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Protecting the Little Guys: How to Prevent The California Supreme Court's New "ABC" Test from Stunting Cash-Strapped Startups

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Protecting the Little Guys: How to Prevent the California Supreme Court's New “ABC” Test from Stunting Cash-Strapped Startups

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ABSTRACT

California startups and independent contractors are in desperate need of a lifeline before they are gone for good. This state has long favored the employee over the employer, but the California Supreme Court’s new “ABC” test tips the scales even further by making it practically impossible for startups to compensate their workers. As a remedy, I propose exemptions to the test for sophisticated contractors who do not need the state’s protection, certified owners who have demonstrated fair play, and small businesses which are still in the developmental stages.

Though the Court based its decision largely on a policy of protecting the proverbial little guys from big bad businesses, it did not address the harm the new law will do to the other little guys: cash-strapped startups. The purpose of this paper is not to undermine the policy behind the Court’s decision but to lobby for the group of people the Court overlooked. Indeed, the ABC test is a win for justice—simplifying convoluted and impractical standards for employee classification under minimum wage orders. Now the law must look toward protecting the honest small businesses that are so essential to California’s identity.

INTRODUCTION:

On April 30th, 2018, the California Supreme Court published a unanimous opinion in *Dynamex Operations West Inc. v. Superior Court of Los Angeles County*, wherein the Court laid out its new “ABC” test for classifying workers as independent contractors rather than employees for the purpose of minimum wage orders.¹ In developing the test, the Court focused on protecting workers who “possess less bargaining power” than their employers; the public, which “assume[s] responsibility for the ill effects” borne by misclassified workers; and “law-abiding businesses” that face “unfair competition from competitor businesses that utilize substandard employment practices.”² Though the Court offered legitimate considerations for these three groups, it failed to consider at least one other group: cash-strapped startups who cannot afford to pay their employees the mandatory minimum wage.³

One of California's most distinguishing characteristics is its penchant for startups, particularly those of the billion-dollar variety.⁴ California is home to more unicorn⁵ startups than any other state in the union, and it is not a close race.⁶ These unicorns all have at least one thing in common: they have achieved their success in spite of California's stymying employment laws. When compared to the rest of the United States, California has the “most burdensome regulations on small businesses,”⁷ which makes California's output of successful startups even more impressive.

Unfortunately, the California Supreme Court's ABC test has created yet another burden for these startups.⁸ This note will weigh the pros and cons of classifying workers as either independent contractors or employees, from the perspective of both an employer and a worker. Then, it will review the old tests for determining independent contractor status,

¹ See *Dynamex Operations W. v. Superior Court*, 416 P.3d 1 (2018), *reh'g denied* (June 20, 2018).

² *Id.* at 952–53.

³ See discussion *infra* Part III. THE NEW PROBLEM FOR CASH-STRAPPED STARTUPS.

⁴ See generally *The United States of Unicorns: Every U.S. Company Worth \$1B+ In One Map*, CB INSIGHTS (July 25, 2017), <https://www.cbinsights.com/research/startup-unicorns-us-map/>.

⁵ “[B]usiness: a start-up that is valued at one billion dollars or more,” MERRIAM-WEBSTER.COM (last updated July 30, 2018), <https://www.merriam-webster.com/dictionary/unicorn?src=search-dict-hed>.

⁶ See CB INSIGHTS, *supra* note 4 (California had sixty-two unicorns inside its borders, while New York had the second-most unicorns at only fifteen).

⁷ WAYNE WINEGARDEN, PH.D., THE 50-STATE SMALL BUSINESS REGULATION INDEX 10 (July 2015).

⁸ See generally AKERMAN LLP, *Say Goodbye to Independent Contractors: The New “ABC” Test of Employee Status*, JD SUPRA (May 7, 2018), <https://www.jdsupra.com/legalnews/say-goodbye-to-independent-contractors-18752/> (predicting the ABC test's immediate consequences for small businesses in California).

addressing the weaknesses of each. After summarizing the *Dynamex* decision and its relevant precedent, this note will call attention to one of the new problems facing cash-strapped startups as a result of the ABC test. Finally, it will propose three practical ways to solve that problem, without undermining the policy behind the Court's decision.

I. BACKGROUND

A. *Pros of the Independent Contractor Classification*

For an employer, the pros of classifying a worker as an independent contractor are abundant. **From a nonfinancial perspective**, independent contractors give employers more freedom when it comes to workplace turnover.⁹ This is useful for seasonal occupations or startup phases, where a worker is only needed for a specific job or a limited period of time.¹⁰ By taking advantage of the independent contractor classification in such circumstances, employers can avoid the headache and potential legal exposure that can arise from laying workers off without cause.¹¹ **In terms of legal exposure**, independent contractors possess significantly fewer options than employees when it comes to the potential theories under which they might sue the entity that hired them.¹²

In terms of financial obligations, hiring independent contractors is simply a cheaper option than hiring employees.¹³ According to some experts, classifying workers as employees instead of independent contractors costs businesses up to thirty percent more per worker.¹⁴ Businesses that go with independent contractors evade the onerous legal responsibilities of paying employment taxes, paying unemployment insurance taxes, and providing insurance plans to their workers.¹⁵ For the purposes of this note, the most important benefit of classifying workers as independent contractors is that employers are not required to comply with the state-mandated minimum wage orders.¹⁶

⁹ See STEPHAN FISHMAN, *Pros and Cons of Hiring Independent Contractors*, NOLO, <https://www.nolo.com/legal-encyclopedia/pros-cons-hiring-independent-contractors-30053.html> (last visited Aug. 6, 2018).

¹⁰ *See id.*

¹¹ *See id.*

¹² *See id.*

¹³ *See id.*

¹⁴ MARISA KENDALL, *Employees or Contractors? On-demand startups still struggle to define their workers*, MERCURY NEWS (Sep. 14, 2016), <https://www.mercurynews.com/2016/09/14/employees-or-contractors-on-demand-startups-still-struggle-to-define-their-workers/>.

