

# A Roadmap for AB 5: California's New Law on Worker Classification

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**W**hen Governor Gavin Newsom signed Assembly Bill 5 (AB 5) on September 18, 2019, it significantly altered the way California law distinguishes between employees and independent contractors.

Not only did AB 5 codify the California Supreme Court's decision in *Dynamex Operations West, Inc. v. Superior Court of Los Angeles*, 4 Cal. 5th 903 (2018) (*Dynamex*) — it also expanded it.

Stated simply, AB 5 makes the independent contractor classification test established in *Dynamex* the general rule in most circumstances, though it does create several exceptions. For those exempted, the common law classification test will apply.

Given this significant change to the independent contractor landscape in California, it's important for employers to understand both standards, when to apply each standard and when the law goes into effect. Here's your roadmap to worker classification compliance in California.

## Assembly Bill 5 codified the California Supreme Court's *Dynamex* decision — and expanded it.

### “ABC Test” vs. Common Law “Borello Test”

In *Dynamex*, the Court adopted a new test, commonly referred to as the “**ABC test**,” for determining whether a worker is an employee or independent contractor for purposes of applying California's wage orders. Under the ABC test, a worker is classified as an employee unless the employer can establish all three of the following:

- A.** That the worker is free from the hiring entity's control and direction in connection with performance of the work, both under the contract for the performance of the work and in actually performing the work;
- B.** That the worker performs work that is outside the usual course of the hiring entity's business; and
- C.** That the worker is customarily engaged in an independently established trade, occupation or business of the same nature as the work performed.

The ABC test is more rigid and inclusive than the older common law classification test, commonly referred to as the “**Borello test**” (*S. G. Borello & Sons, Inc. v. Department of Industrial Relations*, 48 Cal.3d 341 (1989) (*Borello*)). Under the Borello test, the most important factor in determining proper

worker classification is whether the business has the right to direct and control the manner and means of performing the work (sometimes referred to as the “right to control” test). In addition to the right to control, several factors must be considered, including:

- Ability to discharge at will, without cause;
- Whether the one performing services is engaged in a distinct occupation or business;
- The kind of work, and whether it’s usually done under close direction or supervision or by a specialist without supervision;
- Skill required in the particular occupation;
- Whether the principal or the worker supplies the instrumentalities, tools and the place of work for the person doing the work;
- Length of time for which the services are to be performed;
- Method of payment, whether by the time or by the job;
- Whether the work is a part of the principal’s regular business; and
- Whether the parties believe they’re creating the relationship of employer-employee.

These two tests overlap, but the significant difference is that the Borello test doesn’t require a business to satisfy all factors. Rather, courts consider and weigh the factors in each case, making it more flexible and less demanding than the rigid ABC test.

## The ABC test and the Borello test overlap, but the ABC test is more rigid.

### AB 5 Expands ABC Test

After the *Dynamex* decision, the ABC test was applicable only to the Industrial Welfare Commission (IWC) Wage Orders. [AB 5](#), however, enacts **Labor Code section 2750.3**, which codifies and expands the ABC test, applying it to both the Labor and Unemployment Insurance Codes in addition to the IWC Wage Orders. In short, this means the general rule in most circumstances is applying the ABC test to determine whether a worker is an employee or independent contractor — though the new law contains numerous exceptions. If an exception applies, then employers should use the Borello test in most cases. (See page 3 for ABC test exceptions.)

AB 5 doesn’t change the meaning of the terms “employee,” “employer,” “employ,” or “independent contractor” and “any extension of employer status liability” as they are used and defined in the Labor and Unemployment Codes and the IWC Wage Orders. AB 5 specifically identifies one example: the definition of an “employee” in Wage Order 2 includes beauty salon workers/stylists who rent or lease chairs or space. Remember, businesses must continue to be aware of any nuances in these definitions as stated in the wage orders or statutes governing their specific industries.

AB 5 also provides that if a court determines the ABC test “cannot be applied in a particular context,” the Borello test will govern whether a worker is an employee or independent contractor. Employers will have to wait and see how the courts utilize this provision.

Another provision allows a city attorney for a city with a population of 750,000 or more (San Francisco, San Jose, Los Angeles, San Diego) to bring an action for injunctive relief against businesses suspected of misclassifying workers as independent contractors.

