

# Now what? Practical tips for navigating California post-A.B. 5

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On September 18, 2019, California Governor Gavin Newsom signed into law sweeping legislation — Assembly Bill 5 (A.B. 5) — that will dramatically reshape the contours of California’s workforce and economy, and potentially reclassify two million independent contractors — roughly 10% of the state’s workforce — as “employees” for purposes of state labor laws.

Across the Golden State, employers must now examine their workplaces and determine whether and how to modify their business structure to account for these extensive changes.

## HOW DID WE GET HERE?

In 2018, in a decision known as *Dynamex*, the Supreme Court of California held, for the first time, that the so-called “ABC test” is the appropriate standard for determining whether, under state wage and hour law, a worker is an employee (and thus covered) or an independent contractor (outside the scope of such laws).

In doing so, the court upended almost three decades of precedent and threw the status of millions of California workers in doubt.

Under the ABC test, a worker is presumed to be an employee unless a hiring company can satisfy all three “prongs” by establishing that: (a) the worker is free from control and direction in the performance of services; (b) the worker is performing work outside the usual course of the business of the hiring company; and (c) the worker is customarily engaged in an independently established trade, occupation, or business.

There is no debate that this test is far narrower than what has been the traditional standard for employee/independent contractor classification and will result in vastly more workers being “employees.”

A.B. 5 codifies and expands the *Dynamex* holding, and absent statutory exemption, broadly applies the ABC test to determine whether a California worker is an independent contractor or — far more likely — an employee.<sup>1</sup>

In the wake of A.B. 5’s enactment, employers now face a number of choices. Given the risk of significant liability, employers must do so thoughtfully and carefully.

## WHERE DO EMPLOYERS GO FROM HERE?

In the near term, an employer using independent contractor labor in California may first want to analyze its current workforce to determine how many contractors it has engaged, and how many of those may need to be reclassified to meet the ABC test. This should be followed by a close examination of the new law as applied to the unique, specific facts of each contractor relationship.

Most important, whatever tool is used, or analysis conducted should be done in concert with counsel to ensure that results are protected by attorney-client privilege.<sup>2</sup>

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Having established the universe of potential reclassified workers, the employer should next estimate the total cost of conversion of these workers from independent contractor to employee status.

These costs may include hourly rates, benefits, and increased payroll costs for workers’ compensation and unemployment insurance. They may also include additional supervisory costs, as well as additional employment practices liability insurance (EPLI) as a result of increased employee headcount.

Increased HR support for recruitment, hiring, retention, training, and other matters may also be impacted. Of course, in California a critical consideration in this equation will be the arduous task of compliance with the state’s detailed and cumbersome wage and hour laws. At the same time, some costs may in fact be reduced: will bona fide employee status mean lower worker turnover? Higher customer satisfaction or increased productivity?

Next, consider the logistical considerations reclassification may entail. For example, an employer currently using independent contractors to deliver its product on an as-needed basis will need to determine whether newly classified employees delivering these products will have fixed routes or set schedules.

What is the net increase in unit labor costs? Will the company realize costs savings from not paying an independent contractor at a potentially higher rate than it would pay an employee? And

ultimately, an employer will want to ask itself: Can some or all of this increase be passed along to the consumer or end-user? Will some portion need to come out of the bottom line?

Depending upon the nature of the corporate entity, other concerns may become apparent. Public companies will want to consider what impact these changes may have on required filings and revenue estimates, and make any amendments to comply with SEC rules.

A private company, on the other hand, will want to consider the impact of reclassification and potentially changed business models on possible sources of investment, and think about how best to position itself as attractive for investment potential.

If, after having completed this analysis, an employer concludes that reclassification is a viable option, the question becomes how best to implement it. Committed HR support and, equally important, a strong internal communications strategy, will be critical.

Not all workers reclassified as employees may welcome the change, particularly if the status change comes with a decrease in flexibility or independence in how they work. Employers may wish to consider offering flex-time options to retain workers who do not wish to work a fixed or 40-hour week schedule.

And, despite best efforts by the company, some contractors may simply decide to cease doing work for the company. A strategic plan for dealing with reclassification issues should address this potential scenario.