¹⁵ *Dynamex Operations W. v. Superior Court*, 416 P.3d 1, 5 (2018), *reh'g denied* (June 20, 2018).

¹⁶ *See Independent contractor versus employee*, ST. OF CAL. DEP'T OF INDUS. REL. (last visited Aug. 6, 2018), https://www.dir.ca.gov/dlse/faq_independentcontractor.htm.

Being classified as an independent contractor can also be an advantageous option for workers.¹⁷ Unlike employees, independent contractors are ultimately in control of how they go about completing their work, having more authority to negotiate their wages, hours, and working conditions.¹⁸ Independent contractors are also in control of obtaining their own insurance and filing their own taxes, which of course might be a pro or a con depending on how savvy the worker is with such tasks.¹⁹

B. Pros of the Employee Classification

For employers, classifying a worker as an employee means the employer must control the hours, conditions, and wages, ensuring they are all appropriate under the relevant wage and hour legislation.²⁰ The lack of clarity in independent contractor law could also dissuade employers from utilizing the classification. Whereas the laws covering employees are enumerated in specific, statutory language, independent contractor law has been debated and redefined for several decades.²¹ A law that is difficult to understand will be difficult to follow, so the simplicity of employment law could itself be enough to attract employers.²²

For workers, being classified as an employee is advantageous because they are insulated by labor laws and regulations, and they defer responsibility for handling the aforementioned taxes and insurance.²³ The stability provided by the employee classification is also worth considering. Indeed, the policy underlying wage and hour legislation like wage orders is “to ensure that . . . workers are provided at least the minimal wages and working conditions that are necessary to enable them to obtain a subsistence standard of living and to protect the workers’ health and welfare.”²⁴

In any case, being an independent contractor gives the worker more freedom than he would have as an employee. Depending on the light in which that freedom is viewed, a worker could see losing the protections of employment regulation as a fair price to pay for being free from the burdens that arise under those same regulations.

¹⁷ *Dynamex*, 416 P.3d at 5.

¹⁸ *Dynamex*, 416 P.3d at 35.

¹⁹ *Independent Contractors*, WORKPLACE FAIRNESS, <https://www.workplacefairness.org/independent-contractors> (last visited Aug. 6, 2018).

²⁰ *Dynamex*, 416 P.3d at 5.

²¹ *Id.* at 927 (citing background cases that attempted to distinguish independent contractors from employees as early as 1944, as well as more throughout the 20th century).

²² See FISHMAN, *supra* note 9.

²³ *Independent Contractors*, *supra* note 19.

²⁴ *Dynamex*, 416 P.3d at 32.

C. *The Old California Tests and the Federal Test*

1. California's Industrial Wage Commission

California formed the Industrial Wage Commission (“IWC”) in 1913.²⁵ At the time of its formation, the IWC was granted power to dictate and regulate the appropriate wages, hours, and working conditions for jobs in which women and children were employed.²⁶ Through the Civil Rights Act of 1964, the legislature expanded the IWC’s protective powers to reach men in addition to women and children.²⁷ Today, the Labor Commissioner’s Office regulates hours, wages, and working conditions of all employees under the IWC’s provisions.²⁸

i. The IWC’s Wage Orders

As of this writing, the IWC is responsible for the creation of eighteen wage orders covering various industries, including, *inter alia*, mechanical,²⁹ housekeeping,³⁰ and agricultural labor.³¹ As a catchall order, Section 11170 applies to “any industry or occupation” not mentioned under any other order.³² These wage orders define “employee” as “any person employed by an employer.”³³ Under the orders, an “employer” is anyone “who . . . employs or exercises control over the wages, hours, or working conditions of any person.”³⁴ The orders define the verb “employ” as “to engage, suffer, or permit to work.”³⁵ Note that the circular nature of these definitions will be addressed below.³⁶

ii. Enforcing the Wage Orders

California imposes severe penalties upon employers who fail to meet the IWC's wage, hour, and working condition standards.³⁷ After a

²⁵ *Martinez v. Combs*, 231 P.3d 259, 270 (2010).^{[1][2]}

²⁶ *Dynamex*, 416 P.3d at 26.

²⁷ *Martinez*, 231 P.3d at 271.

²⁸ *Industrial Welfare Commission (IWC)*, CAL. DEP’T OF INDUS. REL., <https://www.dir.ca.gov/DLSE/dlse.html> (last visited Aug. 6, 2018) (noting IWC's current non-operation and the Commissioner's role in enforcement).

²⁹ CAL. CODE REGS. tit. 8, § 11040 (2001).^{[1][2]}

³⁰ *Id.* at § 11050.^{[1][2]}

³¹ *Id.* at § 11040.^{[1][2]}

³² *Id.* at § 11170.^{[1][2]}

³³ *Id.* at § 11010.^{[1][2]}

³⁴ *Id.*^{[1][2]}

³⁵ *See, e.g., id.* at § 11010(2)(D).

³⁶ *See* discussion *infra* Sections I.C.3, I.C.5.