## AB 5 Exceptions

The media covered AB 5's developments extensively, referring often to the numerous exceptions for various industries. The frequent informal discussion of who is and isn't "exempt" from the law might mislead employers into thinking that if an exception applies to them, they may classify their workers in any way they choose. But that is not the case, because even if an exception applies, businesses still need to satisfy the Borello test, a demanding standard in and of itself.

The ABC test exceptions contained in Labor Code section 2750.3 subdivisions (b) through (h), as detailed below, vary. Some are straightforward while others are vague, complex and confusing. Many are extremely specific and narrow, as they're qualified by multiple criteria and statutory references. This is included in many of the descriptions below to illustrate the bill's complexity and emphasize that, regardless of whether an exception seems clearly applicable or not, businesses using contractors should consult with legal counsel regarding their circumstances in light of the new law.

## The ABC test exceptions vary; some are straightforward while others are vague, complex and confusing.

The following details AB 5's ABC test exceptions while indicating areas that are unclear or raise additional questions for employers.

### Specific Occupations

Section 2750.3(b) provides that the ABC test doesn't apply to the following occupations, which are subject to the Borello test:

- **A person or organization licensed by the Department of Insurance** under Chapters 5 (commencing with Section 1621), Chapter 6 (commencing with Section 1760) and Chapter 8 (commencing with Section 1831) of Part 2 of Division 1 of the Insurance Code (e.g., certain insurance agents, brokers, analysts, etc.).
- **Physician, surgeon, dentist, podiatrist, psychologist or veterinarian** licensed by the state of California under Division 2 of the Business and Professions Code (commencing with Section 500), performing professional medical services to or by a health care entity, including an entity organized as a sole proprietorship, partnership or professional corporation. Nothing in the subdivision applies to employment settings "currently or potentially governed by collective bargaining agreements" for the licensees identified (it's unclear at this time what it means to be "potentially" governed by a collective bargaining agreement).
- A practicing **lawyer, architect, engineer, private investigator or accountant** who holds an active license from the state of California.
- A **securities broker-dealer or investment adviser** registered with the Securities and Exchange Commission or the Financial Industry Regulatory Authority or licensed by the state of California under Chapter 2 (commencing with Section 25210) or Chapter 3 (commencing with Section 25230) of Division 1 of Part 3 of Title 4 of the Corporations Code.

- A **direct salesperson** as described in Section 650 of the Unemployment Insurance Code, so long as that section's conditions are met.
- A **commercial fisherman** working on an American vessel (details of this exemption were omitted).
- A **newspaper distributor** working under contract with a newspaper publisher, and a **newspaper carrier** working under contract with either a newspaper publisher or newspaper distributor (this exception was added by AB 170).

For the most part, the above exceptions are clear. But because some exceptions are narrow and/or qualified by reference to specific statutes, employers should consult with legal counsel to determine whether the exception applies to their specific circumstances and, if so, whether the circumstances meet the Borello standard.

## Certain “professional services” contracts that meet specific criteria are exempt from the ABC test and are instead controlled by the Borello test.

### Professional Services Contracts

Section 2750.3(c) provides that if specific criteria are met, certain “professional services” contracts are exempt from the ABC test and will be controlled by the Borello test. To fall under this exception, the hiring entity must establish that the individual (contractor):

- Maintains a business location, which may include the individual's residence, that's separate from the hiring entity (but the individual may perform services at the hiring entity's location);
- Has a business license and any required professional licenses or permits to practice in the profession if work is performed more than six months after this section's effective date;
- May set or negotiate their own rates for the services performed;
- May set their own hours outside of project completion dates and reasonable business hours;
- Customarily performs the same type of work under contract with another hiring entity or holds themselves out to other potential customers as available to perform the same type of work;
- Customarily and regularly exercises discretion and independent judgment in performing the services.

An “individual” under this provision may provide services through sole proprietorship or other business entity. Even if all the above criteria are met, only certain “professional services” qualify for the exception, including:

- **Marketing**, provided that the contracted work is original and creative in character and the result of which depends primarily on the invention, imagination, or talent of the employee or work that is an essential part of or necessarily incident to any of the contracted work.
- **Administrator of human resources**, provided that the contracted work is predominantly intellectual and varied in character and is of such character that the output produced or the result accomplished cannot be standardized in relation to a given period of time.

