provider is providing services directly to the contracting business rather than to customers of the contracting business.
 - c) The contract with the business service provider is in writing.
 - d) 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.
 - e) The business service provider maintains a business location that is separate from the business or work location of the contracting business.

- f) The business service provider is customarily engaged in an independently established business of the same nature as that involved in the work performed.
 - g) 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.
 - h) The business service provider advertises and holds itself out to the public as available to provide the same or similar services.
 - i) The business service provider provides its own tools, vehicles, and equipment to perform the services.
 - j) The business service provider can negotiate its own rates.
 - k) Consistent with the nature of the work, the business service provider can set its own hours and location of work.
 - l) The business service provider is not performing the type of work for which a license from the Contractors State License Board is required, pursuant to Chapter 9 (commencing with Section 7000) of Division 3 of the Business and Professions Code.
- 2) This subdivision does not apply to an individual worker, as opposed to a business entity, who performs labor or services for a contracting business.
 - 3) The determination of whether an individual working for a business service provider is an employee or independent contractor of the business service provider is governed by paragraph (1) of subdivision (a) [the ABC Test].
 - 4) This subdivision does not alter or supersede any existing rights under Section 2810.3 [the joint employment statute].

Category 4: Contracts with Individual Contractors in the Construction Industry Who Are Licensed by the Contractors State License Board (new Section 2750.3(f)).

Subdivision (a) and the holding in *Dynamex* do not apply to the relationship between a contractor and an individual performing work pursuant to a subcontract in the construction industry, and instead the determination of whether the individual is an employee of the contractor shall be governed by Section 2750.5 and by *Borello*, if the contractor demonstrates that all of the following criteria are satisfied:

- 1) The subcontract is in writing.
- 2) The subcontractor is licensed by the Contractors State License Board and the work is within the scope of that license.
- 3) If the subcontractor is domiciled 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.
- 4) The subcontractor maintains a business location that is separate from the business or work location of the contractor.
- 5) The subcontractor has the authority to hire and fire other persons to provide or to assist in providing the services.
- 6) The subcontractor assumes financial responsibility for errors or omissions in labor or services as evidenced by insurance, legally authorized indemnity obligations, performance bonds, or warranties relating to the labor or services being provided.
- 7) The subcontractor is customarily engaged in an independently established business of the same nature as that involved in the work performed.
- 8) (A) Paragraph (2) shall not apply to a subcontractor providing construction trucking services for which a contractor's license is not required by Chapter 9 (commencing with Section 7000) of Division 3 of the Business and Professions Code, provided that all of the following criteria are satisfied:
 - i) The subcontractor is a business entity formed as a sole proprietorship, partnership, limited liability company, limited liability partnership or corporation.
 - ii) For work performed after January 1, 2020, the subcontractor is registered with the Department of Industrial Relations as a public works contractor pursuant to Section 1725.5, regardless of whether the subcontract involves public work.
 - iii) The subcontractor utilizes its own employees to perform the construction trucking services, unless the subcontractor is a sole proprietor who operates their own truck to perform the entire subcontract and holds a valid motor carrier permit issued by the Department of Motor Vehicles.
 - iv) The subcontractor negotiates and contracts with, and is compensated directly by, the licensed contractor.

(B) For work performed after January 1, 2020, any business entity that provides construction trucking services to a licensed contractor utilizing more than one truck shall be deemed the employer for all drivers of those trucks.

(C) For purposes of this paragraph, “construction trucking services” mean hauling and trucking services provided in the construction industry pursuant to a contract with a licensed contractor utilizing vehicles that require a commercial driver’s license to operate or have a gross vehicle weight rating of 26,001 or more pounds.

(D) This paragraph shall apply only to work performed before January 1, 2022.

(E) Nothing in this paragraph prohibits an individual who owns their truck from working as an employee of a trucking company and utilizing that truck in the scope of that employment. An individual employee providing their own truck for use by an employer trucking company shall be reimbursed by the trucking company for the reasonable expense incurred for the use of the employee-owned truck.

Category 5: Relationship Between a Referral Agency and a Service Provider (The Angie’s List/HomeAdvisor Exemption) (new Section 2750.3(g)).

The definition of a “referral agency” is limited to the following:

A referral agency is a business that connects clients with service providers that provide graphic design, photography, tutoring, event planning, minor home repair, moving, home cleaning, errands, furniture assembly, animal services, dog walking, dog grooming, web design, picture hanging, pool cleaning or yard cleanup.

Category 6: Individuals Who Provide Services to Motor Clubs (new 2750.3(h)).

For More Information and Guidance

This Playbook is intended to be a starting point for helping businesses consider their options. The Playbook is not legal advice, and every company’s situation will be different. For further guidance and for customized legal advice, please contact any of the following attorneys, all of whom have spent a substantial amount of time advising clients on the potential ramifications of the ABC Test and on strategies for compliance:

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