Finally, insofar as A.B. 5 raises potential retroactivity issues with respect to classification, an employer must be prepared to address the question when and if it is raised. New “employees” may ask if the company intends to make them whole. If the plan is to not make any reclassification retroactive, the employer must be able to defend that decision, both legally and as a matter of employee relations.

Alternately, if after a cost-benefit analysis an employer determines that reclassification of independent contractors is not viable within its business model, it will want to consider other options, many of which will vary based on the nature of the business.

Companies may wish to consider whether work currently done by independent contractors could be done by contractors outside of California. For example, platform companies that simply connect different talent with end users may not require an in-state presence. Others that provide on-the-ground services may not have the luxury of that option.

If a company’s independent contractor work must be done on the ground in-state, it may wish to consider limiting its activities in the state (if California represents a small part of the company’s operations or profit base, for example).

Or, the company may wish to classify its California workers as employees, while leaving workers in other states as independent contractors (although the fact should not be lost that this increasingly may become less and less of an option as time goes by, should the ABC test be adopted by states other than California). In the wake of A.B. 5, already we have seen East and West Coast states attempting to follow California’s lead.

Ultimately, companies for which the broad use of the ABC test will materially impact labor costs may wish to consider whether they want to expand, maintain, or reduce their California footprint.

A company may wish to consider exploring other states where it already does business, or is planning to do so, to assess the economic climate and viability of relocating some current California operations.

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Will states welcome California expatriate companies? Will their economic development offices be interested in courting relocation, perhaps even incentivizing it?

Of course, any such analysis must be done in light of all the facts and circumstances. For potential relocation, what is the state of the target state’s economy and job market? Issues will range from availability of workers, consumer base and tax structure, to employment regulations, climate, transportation access, and quality of life. Any due diligence will need to consider all relevant factors.

Indeed, a company may relocate corporate operations to state X, while maintaining some operations in California, and, given the Golden State’s high rate of taxation, still increase profitability.

Similarly, employers may wish to consider the projected impact of automation and artificial intelligence on their workforces. Will contractor work be automated, or can it be?<sup>3</sup> For example, will automated transport vehicles be able to replace contractor- or employee-delivery drivers in the near future? Can they do the bulk of the work, leaving humans as “last mile” drivers?

Some companies may simply choose, in the face of their risk assessment, to continue operations as they have in the past, while being ready for a potential legal challenge — and the costs associated with one — down the road.

But many organizations impacted by A.B. 5 will have few alternatives but to remain in California, make changes to

comply with the new law, and assume increased costs. A health care system based in California cannot offer routine care to California citizens when its facilities are in Arizona.

For these companies, the question will become, do they accept the increasingly hostile California employment landscape, or do they wish to fight back and consider countering it?

What does the shape of such “resistance” look like? In California today, industry coalitions are exploring challenges to burdensome state regulations by way of legislation and ballot initiative. In 2017, the private ambulance industry was able to obtain relief from onerous regulations regarding meal and rest breaks. Does that effort provide a model or case study for other industries seeking relief?

With respect to A.B. 5, major gig-economy platform companies have publicly committed \$90 million to challenge the law by way of the ballot. Other companies might join this effort. Some organizations focus their efforts on compliance after a law or regulation has been finalized, while others choose to impact policy change, defensively or offensively, before such rules become final.

Those companies that choose the compliance route will find no shortage of resources.<sup>4</sup> Those organizations wishing to engage more fully will face different challenges.

They should evaluate their memberships and contributions to trade associations and professional societies, and ask whether these organizations may be effective in helping to challenge a given law or regulation. If the answer is not as positive as one would like, would a different trade group or coalition of like-minded industry partners be more effective?

Larger companies will want to look to their own government relations functions. Do they have a government relations team, and how fully is it engaged? Where is it based, and is it robust in those states where regulation is most likely? Is it incorporated into the mission of the business, or does it sit in its own corporate silo? Is outside lobbying support appropriate?<sup>5</sup>

Similarly, the company should examine its own state and local outreach — has it established relationships with local assemblypersons, state senators, and municipal leaders? Have they been invited to tour the company’s facilities to know who the company is, what it does, and how many of their constituents it employs? Can the employer articulate the economic impact it brings to the community, through wages, taxes paid, community service efforts, and the like?

It has been said that in today’s world, we are increasingly a country of messaging, not facts. A company should therefore ask itself what steps it is taking, and who is helping it, to develop its own positive narrative.

