Through the Looking Glass:

How California's AB5 Legislation Turned the Owner-Operator Model Upside Down Throughout the United States and Beyond

Hillary Arrow Booth
Managing Partner
Booth LLP
Los Angeles, CA
310-641-1800
www.BoothLLP.com

Jeffrey R. Simmons
Senior Vice President of Legal and Risk
GlobalTranz
Phoenix, AZ
480-399-35\615

Through the Looking Glass:
How California's AB5 Legislation Turned the Owner-Operator Model Upside Down Throughout the United States and Beyond

Along with over 30 other states, California recently overhauled the way in which it defines and classifies employees and independent contractors. Shortly thereafter, the California Trucking Association ("CTA") filed a case in the United States District Court for the Southern District of California seeking to exclude the trucking industry, and more specifically motor carriers, from the application of the "ABC" test codified by California's AB5 legislation. While a preliminary injunction had been initially issued, in April 2021 it was overruled by the Ninth Circuit. The injunction stayed in place while the CTA petitioned for certiorari in the United States Supreme Court. The petition as denied on June 30, 2022. Thus, the ABC test now applies to motor carriers and other transportation companies in California.[1]

A bit of history is important to understand the prior ambiguity surrounding proper worker classification. The confusion is increased for companies operating in more than one state, as state law controls most employment related issues, including worker classification. Until recently, most states used multi-factor tests with different factors being given different weight according to the ever-changing case law. The IRS also uses a list of factors to determine worker classification, which do not always coincide with the factors utilized by courts or labor commission. The uncertainty and inconsistent application of the multi-factor tests in part fueled the desire to adopt the simplified three-prong ABC test, enacted in the states through legislation or case law. States differ slightly in the wording of the test, and some use only two of the three prongs. The common wording of the ABC test is as follows:

> A worker is considered an employee and not an independent contractor, unless the hiring entity satisfies all three of the following conditions:
>
> A. 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;
>
> B. The worker performs work that is outside the usual course of the hiring entity's business; and
>
> C. The worker is customarily engaged in an independently established trade, occupation, or business of the same nature as that involved in the work performed.

As of now, 28 states use the three prong ABC test, and eight states use two of the three prongs of the ABC test.[2] In most states, workers are presumed to be employees unless proven otherwise by the hiring entity, creating a high burden that most-often cannot be met. As the ABC test gains traction nationwide, all business should re-assess how they classify workers and the

[1] *California Trucking Association v. Bonta*, 996 F.3d 644 (9th Cir. 2021), cert denied at 142 S. Ct. 2903 (2022).
[2] In California, the ABC test is codified as California Labor Code § 1775.

terms of their business contracts to ensure that they are not inadvertently creating employment relationships.

To better understand the ABC test, and its application, each prong must be analyzed. In analyzing Prong A of the ABC test, the California Supreme Court in *Dynamex*[3] explained:

> "A worker who is subject, either as a matter of contractual right or in actual practice, to the type and degree of control a business typically exercises over employees would be considered an employee. Depending on the nature of the work and overall arrangement between the parties, a business need not control the precise manner or details of the work in order to be found to have maintained the necessary control that an employer ordinarily possesses over its employees."

The *Dynamex* Court provided the following examples of Prong A being applied:

a. An employer failed to establish that work-at-home knitters and sewers who made the clothing were sufficiently free from the company's control where the employer provided the workers with the same patterns. The court reasoned that "[t]he degree of control and direction over the production (…) is no different when the sweater is knitted at home at midnight than if it were produced between nine and five in a factory."[4]
b. A construction company proved that a worker who specialized in historic reconstruction was sufficiently free of the company's control where the worker set his own schedule, worked without supervision, purchased all materials using his own business credit card, and had declined an offer of employment proffered by the company.[5]

In analyzing Prong B of the ABC test, the *Dynamex* Court explained: "Contracted workers who provide services in a role comparable to that of existing employees will likely be viewed as working in the usual course of the hiring entity's business." The *Dynamex* Court clarified the broad coverage of Prong B by providing the following examples of how Prong B is satisfied, meaning that services are not part of the hiring entity's usual course of business: (1) a retail store hires an outside plumber to repair a leak in a bathroom on its premises; (2) a retail store hires an outside electrician to install a new electrical line. Conversely, the Court found that Prong B was not satisfied when a bakery hires cake decorators to work on a regular basis on its custom-designed cakes. The usual business of the bakery includes decorating cakes, and therefore any persons who perform that service would be classified as employees.