- **Travel agent services** provided by either of the following:
  - » A person regulated by the Attorney General under Article 2.6 (commencing with Section 17550) of Chapter 1 of Part 3 of Division 7 of the Business and Professions Code; or
  - » An individual who sells travel within the meaning of subdivision (a) of Section 17550.1 of the Business and Professions Code and who is exempt from the registration under subdivision (g) of Section 17550.20 of the Business and Professions Code.
- **Graphic design.**
- **Grant writer.**
- **Fine artist.**

## While some “professional services” are clear, others are vague and potentially problematic.

- An **enrolled agent licensed by the U.S. Treasury Department to practice before the Internal Revenue Service** pursuant to Part 10 of Subtitle A of Title 31 of the Code of Federal Regulations.
- **Payment processing agent** through an independent sales organization.
- A **still photographer or photojournalist** who doesn’t license content submissions to the hiring entity more than 35 times per year. This clause is not applicable to an individual who works on motion pictures (includes theatre, television, streaming, other shows, etc.). Details on what constitutes a “submission” have been omitted.
- A **freelance writer, editor or newspaper cartoonist** who doesn’t provide content submissions to the hiring entity more than 35 times per year. Details on what constitutes a “submission” have been omitted.
- **Licensed estheticians, electrologists, manicurists, barbers or cosmetologists** provided that the individuals:
  - » Set their own rates, process their own payments and are paid directly by clients.
  - » Set their own hours of work and have sole discretion to decide the number of clients and which clients for whom they will provide services.
  - » Have their own book of business and schedule their own appointments.
  - » Maintain their own business license for services offered.
  - » If the individual is performing services at the hiring entity’s location, then the individual issues a *Form 1099* to the salon or business owner from which they rent their business space.
  - » This exception will stop applying to licensed manicurists on January 1, 2022.

Some of the above are clear, as they’re qualified by specific statutory references; however, some of the “professional services” are vague and potentially problematic. For example, “graphic design,” “grant writer” and “fine artist” don’t have any qualifying or guiding language *at all*. Although many people likely have an idea of what these services are, how a court will analyze and interpret them under the new law remains an open question.

It’s also unclear exactly what an “administrator of human resources” is. But the new law borrows language from the professional exemption in California’s wage orders in requiring the work be “predominantly

intellectual and varied in character,” which suggests this exception applies to HR professionals performing high level HR work requiring judgment and discretion rather than non-discretionary tasks such as processing payroll, for example. The language’s intent, however, remains unclear at this point.

Similarly, for “marketing,” the law also borrows language directly from the professional exemption for artistic professions. This suggests the individual performing the “original and creative” marketing services has a high level of discretion and independent judgment, though it is unclear what exactly qualifies as marketing services under this law.

In light of the new law, employers considering the use of contractors for any of these professional services should consult with legal counsel before doing so.

## Per the new law, the ABC test doesn’t apply to a “bona fide business-to-business contracting relationship.”

### Real Estate Agents and Repossession Agencies

Section 2750.3(d) makes exceptions to the ABC test for two occupations governed by the Business and Professions Code.

The first exception is for a “**real estate licensee** licensed by the state of California pursuant to Division 4 (commencing with section 10000) of the Business and Professions Code.” The real estate licensee’s classification is determined by Business and Professions Code section 10032 or, if that’s not applicable, under various statutes or the Borello test, depending on the context.

The second is for a **repossession agency** licensed pursuant to Business and Professions Code section 7500.2, which determines worker classification if the agency is free from the hiring person’s or entity’s control and direction in connection with the performance of the work, both under the contract for the performance of the work and in actually performing the work.

### Business-to-Business Contracting Relationships

Section 2750.3(e) states that the ABC test doesn’t apply to a “bona fide business-to-business contracting relationship.” If a business entity — formed as a sole proprietorship, partnership, LLC, LLP, or corporation (business service provider) — contracts to provide services to another business (contracting business), the Borello test determines employee or independent contractor status if the contracting business can satisfy several criteria.

This exception doesn’t apply to an individual who works for a contracting business, and the ABC test governs whether an individual working for a business service provider is an employee.

To qualify under this exception, the contracting business must show all of the following regarding its relationship with the business service provider. The business service provider must:

- Be 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 actually performing the work.
- Provide services directly to the contracting business rather than to customers of the contracting business.