³⁷ *See Martinez v. Combs*, 231 P.3d 259, 272 (2010).

first offense, an employer can face monetary fines of up to one hundred dollars, prison time of at least thirty days, or both.³⁸ If a court determines that an employer intentionally misclassified a worker as an independent contractor, it can impose a civil punishment between five thousand and fifteen thousand dollars per misclassification.³⁹ If a court finds a pattern of misclassification, it can increase the fines to between ten thousand and twenty-five thousand dollars per misclassification.⁴⁰ Furthermore, employers can be required to pay the misclassified employees all of the unpaid minimum and overtime wages, plus interest, in addition to other penalties and damages.⁴¹

2. *Borello's* Common Law Definition for Employee

For nearly thirty years, California had applied a multi-factor test to determine whether a worker should be properly classified as an employee or an independent contractor.⁴² This test was developed in the California Supreme Court case *S.G. Borello & Sons, Inc. v. Department of Industrial Relations*,⁴³ where commercial growers Borello disputed their obligation to secure workers' compensation plans for their seasonal harvesters.⁴⁴ The California Workers' Compensation Act ("WCA") requires employers to provide such plans.⁴⁵ However, the WCA only covers *employee* injuries that arise during employment.⁴⁶ The WCA offers no such protections to independent contractors.⁴⁷ Thus, Borello contended they were under no obligation to offer workers' compensation, because the seasonal harvesters were independent contractors, not employees.⁴⁸

Addressing this defense, the Court considered the fact that aside from providing the pre-cultivated land to the harvesters, Borello left the harvesters responsible for deciding which techniques and tools would be used to complete the hired-for task.⁴⁹ Still, the Court ruled for the harvesters, reasoning that the employers' "right to control" the *manner* of

³⁸ CAL. LAB. CODE § 1199 (2011).

³⁹ LAB. § 226.8(b) (effective Jan. 1, 2013).

⁴⁰ LAB. § 226.8(c).

⁴¹ See e.g., LAB. § 1193.6; LAB. § 1194 (prescribing employees' right to recover unpaid wages); see also, e.g., LAB. § 1194.2 (2011 & Supp. 2018) (prescribing liquidated damages in action to recover unpaid wages).

⁴² See HINA SHAH, *All California Companies Should Mind Their ABCs in Classifying Workers*, AM. CONST. SOC'Y (May 11, 2018), <https://www.acslaw.org/acsblog/all-california-companies-should-mind-their-abcs-in-classifying-workers/>.

⁴³ 769 P.2d 399 (1989).

⁴⁴ See *Dynamex Operations W. v. Superior Court*, 416 P.3d 1, 16 (2018), *reh'g denied* (June 20, 2018).

⁴⁵ LAB. § 3600(a) (effective Jan. 1, 2012); *accord id.* at § 3700(b) (effective Jan. 1, 2013).

⁴⁶ LAB. § 3600(a) (effective Jan. 1, 2012); *accord id.* at § 3700(b) (effective Jan. 1, 2013).

⁴⁶ *Borello*, 769 P.2d at 403.

⁴⁷ See *id.* at 400.

⁴⁸ See *id.*

⁴⁹ *Id.* at 403.

completion was the key consideration.⁵⁰ In reaching this determination, the Court turned to the California Labor Code,⁵¹ which states in relevant part that an employee is “every person in the service of an employer under any appointment or contract of hire . . .”⁵² On the other hand, the Code defines an independent contractor as “any person who renders service for a specified recompense for a specified result, *under the control* of his principal as to the result of his work only and not as to the means by which such result is accomplished.”⁵³

Determining that the control aspect was not itself dispositive,⁵⁴ the Court proposed these nine “secondary” factors for consideration:

- (1) [the employer's] right to discharge at will, without cause;
- (2) whether the one performing the services is engaged in a distinct occupation or business;
- (3) the kind of occupation, with reference to whether in the locality the work is usually done under the direction of the principal or by a specialist without supervision;
- (4) the skill required in the particular occupation;
- (5) whether the principal or the worker supplies the instrumentalities, tools, and the place of work for the person doing the work;
- (6) the length of time for which the services are to be performed;
- (7) the method of payment, whether by the time or by the job;
- (8) whether or not the work is part of the regular business of the principal; and
- (9) whether or not the parties believe they are creating the relationship of employer-employee.⁵⁵

The *Borello* court reiterated that these factors should not be applied separately, but as “intertwined”⁵⁶ tests, with the weight of each factor depending upon the totality of the circumstances from case to case.⁵⁷

After considering the control factor and the nine secondary indicia, the Court sided with the harvesters, determining they were employees⁵⁸ because *Borello* retained “all necessary control over the harvest portion of its operations.”⁵⁹ In particular, the Court noted that what little control the harvesters did maintain over the manner of harvesting was

⁵⁰ *Id.*

⁵¹ *Id.* at 415.

⁵² CAL. LAB. CODE § 3351 (2018).

⁵³ CAL. LAB. CODE § 3353 (2011) (emphasis added).

⁵⁴ See *Borello*, 769 P.2d at 403.

⁵⁵ *Id.* at 404.

⁵⁶ *Id.* (quoting *Germann v. Workers' Comp. Appeals Bd.*, 123 Cal. App. 3d 776, 783 (1981)).

⁵⁷ See generally *Dynamex Operations W. v. Superior Court*, 416 P.3d 1 (Cal. 2018) (describing the *Borello* multi-factor test as one that rests its decision upon the totality of the circumstances).

⁵⁸ *Borello*, 769 P.2d at 409.

⁵⁹ *Id.* at 408.

insignificant,⁶⁰ as the work was “typical farm labor” and not indicative of any “distinct trade or calling.”⁶¹

3. *Martinez's* Interpretation of the Statutory Definition

In *Martinez v. Combs*, workers sued another farming company and two of the company's associate produce merchants under California Labor Code Section 1194 for unpaid wages.⁶² In this case, the farmers could not afford to pay the workers due to financial strains.⁶³ In their motion for summary judgment, the produce merchants contended they were not engaged in an employment relationship with the workers through association to the farming company, and were therefore not liable under California's wage orders.⁶⁴ The Court ultimately agreed with the produce merchants, ruling they were not employers under the IWC wage order definition.⁶⁵

When interpreting the IWC wage order's definition of “employ”⁶⁶ throughout its decision, the *Martinez* court focused on the phrase “engage, suffer, or permit to work.”⁶⁷ The Court acknowledged the value this language provided by reaching “irregular working relationships” under which a clever employer might otherwise avoid liability.⁶⁸ Ultimately, the Court concluded that while the common law control test is “one alternative,”⁶⁹ the IWC's definition of “employ” could be any one of three distinct definitions: “(a) to exercise control over the wages, hours or working conditions, *or* (b) to suffer or permit to work, *or* (c) to engage, thereby creating a common law employment relationship.”⁷⁰

Applying these three definitions, the *Martinez* court determined that the produce merchants did not control the workers' wages, hours, or working conditions.⁷¹ All three of these definitions had the potential to be exceptionally broad in application, allowing for employment relationships to be found as a matter of law in situations that should truly be considered independent contractor relationships.⁷²

⁶⁰ See *id.* at 409.

