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[Podcast]: Worker Classification after Dynamex, Not as Simple as ABC

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In its 2018 decision in *Dynamex Operations West v. Superior Court of Los Angeles County*, the California Supreme Court upended decades of precedent by setting out a new, stringent, three-factor test to determine proper worker classification for purposes of California's wage order rules. Then, this year, the Ninth Circuit first applied *Dynamex* retroactively and then wiped out that ruling and returned the question to the California Supreme Court. In the meantime, Assembly Bill No. 5, which seeks to codify the *Dynamex* test, is before the California Senate. In light of these developments, employers with workers in California are increasingly faced with conflicting information about the practical impact of *Dynamex*.

In this episode of The Proskauer Benefits Brief, Kate Napalkova and Pietro Deserio discuss *Dynamex* and its broader meaning for employers and other stakeholders in the compliance and transaction arenas.

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Kate Napalkova: Hello and welcome to the Proskauer Benefits Brief. I'm Kate Napalkova, Special Counsel in the Executive Compensation and Employee Benefits Department of Proskauer's Los Angeles office. On today's episode I'm joined by Pietro Deserio, Associate in the Labor and Employment Department of Proskauer's Los Angeles office. Hi Pietro.

Pietro Deserio: Hi Kate.

Kate: Today, we'll be discussing a few recent developments in worker classification. This is a topic that has been thrown into the spotlight repeatedly over the past year, due largely to the California Supreme Court's decision last year in *Dynamex Operations West v. Superior Court of Los Angeles County*. That decision laid out a new standard for when workers should be classified as employees rather than independent contractors for purposes of California's wage order rules. Then, earlier this year, the Ninth Circuit Court of Appeals, the *Vazquez v. Jan-Pro Franchising* case, applied *Dynamex* retroactively. So any lawsuits filed now could include claims stretching back to 2015.But, late last month, the Ninth Circuit wiped out that ruling and returned the question to the California Supreme Court. There's also been a move to codify *Dynamex* into state law in California, and that's AB5 (CA AB5), that passed the (California State) Assembly and is now in the (California State) Senate.

Before we get into the specifics – and we'll return to this point again a little later – it's important to keep in mind that worker classification affects a number of areas, including wage and hour, employee benefit plan participation under the Employee Retirement Income Security Act (or ERISA) as well as state and local laws to the extent not preempted by ERISA, and federal income and employment tax laws. All of these regimes apply different tests to determine whether a worker is properly classified as an employee or an independent contractor.

These recent developments affect wage and hour laws specifically. Pietro, a very basic threshold question to start - what exactly are wage and hour laws, and what do they require?

Pietro: While we could spend several hours on the complexities and peculiarities of California's wage and hour laws, I'll try my best to provide a 10,000 foot overview. California's wage and hour laws provide a framework that governs almost every aspect of the employer-employee relationship, including things like minimum wage, overtime, and how often and when employers are required to provide employees with the opportunity to take rest and meal breaks.

While the FLSA does apply to those working in California, more often than not California's laws offer much greater protections than the FLSA. For example, with respect to overtime, the FLSA and California law both require overtime pay for those working in excess of 40 hours in a week—California law goes a step further and requires overtime pay for hours in excess of 8 per day.

But California's wage and hour laws, like the FLSA, apply only to employees, and not independent contractors. And that's where the *Dynamex* decision enters the picture. The court's decision in *Dynamex* and the DOL's opinion letter you mentioned discuss different standards that should be used for properly classifying workers as employees or independent contractors, expressly for the limited purpose of determining whether these workers will be classified as independent contractors or employees, and whether they will get the benefit of California or federal wage and hour laws.

Kate: With that in mind, when an employer is looking at whether its workers are properly classified for wage and hour purposes, what are the relevant tests in California and then more broadly at the federal level and in other states?

Pietro: The California Supreme Court's decision in the *Dynamex* case set the standard: First off, the burden of proof is on the employer – the worker is presumed to be an employee for California wage order purposes unless the employer can affirmatively establish that all three of the following factors exist. Because there are three factors, this is referred to as the "ABC" test. The three factors are (a) that the worker is free from the hiring party's direction and control over how the work is to be performed (both in fact and as a matter of contract), (b) that the work to be performed is outside the usual course of the hiring party's business, and (c) the worker customarily engages in an independently established trade, occupation or business of the same nature as the personal services the worker is providing. If all of the three factors exist, the worker is an independent contractor for California wage and hour purposes. But if even one of the factors is not met, then the worker would be classified as an employee. It's a very high bar to meet. And in a decision issued just last month in a case called *Vazquez v. Jan-Pro Franchising*, the Ninth Circuit ruled that the 'ABC' test established in *Dynamex* applied retroactively, meaning companies can be liable for misclassification under the 'ABC' test going back 4 years (which is the statute of limitations on most wage and hour claims).

Then, following a motion for reconsideration, the Ninth Circuit issued a decision on July 22nd withdrawing that recent retroactivity decision and indicating that the Ninth Circuit will be certifying that question of retroactivity to the California Supreme Court. So that question is still pending.

Previously in California – for almost thirty years – the test was a less stringent multi-factor test broadly described in the California Supreme Court's decision in *S.G. Borello & Sons, Inc. v. Department of Industrial Relations*, which is similar to the multi-factor test used for purposes of the FLSA and the test generally used by most states other than California post-*Dynamex*. New Jersey, Connecticut, and Massachusetts are the few other states that have implemented a test similar to the 'ABC' test used in California.

Kate: That's right, it's still the case that most states and the DOL will apply the multi-factor test. To see the DOL apply the multi-factor test, we can look back to April of this year when the DOL determined that an un-named gig economy company – a virtual marketplace company that connects service providers with consumers – was not the employer of the workers that performed services through its platform.

