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What Companies Should Know in the Wake of California's New Worker Classification Ruling

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California's highest court recently pronounced a new worker classification standard in *Dynamex v. Lee*, a case involving wage and hour requirements under the California Labor Code. Compared with the old rule, the new standard is simpler, arguably more predictable—and will make it more difficult for businesses to classify workers as independent contractors. *Dynamex* will have immediate consequences for businesses operating in California. Indeed, within days of the ruling, workers sued two prominent "gig economy" companies alleging unlawful worker classifications. For companies in every state, the decision is a reminder that the potential risks of worker misclassification could arise under myriad state and federal laws.

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Background on Worker Classification

Various federal and state laws guarantee certain protections and benefits to employees, and impose corresponding obligations on their employers. Often, such protections, benefits, and obligations do not apply in the case of workers who are properly classified as independent contractors. If a business classifies a worker as an independent contractor and that classification is challenged, the legal test used to determine the worker's status will depend on the particular law at issue. The Internal Revenue Service ("IRS"), Department of Labor ("DOL"), and many states employ some form of balancing test that considers all relevant circumstances and weighs multiple (non-exhaustive) factors. Although the applicable factors vary among these tests, common themes include the degree of the company's control over the worker's performance of services, the worker's economic dependence on the company, and the connection between the worker's services and the company's business. The complexity and generality of these tests can make it hard to predict how a court or agency might decide a given case.

Improperly treating a worker as an independent contractor is referred to as "employee misclassification." The potential consequences of employee misclassification could include substantial fines or penalties and liability for past wages, overtime, benefits, employment tax or unemployment insurance tax. Companies also could be liable to federal or state tax authorities for income and Social Security taxes that would have been withheld from the worker's paychecks had the worker been properly classified.

Before *Dynamex*, California courts applied the multi-factor *Borello* standard to determine worker classification for most purposes. *Borello* is a flexible, general test focused primarily on the company's control over workers.

What did *Dynamex* do?

Dynamex, a nationwide courier service, reclassified its delivery drivers from employees to independent contractors in 2004. Drivers in California brought suit in 2005, alleging they were statutory employees for purposes of California wage orders, which are "constitutionally-authorized, quasi-legislative regulations that have the force of law." (*Dynamex*) The relevant wage order defines employment to include any circumstance in which a purported employer "suffers or permits the worker to work." After a decade of interim decisions and appeals, the trial court certified a class of workers, and Dynamex appealed.

On April 30, 2018, the court adopted the so-called ABC test for purposes of most California Labor Code protections, including wage and hour provisions. Under the ABC test, a worker is properly considered an

independent contractor only if the company proves all three of the following factors:

- **The worker is free from the hirer's control and direction in connection with the performance of the work, under the contract and in fact.**

The court observed that independent contractors generally operate autonomously, whereas employees' activities are supervised. For example, a company is less likely to satisfy this factor if it provides detailed instructions to a worker, supervises the worker's schedule or the development of work product, or provides training in areas that represent the worker's core functions or expertise.

- **The worker performs work that is outside the usual course of the hiring entity's business.**

Independent contractors generally have highly specialized skills that fall outside the hiring entity's core business, whereas employees provide services that are "within the usual course of the hiring entity's business." (*Dynamex*) The court illustrated this factor with two contrasting examples. When a retail store hires a plumber or an electrician to make repairs, the plumber and electrician are not performing services integral to the store's core business and thus are less likely to be viewed as employees. On the other hand, when a clothing manufacturer hires a seamstress or a bakery hires a cake decorator, such workers are closely connected to the hiring entity's usual business operation and thus more likely to be viewed as employees.

- **The worker is customarily engaged in an independently established trade, occupation, or business of the same nature as the work being performed.**

Under the court's new test, an independent contractor generally is understood to mean someone who has independently decided to go into business for herself. This is often evident through the workers' own business incorporation, licensure or advertisements, although these facts are not necessarily required for a company to establish this factor. Importantly, the court emphasized that this factor cannot be satisfied solely by the company's *allowing* the worker to provide services to other customers; the worker must actually be engaged in an independent established trade.

Within days of the decision, workers classified as independent contractors filed purported class actions against Lyft, Inc. and Postmates Inc., alleging the companies had willfully misclassified them. The complaints seek back pay, reimbursement of business expenses, pre- and post-judgment interest, attorneys' fees, and injunctive relief. Other businesses will likely face similar claims in the near future. It is not yet clear whether the courts in California will extend the *Dynamex*standard to California Labor Code protections that are not addressed in wage orders, such as rules governing workers' compensation and reimbursement of business expenses. The court signaled, however, that it views the old test as insufficient to adequately protect workers. In explaining its decision, the court stressed its view that the new test would provide "greater clarity and consistency" and "less opportunity for manipulation" compared with the multifactor balancing tests.

An Important Reminder for All Companies

California is the country's most populous state, and most large national businesses have a presence there. *Dynamex* will likely cast a long shadow. Furthermore, all companies should bear in mind that worker classification has important consequences in any jurisdiction.

Under the Obama Administration, DOL prioritized enforcement of employee misclassification, announcing agreements with numerous states to share resources and enhance enforcement activity and issuing informal guidance in 2015 (Administrative Interpretation No. 2015-1) that reflected a strict interpretation of its worker classification rules. In 2017, soon after the current Secretary of Labor was confirmed, DOL announced the withdrawal of the 2015 guidance (although the announcement made clear that the underlying law would not change). This withdrawal led some to speculate that DOL would no longer treat this issue as an enforcement priority. Yet the agency's enforcement activity continues. The same day *Dynamex* was issued, DOL announced adverse enforcement action in three misclassification investigations.

Moreover, as *Dynamex* reminds us, DOL guidance relates to only one among myriad legal standards that apply to worker classification. For example, potential misclassification could bring consequences from—

- Lawsuits by employees in federal or state court claiming they are entitled to protections under federal or state wage and hour laws, benefits under the company's employee benefit plans, or protections under anti-discrimination laws;
- DOL investigations or other enforcement activity;
- State agency investigation or other enforcement activity under wage and hour, worker's compensation or unemployment insurance laws (Note that some states encourage workers to submit complaints or requests for investigation of suspected misclassification); or

- Audits by IRS or state tax authorities.

Companies may therefore wish to review their worker classifications, especially in light of the recent change in California.

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