⁶¹ *Id.*

⁶² 231 P.3d 259, 262–63 (Cal. 2010). [1] [SEP]

⁶³ *Id.* at 265–66.

⁶⁴ *Id.* at 266–67.

⁶⁵ *Id.* at 267.

⁶⁶ See, e.g., 8 C.C.R. § 11010, *supra* note 33; *accord id.* at § 11020 (effective Jan. 1, 2001).

⁶⁷ *Martinez*, 231 P.3d at 278.

⁶⁸ See *id.* at 273.

⁶⁹ *Id.* at 277.

⁷⁰ *Id.*

⁷¹ See *id.* at 285.

⁷² See generally Peter Tran, *Misclassification of Employees and California's Latest Confusion Regarding Who is an Employee or an Independent Contractor*, 56 SANTA CLARA L. REV. 677, 697–99 (2016).

4. *Ayala's* Clarification of the *Borello* Test

Shortly after the *Martinez* decision, a group of newspaper carriers brought a wage and hour action against Antelope Valley Press (“AVP”), alleging AVP misclassified them as independent contractors instead of employees, and violated IWC wage order 1-2001.⁷³ In *Ayala*, the trial court denied the plaintiffs’ motion to certify the action as a class action, applying the common law *Borello* test to determine whether common issues predominated.⁷⁴

In reviewing the trial court’s decision, the Supreme Court decided not to apply the IWC wage order test from *Martinez*, because both parties had agreed at trial that the common law test from *Borello* was the more appropriate standard there.⁷⁵ This is a crucial fact to address because, as a result, the Court did not actually decide which of the two tests was the correct standard for deciding whether a worker should be properly classified as an independent contractor or an employee.⁷⁶

5. Federal Definition of Employee

Much like California’s, the federal definition of employee is ill-defined statute.⁷⁷ Under the Fair Labor and Standards Act of 1938 (“FLSA”), “employee” is defined as a person who is “employed” by an employer.⁷⁸ The FLSA defines “employer” as “any person acting directly or indirectly in the interest of an employer in relation to an employee.”⁷⁹ While these two definitions are glaringly redundant, the FLSA does offer some guidance through its definition of the verb “employ” as “to suffer or permit to work.”⁸⁰

Choosing to apply the more manageable suffer or permit to work definition, federal courts developed the “economic realities” test to determine whether an employment relationship exists.⁸¹ By considering a multitude of factors *à la Borello*, the economic realities test focuses on

⁷³ See *Ayala v. Antelope Valley Newspapers, Inc.*, 327 P.3d 165, 336 (Cal. 2014).

⁷⁴ See *Dynamex Operations W. v. Superior Court*, 416 P.3d 1, 24 (2018), *reh'g denied* (June 20, 2018).

⁷⁵ See *id.*

⁷⁶ See *id.*

⁷⁷ See generally *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318, 322 (1992).

⁷⁸ 29 U.S.C. § 203(e)(1) (2012) (effective Mar. 23, 2018).¹¹⁷

⁷⁹ *Id.* at § 203(d).

⁸⁰ *Id.* at § 203(g).

⁸¹ See *Dynamex*, 416 P.3d at 33.

whether the worker is “economically dependent” on his hiring entity.⁸² If so, the worker should properly be classified as an employee.⁸³ If the worker is economically *independent* from the employer, the worker should properly be classified as an independent contractor.⁸⁴ While it appears in theory to be a more manageable option than applying the statutory definitions, the economic realities test is excessively broad in application, as it heavily favors the employee classification.⁸⁵

II. THE PROBLEM LEADING UP TO *DYNAMEX*

Following *Borello*, *Martinez*, and *Ayala*, California courts were stuck with two distinct tests for determining whether a worker is an independent contractor or an employee.⁸⁶ While the *Borello* court endorsed nine “secondary” factors concerning the nature of the relationship, the “most important” factor of the *Borello* test was “the right to control the manner and means of accomplishing the result desired.”⁸⁷ On the other hand, the *Martinez* court offered three distinct definitions for “employ”: “(a) to exercise control over the wages, hours or working conditions, or (b) to suffer or permit to work, or (c) to engage, thereby creating a common law employment relationship.”⁸⁸ Finally, although the *Ayala* court applied the *Borello* test, it did not affirm that test as the proper standard.⁸⁹

While both the *Borello* and *Martinez* tests consider control factors, they are actually concerned with different types of control. The *Borello* control test focuses on who possesses “absolute overall control” of the *outcome* of the hired-for work, rather than control over the specific actions taken to achieve that outcome.⁹⁰ Conversely, the *Martinez* control test is unconcerned with the outcome of the work, instead focusing on who controls the wages, hours, and work conditions of the working relationship.⁹¹ By not clarifying this distinction or determining which test

⁸² SEE GENERALLY JOY WALTEMATH, ‘SUFFER OR PERMIT’ PLUS ‘ECONOMIC REALITIES’ MEANS VERY BROAD DOL DEFINITION OF EMPLOYEE, EMP. L. DAILY: NEWS (JULY 17, 2015), [HTTP://WWW.EMPLOYMENTLAWDAILY.COM](http://www.employmentlawdaily.com) (FOLLOW “NEWS” HYPERLINK; THEN SEARCH ARTICLE’S TITLE).

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ See generally *id.* (asserting that “most workers are employees under the FLSA” when the economic realities test is applied).