In analyzing Prong C of the ABC test, the *Dynamex* Court and subsequent appellate court decisions explained: "The hiring entity must prove the independent business operation is actually in existence at the time the work is performed. The fact that the business operation could come into existence in the future is not sufficient." The Court recognized that an individual who

---

[3] *Dynamex Operations West, Inc., v. The Superior Court of Los Angeles County*, et al, 4 Cal.5th 903 (2018) – recognized and adopted the ABC test for the first time in California.
[4] See also, *Fleece on Earth v. Dep't of Emple. & Training* (Vt. 2007) 181 Vt. 458.
[5] See also, *Great N. Constr., Inc. v. Dept. of Labor* (Vt. 2016) 204 Vt. 1.

independently has made the decision to go into business generally takes the usual steps to establish and promote that independent business. Examples of this include (1) incorporation, licensure, advertisements; and (2) routine offerings to provide the services of the independent business to the public or to a number of potential customers.

In contrast, Prong C is not satisfied where the hiring entity (1) unilaterally assigns the worker the label "independent contractor;" (2) where the hiring entity requires the worker, as a condition of hiring, to enter into a contract that designates the worker an independent contractor or requires the individual to form an entity; or (3) if an individual's work relies on a single hiring entity. As an example, Prong C was not satisfied where a taxi driver was required to hold a municipal permit that may only be used while that driver worked for a specific taxi company.[6]

Within the transportation industry, the ABC test primarily impacts motor carriers. Motor carriers are defined as: "(14) Motor carrier. The term 'motor carrier' means a person providing motor vehicle transportation for compensation."[7] Because their usual business is the movement of cargo from one place to another, the retention of "independent" owner-operators to move cargo prevents the motor carrier from satisfying Prong B: "The worker performs work that is outside the usual course of the hiring entity's business." Thus, even if the motor carrier exerts almost no control (Prong A), and the owner-operator is customarily engaged in his own business (Prong C), the owner-operator will nevertheless be considered an employee of the motor carrier because all three prongs must be established by the motor carrier to prove independence.

Throughout the country, motor carriers are reorganizing to become compliant with the ABC test. The two most prevalent methods are to convert all drivers to employees or to become or utilize a freight broker. Drivers who have been operating as owner-operators and want to maintain their autonomy may not be in favor of converting to employees. Thus, some motor carriers have implemented a hybrid employment model separating the owner from the operator. The operator (driver) is hired at a relatively low wage, and separately, the owner leases his vehicle to the motor carrier. The driver is compensated through payroll, and lease payments are made by regular company check like any other business expense. Using the employment model requires motor carriers to comply with the various state laws governing employer-employee relationships, including restrictions on piece-rate (milage) compensation. Despite the employment law requirements and the resistance from owner-operators, many motor carriers have converted to employee-only drivers to reduce their risk and have consequently enjoyed the benefits that come with full control over their drivers work hours and routes.

Alternatively, another response by motor carriers has been to obtain freight broker authority, either for the same company or a related company. Doing so allows the newly formed brokerage to provide freight to owner-operators as long as the owner-operators have their own motor carrier authority and they enter into proper contracts. Creating a brokerage overcomes the impossibility of satisfying Prong B because the work performed by a broker and a motor carrier are fundamentally different – a broker arranges for the transportation of freight and a motor carrier transports fright from one location to another.[8] The "B" prong of the ABC test requires that independent contractors perform work that is outside the usual course of the hiring entities

[6] *Garcia v. Border Transportation Group* (2018) 28 Cal.App.5th 558, 575.