What does success in that arena look like — how is it measured, and what is the return on investment? Does the company have a press relations strategy in place should it

become a corporate target? Every company has a strategic plan, an operations interruption plan, a security plan, and the like. What is the organization’s plan in the event of a public relations attack?

If — as we have already seen happen — the company is sued by the state for monetary or injunctive relief, it must be ready with a plan for both a legal response, and equally pressing, a comprehensive communications strategy for responding to employees, contractors, suppliers, customers, shareholders, the Board of Directors, and the media.

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Above all, these issues must resonate up to the C-Suite. Indeed, at a fundamental level, there are governance issues for a company’s Board. Company leaders must be asked and held accountable for their answers: has the business been proactive in analyzing its efforts to develop specific recommendations with respect to its big-picture, public-facing strategy? And what more can and should it be doing?

There are no easy answers to these questions, and no “one-size-fits-all” solution. Each company’s analysis will be different. But whether through a focus on ensured post-hoc compliance or pro-active issue advocacy, businesses that fail to meet these challenges head-on may be doomed to see history repeating.

#### Notes

<sup>1</sup> See Patrick Stokes, Michael Lotito, and Bruce Sarchet, *AB 5 Update: California Legislature Passes Final Bill on September 11, 2019*, (<https://bit.ly/2nMlWoq>) Littler Insight (Sept. 13, 2019); Bruce Sarchet *et al.*, (<https://bit.ly/2nOLnSB>) WPI Report (Aug. 8, 2019).

<sup>2</sup> One such tool provided by Littler and ComplianceHR is the NavigatorIC solution, which is part of the Navigator suite. More information on this tool is available here (<https://bit.ly/2oAEbND>).

<sup>3</sup> While the role of automation’s impact on the workplace is beyond the scope of this analysis, Littler has examined the issue in depth, particularly in its work with the Emma Coalition (<https://www.emmacoalition.com>). See Michael J. Lotito, James A. Paretti, Jr., Matthew U. Scherer, and David C. Gartenberg, *Automation & Artificial Intelligence: TIDE at the Tipping Point*, (<https://bit.ly/2n0F95c>) WPI Report (May 9, 2019).

<sup>4</sup> For example, Littler, among other firms, offers free webinars, publications, conferences, and services to assist its clients in compliance. Trade associations and government resources will likewise often be helpful in enabling employers — particularly smaller ones — to determine their obligations under new rules.

<sup>5</sup> The services of entities like Littler’s Workplace Policy Institute and others can work with employers on novel solutions and legislative advocacy on local, state, and federal levels.

**The following are some steps employers can consider taking to address contractor reclassification and help prepare for A.B. 5's implementation:**

- Identify the number of contractors who potentially would be reclassified under the law
- Analyze carefully the facts and circumstances of work performed for each position with the ABC test in mind
- For those contractors who may be reclassified, assess costs of doing so:
  - o Direct costs (wages, salary, benefits)
  - o Overhead costs (HR support, EPLI, recruitment, training)
  - o Cost savings (lower rate of pay, decreased turnover, increased customer satisfaction)
- Logistical issues of reclassification
  - o Scheduling
  - o Operational challenges
  - o Workflow challenges
  - o Public companies—reflect changes in corporate documents
  - o Private companies—assess impact on investment potential
  - o HR/Communications support to explain reclassification, answer questions
- If reclassification not possible:
  - o Can work be done outside of California?
  - o Limit in-state activities?
  - o Classify workers in California as employees, contractors in other states as permitted
- Maintain some operations in California, consider relocating others
- Explore relocation to friendlier economic climates
  - o Analyze “target” states
    - Economic forecast
    - Job market
    - Tax structure
    - Legal/Regulatory structure
    - Explore incentives, economic development
- Challenging the law?
  - o Assess strength of trade, business associations
  - o Consider forming a coalition with industry partners
  - o Assess government relations function—in-house, outsourced
- Strategic Plan/Outreach
  - o Leadership must come at highest levels
  - o Comprehensive
    - Federal, state, local outreach
    - Quantify benefits of employer presence in-state (e.g., tax base, jobs)
  - o Communications plan/corporate campaign
  - o Legal, public relations responses

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