⁸⁶ See Tran, *supra* note 72, at 692.

⁸⁷ S.G. Borello & Sons, Inc. v. Dep’t of Indus. Rel., 769 P.2d 399, 404 (1989).

⁸⁸ Martinez v. Combs, 231 P.3d 259, 278 (2010).

⁸⁹ See Dynamex Operations W. v. Superior Court, 416 P.3d 1, 28–29 (2018), *reh’g denied* (June 20, 2018); see also Ayala v. Antelope Valley Newspapers, Inc., 327 P.3d 165, 168–169 (Cal. 2014).

⁹⁰ See *Borello*, 769 P.2d at 407.

⁹¹ See *Martinez*, 231 P.3d at 277.

was proper, the *Ayala* court made it even more challenging for employers and workers to appropriately define the nature of their relationship.⁹²

Both tests have had their disadvantages when applied. Because the *Borello* test was so fact-specific and circumstantial, it allowed employers to misclassify their workers as independent contractors for decades “by dividing [their] work force into disparate categories and varying the working conditions of individual workers within such categories with an eye to the many circumstances that may be relevant under the multifactor standard.”⁹³ On the other hand, when the “suffer or permit work” portion of the *Martinez* test was applied literally, it would tend to encompass workers who were not intended to be protected by California wage orders.⁹⁴ Enter *Dynamex* and the new ABC test.

A. Procedural History

The *Dynamex* case began with two plaintiffs attempting to sue a trucking company on behalf of hundreds of drivers that the company had collectively converted from employees to independent contractors in an effort to save money on payroll expenses.⁹⁵ Prior to this conversion, all of the drivers had been considered employees and were thus being paid according to California wage and hour legislation.⁹⁶ At trial, the court certified the class of truck drivers, and, after having its motion (as well as its renewed motion) to decertify the class denied, *Dynamex* filed a petition for writ of mandate in the Court of Appeal.⁹⁷

In this petition, *Dynamex* claimed the trial court improperly applied the IWC definition of employee, as set forth in *Martinez*, in its determination of whether the drivers were employees or independent contractors.⁹⁸ The Court of Appeal denied the petition in part, ruling that the trial court was correct in its application of *Martinez* “when assessing those claims in the complaint that fall within the scope of the applicable wage order.”⁹⁹ However, in response to the then-recent *Ayala* decision that clarified *Borello*, the Court of Appeal granted the petition in part, ruling that the *Borello* standard should have been applied to the claims falling outside of the applicable wage order.¹⁰⁰

⁹² See TRAN, *supra* note 72, at 693.

⁹³ *Dynamex*, 416 P.3d at 34.

⁹⁴ *Id.* at 30.

⁹⁵ *Id.* at 5.

⁹⁶ *Id.* at 8.

⁹⁷ *Id.* at 12.

⁹⁸ *Id.*

⁹⁹ *Id.* at 13.

¹⁰⁰ *Id.*

In response to the partial denial, Dynamex filed a petition for review with the California Supreme Court, challenging the appellate court's conclusion that the *Martinez* test was the appropriate test for determining whether a worker is an employee or an independent contractor for the purposes of California's wage orders.¹⁰¹ The court granted the petition for review to consider that issue.¹⁰²

B. The New Test

To minimize the actual and potential abuses of the old tests, the court in *Dynamex* sought to develop a new “ABC” test for interpreting the suffer or permit to work standard in California's wage orders.¹⁰³ Drawing on inspiration from the multi-factor *Borello* test, the IWC wage order *Martinez* test, the federal “economic reality” test, and ABC tests from other states,¹⁰⁴ the court interpreted the “suffer or permit to work” standard as follows:

(1) [the burden is] on the hiring entity to establish that the worker is an independent contractor . . . ; and (2) . . . the hiring entity . . . [must] establish each of the [following] three factors . . . [:] (A) [T]hat the worker is free from the control and direction of the hiring entity in connection with the performance of the work, both under the contract for the performance of the work and in fact; and (B) [T]hat the worker performs work that is outside the usual course of the hiring entity's business; and (C) [T]hat the worker is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed.¹⁰⁵

If the hiring entity fails to satisfy factor A, B, or C, then the worker is an employee for the purposes of California wage orders.¹⁰⁶

As no California case had yet applied the ABC standard, the Court applied each factor by citing to similar tests from out-of-state cases that served as persuasive authority for the Court's decision.¹⁰⁷ These explanations were integral to the Court's development of the ABC standard and to its application of the test to Dynamex's relationship with its drivers.¹⁰⁸ As such, it is prudent to review each explanation in detail.

¹⁰¹ *Id.* at 7.

¹⁰² *Id.* at 13.

¹⁰³ *See id.* at 34.

¹⁰⁴ *See id.* at 40.

¹⁰⁵ *Id.* at 35 (emphasis omitted).

¹⁰⁶ *Id.* at 40.

¹⁰⁷ *See generally id.* at 35–40.

¹⁰⁸ *See generally id.*

1. Factor A

To satisfy this factor, the employer has the burden of demonstrating “that the worker is free from the control and direction of the hiring entity in connection with the performance of the work, both under the contract for the performance of the work and in fact . . .”¹⁰⁹ In its discussion of this factor, the court considered the employer’s control over the worker’s performance, including whether the worker supplies his own equipment or whether he controls the specific details of his work without the hiring entity interfering.¹¹⁰

However, under the persuasive authority that the court considered, even a worker who controls his or her own pace, schedule, equipment, and work location is not “free from the control and direction of [the hiring entity]” if the hiring entity ultimately dictates the outcome of the work.¹¹¹ Thus, to appropriately hire a worker as an independent contractor, an employer must do more than allow that worker to set his own hours, work from his own office, and negotiate his own wages. The employer must show that the worker has sufficient freedom to control the *outcome* of his work, operating with full autonomy in all decisions that affect the outcome of the hired-for work.¹¹²

2. Factor B

To satisfy this factor, the employer has the burden of demonstrating “that the worker performs work that is outside the usual course of the hiring entity’s business . . .”¹¹³ To demonstrate this type of relationship, the court offered the examples of a retail store hiring a plumber to fix a leak and an electrician to install an electrical line.¹¹⁴ Fixing a leak and installing electrical lines are clearly “not part of the store’s usual course of business [so] the store would not reasonably be seen as having [employed] the plumber or electrician . . .”¹¹⁵

¹⁰⁹ *Id.* at 35.