- Have a contract in writing.
- Have the required business license or business tax registration if the work is performed in a jurisdiction that requires such licensing and registration.
- Maintain a business location that's separate from the contracting business' work location.
- Customarily be engaged in an independently established business of the same nature as that involved in the work performed.
- Actually contract with other businesses to provide the same or similar services and maintain a clientele without restrictions from the hiring entity.
- Advertise and hold itself out to the public as available to provide the same or similar services.
- Provide its own tools, vehicles and equipment to perform the services.
- Be able to negotiate its own rates.
- Be able to set its own hours and location of work consistent with the nature of the work.
- Not be performing the type of work for which a license from the Contractor's State License Board is required, pursuant to Chapter 9 (commencing with Section 7000) of Division 3 of the Business and Professions Code.

## **AB 5 is “not intended to replace, alter, or change joint-employer liability between two businesses.”**

— Assemblywoman Lorena Gonzalez, bill author

Businesses must comply with *all* of the aforementioned factors to use this exception — which only means that the Borello test applies instead of the ABC test. Businesses must be mindful of the details in using this exception. For example, the lack of a contract *in writing* or a required business license may be the difference between applying Borello or the ABC test.

One of the most important factors above is the requirement that the service provider only provide services *directly to the contracting entity*, not to its customers. This presents a problem for a number of work/service arrangements. Staffing/temp agencies in particular will need to consult with counsel about how the new law will affect their circumstances.

Some big concerns/questions that emerged in connection with the business-to-business provision as a whole is its potential effect on existing joint-employer status law, whether one independent business' employees/workers could be considered employees of the other independent business if it fails to satisfy the above criteria, or even whether a business might be considered an “employee” of another business under the law as it's currently drafted.

The author of the bill, Assemblywoman Lorena Gonzalez (D-San Diego), stated in a letter to the California Assembly's *Daily Journal* that the business-to-business provision isn't intended to suggest that business service providers are necessarily employees if the above criteria are not satisfied. She further stated that AB 5 is “not intended to replace, alter, or change joint-employer liability between two businesses. AB 5 is focused upon the determination whether an individual is an employee or an independent contractor.”

Even if AB 5 is primarily intended to focus on the classification of individuals, it remains to be seen how courts will interpret this provision. Businesses should consult with legal counsel regarding their business-to-business contracts under the new law.

## Contractor and Subcontractor Relationship

Section 2750.3(f) creates an exception for the “relationship between a contractor and an individual performing work pursuant to a subcontract in the construction industry.” Both the Borello test and Labor Code section 2750.5, which is specific to contractors and very similar to the Borello test, will determine whether an individual is a contractor’s employee. To qualify for this exception, the contractor must show:

- The subcontract is in writing.
- The subcontractor is licensed by the Contractors State License Board and the work is within the scope of that license.
- 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.
- The subcontractor maintains a business location that’s separate from the contractor’s business or work location.
- The subcontractor has the authority to hire and to fire other persons to provide or to assist in providing the services.
- 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.
- The subcontractor is customarily engaged in an independently established business of the same nature as that involved in the work performed.

## In light of the new law, businesses using contractors should consult with legal counsel.

Additionally, a subcontractor providing **construction trucking services** need not be licensed by the Contractor’s State License Board, provided the following are met:

- The subcontractor is a business entity formed as a sole proprietorship, partnership, limited liability company, limited liability partnership or corporation.
- 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.
- 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.
- The subcontractor negotiates and contracts with, and is compensated directly by, the licensed contractor.



## Referral Agencies

Section 2750.3(g) excludes “referral agencies” from the ABC test on certain conditions. A “service provider” under this exception must be a business entity, not an individual, but the entity can be a sole proprietorship. If a business entity (service provider) provides services to clients through a referral agency, the Borello standard applies if the referral agency can show the following:

- The service provider is free from the control and direction of the referral agency in connection with the performance of the work for the client, both as a matter of contract and in actually performing the work.
- If work for the client is performed in a jurisdiction that requires the service provider to have a business license or business tax registration, the service provider has the required business license or business tax registration.
- If work for the client requires the service provider to hold a state contractor’s license pursuant to Chapter 9 (commencing with Section 7000) of Division 3 of the Business and Professions Code, the service provider has that license.
- The service provider delivers services to the client under service provider’s name, rather than under the name of the referral agency.
- The service provider provides its own tools and supplies to perform the services.