In doing so, the DOL pointed out that the definition of "employee" under the FLSA was "obviously not intended to stamp all persons as employees", and that the key to determining whether a worker was an "employee" under the FLSA was "economic dependence." The DOL reiterated the six factors that it considers when determining economic dependence, which are derived from Supreme Court precedent and include (1) the nature and degree of control, (2) permanence of the work, (3) the worker's investment in facilities, equipment or helpers, (4) the amount of skill required, (5) opportunity for profit or loss, and (6) level of integration into the employer's business.

The six factors are not exclusive – the presence or absence of one factor is not determinative as it is in the 'ABC' test. And there is no presumption that the worker is an employee – the burden of proof isn't on the employer as it is in the 'ABC' test.

So, for purposes of the FLSA and the many states who have not adopted the 'ABC' test, the test remains the more flexible multi-factor test.

Pietro, can you briefly describe the consequence for an employer that fails to properly classify a worker as an employee in California and for purposes of the FLSA?

Pietro: Sure, if an employer fails to properly classify a worker as an employee, then they subject themselves to penalties under both the FLSA and California state law. There are lots of consequences that flow from misclassification – for example, misclassification can lead to a company not paying the appropriate minimum wage or overtime, or not otherwise recording an employee's hours correctly.

For violations of the FLSA, employers can be required to pay back wages for up to three years, as well as face liquidated damages unless they can show they acted in good faith (which is a tough standard to meet in this context) – liquidated damages equate to double the amount of back wages owed, which is paid in lieu of interest and can really mount up.

California penalties can also add up, as employers can be subject to several penalties beyond merely having to pay back wages. Those penalties can include a meal or rest break premium (which equates to one hour of paid work per day for each missed meal or rest break), penalties for inaccurate wage statements (which can add up to $4000 per employee), and penalties for failure to pay employees upon termination, (which can add up to an additional 30 days' pay for each employee). Also worth noting that the statutes provide for attorneys' fees for plaintiffs' attorneys, and companies can also expose themselves to penalties under California's Private Attorney General Act, referred to as PAGA, which is a whole other animal.

And note that because *Dynamex* applies retroactively, depending on how the California Supreme Court decides the issue, employees who can prove misclassification can now recover going back four years, even if the test that applied when they were classified as independent contractors years ago was different than the current ABC test.

Employers faced with the risk of a meritorious lawsuit could consider re-classifying their workers as employees, paying owed back wages, and hopefully avoiding the additional penalties by agreeing to offer some added amount of money in exchange for a release of claims from those employees.

Kate: That really drives home how the consequences of misclassification can be significant to an employer and helps explain why, post-*Dynamex*, the issue of classification of workers has gotten a lot of press. As you mentioned earlier, the *Dynamex* decision only applies to wage and hour laws, which isn't always underscored if you look at the press coverage.

So, if an employer with employees in the 'ABC' test states is doing an internal compliance review, or if an acquirer is conducting due diligence and negotiating the acquisition of a potential target company that has employees in the 'ABC' test states, they should keep in mind that one worker can be an employee for certain purposes but an independent contractor for others.

Pietro: Does that mean that if a worker is a *Dynamex* employee it doesn't necessarily follow that the employer has to offer that worker employee benefits and doesn't have to treat the worker as an employee for purposes of tax withholding?

Kate: Exactly, the tests for purposes of employee benefit plan participation and for withholding tax are common law tests that, similar to the DOL's test, focus on multiple factors.

On a very high level, the IRS generally considers the degree of control and independence between an employer and a worker, and specifically looks at behavioral control, financial control and the type of relationship between the employer and the worker. And the test for purposes of ERISA and benefit plan participation is set out in the Supreme Court's decision in *Nationwide Mutual Insurance Company v. Darden*, and applies a 13-factor control-oriented agency test. A worker can easily be a *Dynamex* employee without being an employee under these other tests.

Pietro: To play it safe, can an employer simply classify every *Dynamex* employee as an employee for all purposes?

Kate: So, that approach can be problematic from a business perspective because it can severely increase labor costs for the employer. Moreover, including non-employees in employee benefit plans can open up the employer to liability from the perspective of benefit plan compliance, benefit plan tax qualification, and even securities laws.

The key takeaway for employers, particularly those with employees in ABC test states, is that they have to carefully review how they classify workers for all purposes and keep in mind that there are different tests – some more stringent and some much less.

From a due diligence and transaction agreement perspective, buyers should be mindful of this. It's key that the scope of inquiry into a target company's employee classification practices in diligence, and the scope of representations that a buyer includes in a transaction agreement, cover classification for all purposes – understanding that for one employee the answer may be different depending on the purpose.

Pietro, if an employer goes through the exercise of classifying workers applying each different test and determines that a worker is not an employee for benefit plan and tax purposes but is an employee for wage and hour purposes, what are the additional the costs typically associated with that?

Pietro: If the worker is considered an employee for wage and hour purposes, they will be entitled to almost all the protections that states like California have to offer, as well as the protections of the FLSA. Overtime will likely be the biggest culprit for additional costs. For example, instead of a company being able to pay an independent contractor a fixed fee, the company will need to pay an employee (assuming he or she is an hourly, non-exempt employee) per hour, including minimum wage and overtime.

Needless to say, employers need to take a really hard look at their workforce under the different tests and determine, in each instance, the costs of doing business considering that they need to comply with state and federal wage and hour laws.

Kate: Thanks, Pietro for your insights on this. And thank you all for joining us today on the Proskauer Benefits Brief. Please stay tuned for more insight on the latest in compensation, benefits, labor and employment law, and be sure to follow us and our sister podcast, *The Proskauer Brief*, hot topics in labor and employment law on iTunes, Spotify, and Google Play.

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