¹¹⁰ *See id.* at 36.

¹¹¹ *See* Fleece on Earth v. Dep’t of Emp’t & Training, 923 A.2d 594, 604 (Vt. 2007) (knitters and sewers were deemed employees of children’s wear company who provided patterns, as these dictated *how* the work was to be done albeit not *when* or *where* it was to be done).

¹¹² *See generally* W. Ports Transp., Inc. v. Emp’t Sec. Dep’t of Wash., 41 P.3d 510 (Wash. Ct. App. 2002) (hiring entity failed to establish that truck driver was free from its control within the meaning of part A of the ABC test, where hiring entity required driver, *inter alia*, to obtain the company’s permission before transporting passengers, and to go to the company’s dispatch center to obtain assignments not scheduled in advance).

¹¹³ *Dynamex*, 416 P.3d at 35.

¹¹⁴ *Id.* at 37.

¹¹⁵ *Id.*

Conversely, the court offered the examples of a clothing company hiring a private seamstress to make dresses from the company's supplies and patterns, and of a bakery hiring a cake decorator to work according to the bakery's designs.¹¹⁶ In these latter examples, "the workers are part of the hiring entity's *usual business operation* and the hiring business can reasonably be viewed as having [employed] the workers to provide services as employees,"¹¹⁷ not as independent contractors.

Under other persuasive authority addressing this factor, an employer could satisfy factor "B" by demonstrating that the work provided is not an "integral part" of the employer's business.¹¹⁸ For example, an employer could contend that he needed to hire the worker to perform work requiring specialized equipment or expertise, outside the scope of the employer's practice.¹¹⁹

3. Factor C

To satisfy this factor, the employer has the burden of demonstrating that "the worker is customarily engaged in an independently established trade, occupation, or business of the same nature . . . as the work performed."¹²⁰ According to the court, this means that the worker must have "*independently* made the decision to go into business for himself or herself."¹²¹ During its discussion of this factor, the Court considered workers independent when they have taken "the usual steps to establish and promote his or her independent business—for example through incorporation, licensure, advertisements, routine offerings to provide the services of the independent business to the public or to a number of potential customers, and the like."¹²²

Under persuasive authority, a worker may be deemed an independent businessperson when he holds himself out as independent by having his own clientele, business cards and advertisements, or maintaining a separate office from the hiring entity.¹²³ While this factor

¹¹⁶ *Id.* at 37.

¹¹⁷ *Id.* at 37 (emphasis added).

¹¹⁸ See generally *McPherson Timberlands, Inc. v. Unemployment Ins. Comm'n*, 714 A.2d 818, 821 (Me. 1998) (rejecting timber management company's contention that timber harvesting work done by an individual worker was outside its usual course of business because the company did not currently own any timber harvesting equipment itself, deeming the harvesting work "integral" to the business).

¹¹⁹ See generally *Great N. Constr., Inc. v. Dep't of Lab.*, 161 A.3d 1207 (Vt. 2016) (construction company established historic restoration worker was an independent contractor because his work involved specialized equipment and special expertise that the company did not possess and did not need for its usual general commercial and residential work).

¹²⁰ *Dynamex*, 416 P.3d at 34.

¹²¹ *Id.* at 39 (emphasis added).

¹²² *Id.*

¹²³ See generally *Boston Bicycle Couriers v. Deputy Dir. Of the Div. of Empl. & Training*, 778 N.E.2d 964 (Mass. App. Ct. 2002) (courier deemed employee because the hiring entity, a same-day pickup and delivery service, did not present evidence that courier "held himself out as an independent businessman performing courier services for any community of potential customers" or

seems the easiest to satisfy of the three, it is important to remember that all three factors of the test must be satisfied.¹²⁴ Thus, it would not be enough for a worker to hold himself out as independent in any of these ways if the reality of the relationship is that he is under the control of the hiring entity, or performing work that is within the scope of the hiring entity's business.¹²⁵

C. A Win for the Workers

Following its discussion of the test, the court agreed with Dynamex's contention that the trial court erred in its overly broad application of the suffer or permit to work standard.¹²⁶ However, the court upheld the trial court's certification of the drivers' class.¹²⁷ Applying the new ABC test, the court ruled that the drivers should have been considered employees for the purposes of the relevant California wage order.¹²⁸

III. THE NEW PROBLEM FOR CASH-STRAPPED STARTUPS

To be sure, the multi-factor *Borello* test and the *Martinez* test needed to be updated in the interest of protecting workers from manipulative employers.¹²⁹ The Dynamex decision gives California employers and workers a streamlined test that is faithful to its extensive precedent.¹³⁰ Indeed, the California Supreme Court has endorsed the ABC test as a means for courts “to look beyond labels and evaluate whether workers are truly engaged in a separate business or whether the business is being used by the employer to evade wage, tax, and other obligations.”¹³¹

To that end, the ABC test favors workers by giving employers the burden to overcome the presumption of employee status by satisfying *each* factor of the new test.¹³² In its future applications, the test may very well fulfil its purpose by preventing abuse of the independent contractor classification. That said, the court neglected to address the possibility that the new test could overly restrict even the *use* of the independent

that he “had his own clientele, utilized his own business cards or invoices, advertised his services or maintained a separate place of business and telephone listing”).

¹²⁴ See *Dynamex*, 416 P.3d at 40.

¹²⁵ See generally *id.*

¹²⁶ See *id.* at 41.