**As with other provisions in this new law, the list of service providers under the “referral agencies” exemption is vague and problematic.**

- The service provider is customarily engaged in an independently established business of the same nature as that involved in the work performed for the client.
- The service provider maintains a clientele without any restrictions from the referral agency and the service provider is free to seek work elsewhere, including through a competing agency.
- The service provider sets its own hours and terms of work and is free to accept or reject clients and contracts.
- The service provider sets its own rates for services performed, without deduction by the referral agency.
- The service provider isn’t penalized in any form for rejecting clients or contracts. This subparagraph doesn’t apply if the service provider accepts a client or contract and then fails to fulfill any of its contractual obligations.

Additionally, not all referral agencies can take advantage of the exception. The bill specifically defines “referral agency” as “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.**”

As with other provisions in this new law, this list of service providers is vague and problematic. For some service providers listed, the law provides specific qualifications; a “tutor,” for example, means a person who develops and teaches their own curriculum, not one developed by a public school, or who contracts with a public school. Likewise, the law contains a specific definition for “animal services.”

But the law provides no definitions or qualifications for the other terms used in this provision, which is problematic because some are quite vague. For example, it's entirely unclear what "minor home repair" means (as opposed to "major" home repair?), or what could possibly be encompassed by the generic term "errands." As such, referral agencies should consult with legal counsel to analyze their circumstances under the new law.

## Motor Clubs

Lastly, per section 2750.3, the ABC test will not apply to "the relationship between a motor club holding a certificate of authority issued pursuant to Chapter 2 (commencing with Section 12160) of Part 5 of Division 2 of the Insurance Code and an individual performing services pursuant to a contract between the motor club and a third party to provide motor club services utilizing the employees and vehicles of the third party."

Instead, the Borello test will apply if the motor club shows that the third party is a "separate and independent business" from the motor club.

Remember: Even if an exception to the ABC test applies, employers should use caution in classifying workers as independent contractors — consult with legal counsel before doing so to assess any risk of misclassification.

**While the bulk of AB 5 goes into effect on January 1, 2020, the Supreme Court's *Dynamex* decision has been in effect since 2018.**

## AB 5's Effective Date

**The new law goes into effect on January 1, 2020.** However, the bill provides for differing retroactive and prospective application in certain areas.

First, the bill states that it does not change, "but is declaratory of, existing law" with regard to the IWC Wage Orders and "violations of the Labor Code *relating* to wage orders." In other words, AB 5 does not change existing law related to the wage orders, most notably the *Dynamex* decision, which has been the law *since 2018*. It's unclear which Labor Code sections are "related" to the wage orders. However, in a May 2019 opinion letter, the Division of Labor Standards Enforcement explained that it would be appropriate to apply the ABC test to any claim, including Labor Code violations, that rest on an employer's obligations under a wage order, including minimum wage, overtime, reporting time pay, recordkeeping violations, meal and rest periods, and others.

The new law doesn't expressly state that the ABC test applies retroactively; however, it specifically states that the *exceptions* described above apply *retroactively* "to the maximum extent permitted by law."

The law applies prospectively, from **January 1, 2020**, forward, with respect to claims for violations of the Labor and Unemployment Insurance Codes.

Lastly, the ABC test will apply for purposes of workers' compensation on or after **July 1, 2020**.

Employers should remember that, while the bulk of AB 5 goes into effect on January 1, 2020, the Supreme Court's *Dynamex* decision has been in effect since 2018 and remains current law. So for purposes of applying the IWC Wage Orders, the *Dynamex* decision applies.

## Final Thoughts for Employers

AB 5 is complex. While the new ABC test will likely sweep more individuals into the “employee” classification, knowing *when* and *to whom* it applies is not always clear given the numerous exceptions that are vague, unclear or downright confusing.

While definitive answers on some issues raised here very likely will be specific to employer and industry circumstances, other questions may not be answered until further amendments to the law are passed or court decisions/interpretations are published.

Employers should continue using caution in classifying workers as independent contractors — they should consult with legal counsel about the new law and how it impacts their specific work/service arrangements and circumstances, including which classification standard applies to a given arrangement/contract, whether any of the numerous exceptions in AB 5 apply, and if there’s any risk of misclassification under the applicable standard.

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