[7] 49 U.S. Code § 13102(14).

[8] 49 U.S. Code § 13102(2).

business. Therefore, if the hiring entity is a broker rather than a motor carrier, freight movement would no longer be a part of the hiring company's activities. Of course, the A and C Prongs must also be satisfied.

The duel authority alternative is especially attractive to motor carriers that previously utilized both employee drivers and independant contractors. This allows them to use their motor carrier authority to transport cargo using their employee drivers and their broker authority for the loads that had been outsourced to owner-operators and for overflow. While this seems like a simple solution, many motor carriers have difficulty maintaining a separation between their motor carrier and broker authorities, and some have difficulties converting their shipper customers to the use of their broker company. Even with these challenges, the duel authority approach removes the risk of a misclassification lawsuit while allowing the use of sole proprietor motor carriers (owner-operators).

While there is no specific exemption for the trucking industry, any business may continue to enter into business-to-business contractual relationships. However, unlike the past, these contracts are subject to scrutiny to ensure that they are not merely covering up an employment relationship when used between a company, such as a large motor carrier or broker, and a sole proprietor such as an owner-operator or broker's agents. Although currently not a target, freight brokers with agent models may have exposure under the ABC test, as arguably, broker agents are in the same business as their principals. To minimize unwanted risk, broker-agents in California and other states need to comply with the "business-to-business" exception to the ABC test. Independent, non-excusive agents may meet the "business-to-business" exception but it becomes difficult if the agent provides services to only one broker.

As an example, California Labor Code § 2776 provides a business-to-business exemption to the ABC test for "business service providers." This is perhaps the broadest category of exemptions under California's ABC test. The term "business service provider" is not defined in the statute, but appears to provide a catch-all exemption for categories not specifically exempted. The "business service provider" can be a sole proprietor, or a business entity such as a partnership, LLP, LLC, or corporation. There are many conditions that must be met before a "business service provider" can qualify under the new exemption. The primary requirements of a business-to-business or service provider relationship, are as follows:

- The service provider is free from the direction and control of the other contracting business. It is important to understand that the element of control is present in most business relationships. But the "control" that requires a provider to be treated as an employee, is control over the details of the job (means and methods) as opposed to the control of the outcome.
- The service provider must have a written contract that specifies the payment amount, including the applicable rate of pay, for services to be performed, as well as the due date of payment for such services.
- The service provider must be able to negotiate its own rates.
- Some states may require that the service provider must provide services directly to the contracting business rather than to customers of the contracting business. (California no longer has this requirement and instead allows service providers to direct services to customers of the company with which it contracts.)

- If the work is performed where a service provider must have a business license or business tax registration, those requirements must be met.
- The service provider must maintain a business location. This location may include the service provider's residence.
- The service provider advertises and holds itself out to the public as available to provide the same or similar services.
- The service provider must have its own tools, vehicles, and equipment to perform the services.

In sum, the recent changes in over 30 states implementing part or all of the ABC test have dramatically changed the organization and economics of motor carriers throughout the country, with rippling impact throughout the transportation industry. Even a motor carrier located in a state that does not utilize the ABC test may find themselves on the wrong end of a lawsuit or enforcement claim if they maintain an independent contractor relationship with an owner-operator who resides in one of the states using the ABC test. Individuals are entitled to have the laws of their resident state apply to their employment. Thus, even if a motor carrier has what appears to be an iron-clad independent contractor agreement with an owner-operator that calls for application of the laws of a non-ABC test state, when that owner-operator sues in his home state claiming to be an employee, and that home state uses the ABC test, the contractual agreement will be meaningless. Accordingly, all entities in the transportation industry must remain aware of employment laws in other states to protect themselves from inadvertent exposure.