¹²⁷ *Id.*

¹²⁸ *Id.*

¹²⁹ See generally SHAH, *supra* note 42.

¹³⁰ See generally *id.*

¹³¹ See generally Anna Deknatel & Lauren Hoff-Downing, *ABC on the Books and in the Courts: An Analysis of Recent Independent Contractor and Misclassification Statutes*, 18 U. PA. J.L. & SOC. CHANGE 53, 84 (2015).

¹³² See SHAH, *supra* note 42.

contractor classification by honest California employers, and especially by those whose startups depend on the classification.¹³³

In California, the use of independent contractors is higher than the national average, comprising 8.5 percent of the workforce.¹³⁴ Moreover, many startups defer compensation of their initial employees and founders through the use of stock options and other alternatives because they have not yet made enough money to afford minimum wage payments.¹³⁵ This practice is perfectly legal with independent contractors who agree to such terms, but explicitly forbidden with employees.¹³⁶ Thus, by solving the problem in regard to malicious businesses, the California Supreme Court created a new problem for honest businesses just trying to get their company off the ground.¹³⁷

These small businesses are a critical component of the national economy.¹³⁸ It is estimated that between 2000 and 2018, startups were responsible for 65.9% of job creation in the country.¹³⁹ In the interest of protecting cash-strapped startups from the harsh limitations of the new ABC test, it is imperative that a solution be offered.

IV. PROPOSED SOLUTIONS

A. “Sophisticated Contractor” Exemption

As stated above, the ABC test was designed in part to protect workers who “possess less bargaining power” than their employers.¹⁴⁰ Oftentimes, minimum wage workers are so desperate to find work and provide for their families that they are strong-armed into one-sided contracts that skirt wage order protections.¹⁴¹ An accreditation process could be implemented to preserve the protections afforded to such workers under the new ABC test, while granting other more sophisticated workers

¹³³ See generally Tony Cagala, *Ruling on Independent Contractors to Affect all Businesses*, SAN DIEGO BUS. J. (May 30, 2018), <https://www.sdbj.com/news/2018/may/30/ruling-independent-contractors-affect-all-business/?page=1>.

¹³⁴ Annette Bernhardt & Sarah Thomason, *What Do We Know About Gig Work in California? An Analysis of Independent Contracting*, UC BERKELEY CTR. FOR LAB. RES. AND EDUC. (June 14, 2017) <http://laborcenter.berkeley.edu/what-do-we-know-about-gig-work-in-california/>.

¹³⁵ See generally Asheesh Advani, *Paying Employees During the Startup Stage*, THE ENTREPRENEUR, <https://www.entrepreneur.com/article/71108> (last visited Aug. 6, 2018).

¹³⁶ See Cal. Civ. Code § 3513 (1872).

¹³⁷ See generally Cagala, *supra* note 133.

¹³⁸ See Wayne Winegarden, *States Where Regulations Harm Small Businesses The Most*, FORBES (July 28, 2015), <https://www.forbes.com/sites/econostats/2015/07/28/states-where-regulations-harm-small-businesses-the-most/#697791a3103f>.

¹³⁹ *Frequently Asked Questions about Small Business*, U.S. SMALL BUS. ADMIN. (Aug. 2018) <https://www.sba.gov/sites/default/files/advocacy/Frequently-Asked-Questions-Small-Business-2018.pdf>.

¹⁴⁰ See *Dynamex*, 416 P.3d at 32.

¹⁴¹ See *id.*

the freedom to contract for their own wages, hours, and working conditions.

As the Court noted, the purpose of minimum wage legislation has always been to protect the health and welfare of workers who cannot otherwise protect themselves.¹⁴² Under federal securities law, certain securities cannot be offered to an individual unless that individual is an “accredited investor.”¹⁴³ The Securities and Exchange Commission (“SEC”) implemented the accredited investor exemption to “identify persons who can bear the economic risk” involved in purchasing unregistered securities.¹⁴⁴ To serve a similar function in employment law, an exemption should be implemented to identify workers who can bear the risk of being paid less than the state-mandated minimum wage, in exchange for a more valuable deferred payment or stock option.

The SEC’s accredited investor test requires that a person either earn a minimum yearly income or have a minimum net worth.¹⁴⁵ If the person satisfies either of these requirements, then a company may freely offer the accredited investor its securities, and the accredited investor may purchase them.¹⁴⁶ The SEC also allows trusts to participate in these unregistered offerings, so long as the trust meets certain requirements, including the requirement that a “sophisticated” person directs it.¹⁴⁷ The SEC defines a sophisticated person as one with “sufficient knowledge and experience . . . to evaluate the merits and risks of the prospective investment.”¹⁴⁸

The accredited investor and sophisticated person exemptions are perfect examples of how the government protects a person from risk without restricting that person’s ability to take on that risk in exchange for a potentially great reward. A similar exemption should be offered in the context of minimum wage legislation. For example, the IWC could amend current legislation to allow “sophisticated contractors” to contract out of minimum wage requirements. The test for sophisticated contractor status could depend upon a worker’s financial stability and relevant experience, drawing inspiration from the SEC’s tests for accredited investors and sophisticated persons.

In this way, only those workers who can bear the risk of foregoing the guaranteed protections of minimum wage laws would be allowed to do

¹⁴² *See id.*

¹⁴³ *See Investor Bulletin: Accredited Investors*, INVESTOR.GOV (Sep. 23, 2013) <https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-accredited-investors>.

¹⁴⁴ *See id.*

¹⁴⁵ *See id.*

¹⁴⁶ *See id.*

¹⁴⁷ *See id.*

¹⁴⁸ *See id.*

so. Moreover, this test burdens unsavory employers in the same way, preventing them from entering wage-evasive contracts with workers who do not satisfy the sophisticated contractor test. By instituting this exemption, the ABC test protects the workers who were intended to be protected by minimum wage legislation, while allowing honest and sophisticated parties to contract freely with one another under more equal bargaining powers.

