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US

Volume 41 | Issue 41 | May 23, 2018

The Gig Is Up: California Supreme Court Rewrites Rules for Independent Contractors

On April 30, the California Supreme Court issued a decision with significant implications for California employers and the gig economy generally. The new, worker-friendly standard the court articulated presumes that all workers are employees for purposes of California wage orders unless the entity hiring them can establish otherwise. Employers should re-evaluate their worker classifications in light of this decision, especially where the business model relies on a contractor workforce. They should also consider any practical effects of the decision on their employee benefit plans.

Background

The California Industrial Welfare Commission has issued a series of wage orders that regulate wages, hours, and employee working conditions in certain industries and occupations. The state's Division of Labor Standards Enforcement (DLSE) enforces the provisions of these wage orders, including minimum wage, work hours, overtime, meal period, and rest break requirements.

Because independent contractors are not protected by California's wage and hour laws, or its antidiscrimination and retaliation laws, proper worker classification is critical. Although the DLSE may start with the presumption that the worker is an employee, the actual determination of employee or independent contractor status depends on a number of factors, none of which is controlling.

For nearly 30 years, California courts — and the DLSE — have applied the multi-factor or "economic realities" test set out in *S.G. Borello & Sons v. Department of Industrial Relations* in determining worker classification. In applying that test, the most significant factor is whether the person receiving services has control of, or the right to control, the worker with respect both to the work and to the manner and means in which it is done. The DLSE has identified 21 other factors to consider in determining a worker's status. Among them are the worker's skills, duration of services, whether the work is part of the hiring entity's regular business, and whether the parties intend to create an employer-employee relationship.

Comment. Other California state agencies are also involved with the determination of independent contractor status for tax and other purposes, including the Employment Development Department, Franchise Tax Board, and Contractors State Licensing Board. Since different laws are involved, the same individual may be considered an employee for purposes of one law and an independent contractor under another.

Dynamex Operations West, Inc. v. Superior Court of Los Angeles

Dynamex is a national package and document delivery service. A former driver sued the company, alleging that it misclassified him and all other delivery drivers who currently or formerly performed services at Dynamex as independent contractors in violation of California Industrial Welfare Commission Wage Order No. 9, which governs the transportation industry. The driver sought to certify the lawsuit as a wage and hour class action.

In considering class certification, the trial court addressed whether the drivers were employees. To find that commonality existed among the drivers, the court looked to the California Supreme Court's decision in *Martinez v. Combs*. Albeit in the joint employment context, the *Martinez* court held that the wage orders embodied three alternative definitions of what it means to "employ" someone:

- To exercise control over the wages, hours, or working conditions
- To suffer or permit to work
- To engage, thereby creating a common-law employment relationship

Relying on *Martinez*, the trial court broadly defined "employ" to mean "to engage, suffer or permit to work" in the wage order context, and certified a class of Dynamex drivers. The Court of Appeal upheld the class certification with respect to the wage order claims, which Dynamex challenged.

As Easy As ABC

On appeal, the California Supreme Court adopted a more structured standard for determining who is protected by California's wage orders — the ABC test. Under this three-pronged test, a worker is classified as an independent contractor rather than an employee only if the hiring entity can show the worker:

- Is free from the control and direction of the company in connection with the performance of the work, both under the contract and in fact
- Performs work that is outside the usual course of the company's business, and
- Is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed for the company

Under the ABC test, a worker is presumed to be an employee, with the burden on the hiring entity to prove each of the three factors listed above to overcome the presumption and establish independent contractor status.

Other States Use ABC Test

Other states use ABC independent contractor tests, often in the unemployment or workers' compensation contexts. For example, Connecticut Illinois, and New Jersey use the test for unemployment purposes, while New Hampshire uses it for workers' compensation purposes. Massachusetts applies a stricter version of the ABC test not only to unemployment and workers' compensation laws, but also for state wage and hour purposes.

Comment. The California Supreme Court decided only "what standard applies, under California law, in determining whether workers should be classified as employees or independent contractors *for purposes of California wage orders*." Whether California courts will also apply the ABC test to other wage and hour laws or in other contexts remains to be seen. However, as a practical matter, it is likely that employers will use the same definition of employee for most, if not all, purposes.

Impact on Benefit Plans?

Dynamex applies for purposes of California wage orders only; it does not mandate changes to employee benefit plans. Employers with a California workforce affected by this decision, however, should consider — and confer with trusted advisors about — some possible benefit plan implications. For administrative convenience, once an employer must treat an individual as an employee for purposes of California wage orders, it might deem that individual an employee in all areas — including for benefit plan purposes. Employee relations concerns also may motivate an employer to treat all individuals working in a particular role or job (e.g., drivers) as employees, whether they work in California or other states.

Worker reclassification can affect plan eligibility. Many retirement plans address the issue of retroactive plan eligibility for reclassified workers, providing that an independent contractor who is reclassified as an employee by a government agency or court does not become eligible to participate in the plan because of such reclassification. These provisions are called "Microsoft language," after a 1997 case in which an appeals court determined that a group of long-term "temporary" workers hired as independent contractors were actually retirement plan-eligible employees. Plan provisions can be drafted to exclude participation on a retroactive basis only, or on both a retroactive and prospective basis. However, the plan must meet applicable coverage and nondiscrimination tests. (For more on contingent workers and possible consequences for retirement plans, please see our March 27, 2018 *For Your Information*.)

Classification changes can also impact health and welfare plans. The Affordable Care Act (ACA) defines "applicable large employer" (ALE) for purposes of the employer shared responsibility requirements as an employer with at least 50 full-time "employees." ALEs must offer minimum essential coverage to substantially all full-time employees and their dependents, or pay a nondeductible assessment if at least one full-time employee enrolls in marketplace coverage and receives a premium tax credit. Even if they offer employees coverage, ALEs may still be subject to an employer shared responsibility payment if the coverage they offer to full-time employees is "unaffordable" or fails to provide minimum value. Reclassification can affect whether an employer will satisfy these standards as well as the extent of an ALE's liability for failing to satisfy them. (For more on the employer shared responsibility requirements, please see our March 21, 2018 *For Your Information*.) Additionally, classification changes affect health and welfare plan nondiscrimination testing and could negatively impact results. (See our November 8, 2017 *For Your Information* for an overview of health and welfare plan nondiscrimination testing rules.)

In Closing

The California Supreme Court's adoption of the so-called ABC test for determining whether workers are employees or independent contractors is expected to make it more difficult for businesses to classify workers as independent contractors for purposes of the wage orders. Employers should re-evaluate their worker classifications in light of *Dynamex*, especially where the business model relies on a contractor workforce. They should also consider any practical implications of this decision on their benefit plans.

Authors
Nancy Vary, JD
Julia Zuckerman, JD

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