B. “Certified Owner” Exemption

One potential drawback to the sophisticated contractor exemption is that contractors could have trouble satisfying the financial or experiential requirements. It would be a step in the right direction, but young and inexperienced workers would still be tied to the ABC test, and therefore so would be the businesses who hire them. Moreover, unless workers chose to exercise their ability to opt out of the ABC test, many startups would have to hire employees whom they cannot afford to pay in wages. To give these startups more contract freedom and reduce their unilateral dependence on workers' financial status and experience, an exemption should be created for startup owners who demonstrate a track record of good faith and fair dealing.

Much like how the California Bar Association regulates and certifies attorneys,¹⁴⁹ or how the California Department of Oversight regulates and certifies financial institutions,¹⁵⁰ the California Labor Commissioner could expand its powers¹⁵¹ to regulate and certify owners who wish to utilize independent contractors under appropriate circumstances. Owners who have a clean track record in all their contracts and employment relationships could petition the Commissioner for an exemption to the relevant California Wage Order. These exemptions should be revoked upon any evidence of abuse or unequal bargaining power. In this way, the ABC test fulfills its purpose of protecting wage-dependent workers from malicious businesses, while allowing honest entrepreneurs and willing independent contractors to engage in mutually beneficial relationships.

¹⁴⁹ See generally *Our Mission: What We Do*, THE ST. BAR OF CAL., <http://www.calbar.ca.gov/About-Us/Our-Mission> (last visited Aug. 6, 2018).

¹⁵⁰ See generally *About Us*, CAL. DEP'T OF BUS. OVERSIGHT, http://www.dbo.ca.gov/About_DBO/default.asp (last visited Aug. 6, 2018).

¹⁵¹ See generally *Labor Commissioner's Office*, CA.GOV, <https://www.dir.ca.gov/DLSE/dlse.html>. (describing Commissioner's powers as used in fulfillment of the Commission's mission) (last visited Aug. 6, 2018).

C. “Small Business” Exemption

Finally, the simplest solution is creating a bright line exemption for businesses whose funds are insufficient to pay their founding workers. As it so happens, such a bright line exemption already exists under federal law. The FLSA, which establishes both the amount of the federal minimum wage and the employees whom it covers, provides an exemption for small businesses.¹⁵² The federal minimum wage applies only to employees of a business “whose annual gross volume of sales made or business done is not less than \$500,000.”¹⁵³ Thus, cash-strapped startups that have yet to generate enough money to pay their employees (i.e. startups whose annual gross volume of sales made or business done is less than \$500,000) find safe harbor under this federal small business exemption.

It should be noted that several states include similar exemptions for small businesses in their minimum wage legislation,¹⁵⁴ but California is not yet one of them.¹⁵⁵ The federal government defers to state employment laws that are more protective to employees,¹⁵⁶ so California's businesses are required to follow state law because it offers a higher minimum wage than federal law.¹⁵⁷ Thus, California's startups miss out on the federal small business exemption. Just as the California Supreme Court looked to other states in developing the ABC standard,¹⁵⁸ California legislators should look to federal law in developing a small business exemption. If this were accomplished, cash-strapped startups could faithfully classify their workers as employees without risking violation of the minimum wage requirements.

¹⁵² See 29 U.S.C.A. § 206(a)(1) (effective Jun. 30, 2016) (defining minimum wage and to whom paid).

¹⁵³ See *id.* at § 203(s)(1)(A)(ii) (defining “enterprise” under which a covered employee must be employed).

¹⁵⁴ See generally *State Minimum Wages: 2018 Minimum Wage by State*, NATIONAL CONFERENCE OF STATE LEGISLATURES: RESEARCH (July 1, 2018), <http://www.ncsl.org/research/labor-and-employment/state-minimum-wage-chart.aspx>.

¹⁵⁵ See, e.g., CAL. CODE REGS. tit. 8, § 11040 (2001) (omitting small business exemption).

¹⁵⁶ See *Fact Sheet #17A: Exemption for Executive, Administrative, Professional, Computer & Outside Sales Employees Under the Fair Labor Standards Act (FLSA)*, U.S. DEPT. OF LAB.: WAGE AND HOUR DIVISION (July 2008), https://www.dol.gov/whd/overtime/fs17a_overview.htm.

¹⁵⁷ *Compare Minimum Wage*, CALIFORNIA DEPT. OF INDUS. REL.: LAB. COMMISSIONER’S OFF., https://www.dir.ca.gov/dlse/faq_minimumwage.htm (last visited Aug. 6, 2018) (denoting California’s current minimum wage as \$10.50 and \$11.00 per hour for employers with 25 employees or less and employers with 26 employees or more, respectively), with *Minimum Wage*, U.S. DEPT. OF LAB.: WAGES, <https://www.dol.gov/general/topic/wages/minimumwage> (last visited Aug. 6, 2018) (denoting the current federal minimum wage as \$7.25 per hour).

¹⁵⁸ *Dynamex Operations W. v. Superior Court*, 416 P.3d 1, 35–40 (2018), *reh’g denied* (June 20, 2018).

CONCLUSION

This note weighed the pros and cons of classifying workers as either independent contractors or employees, summarized the *Dynamex* decision and its relevant precedent, discussed the problem facing cash-strapped startups because of the ABC test, and proposed three viable solutions for that problem. Although the Court properly considered the need to protect workers and the public from the one-sided bargaining power of unsavory businesses, it ended up doing a disservice to honest startups who cannot afford to pay their employees the mandatory minimum wage in the early stages of development.

That said, the ABC test was a win for justice, simplifying convoluted and impractical standards for employee classification under minimum wage orders. Now the law must look toward protecting the honest businesses that are so essential to California, beginning with cash-strapped startups. This can be accomplished by lobbying for exemptions for sophisticated contractors, certified owners, and small businesses.

