
What Happens in California Doesn't Necessarily Stay in California

By Dan Beederman
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California has recently enacted a number of new laws that can affect businesses throughout the country, including manufacturers and sales representatives. This multi-part article focuses on two of them: California Assembly Bill 5 (“AB5”), which provides a test to determine if a worker/service provider is an independent contractor or employee, and “Proposition 65,” which addresses environmental and health-related concerns about products sold in California.



Why should I be concerned about these statutes if my company is not located in California, you ask? It's a good question. Well, whether your company is in San Diego, San Antonio, Saint Augustine or points in between, if you are a manufacturer whose products are sold into California, whether directly or indirectly, or who uses an independent sales representative in California, or if you are a sales representative that ships consigned products into California, or are a "buy/sell" representative that sells products that end up in California, even if sold online, or if you use a sub-representative in California, you will need to comply with these laws or face potentially significant legal exposure.

AB5

California's AB5, which became effective January 1, 2020, provides a test to avoid the misclassification of employees as independent contractors. Exactly who is an employee, as opposed to an independent contractor, is a common question in many business relationships where one person provides services to another. If the service provider is an employee, he or she will be entitled to all of the rights and benefits afforded that status by federal and state laws, as well as by company policies. In an effort to avoid the cost of providing insurance and other benefits and the potential exposure for resulting legal obligations, companies sometime mis-classify their employees as independent contractors. That is why many rep and sub-rep agreements include a provision emphatically stating that sales reps are independent contractors. Ultimately titles assigned and self-serving statements made in a contract do not matter. Instead, whether someone is an employee or independent contractor is determined by how the parties conduct themselves in their business relationship.

Courts and taxing authorities have used various means to determine if someone is an employee or an independent contractor. The IRS once used the well-known "20 Factor Test" to evaluate which party in a business relationship had the right to control the manner and means by which services were provided — the person who performed the services, or the person for whom the services were performed. The more control exercised by a company over how, when and where a worker performed work for its benefit, the more likely the worker would be found to be an employee.

Today, the IRS has reduced its 20 Factor Test into three general categories that it uses to evaluate whether someone is an employee:

1. Which party has behavioral control.
2. The financial terms with the worker.
3. The nature of the relationship between the parties.

In California, AB5 has further refined and simplified the evaluation process through its own three-part test, the stated goal of which is to make it easier to identify, address and remedy the mis-classification of workers (service providers), a goal shared by all states and the federal government.

As a matter of background, AB5 codifies the decision issued by the California Supreme Court in 2018 (in the case of *Dynamex Operations West, Inc. vs. Superior Court*). The genesis of the ruling in *Dynamex*, which then generated AB5, was the need to address issues arising from the new “gig” economy, such as were raised by drivers for Uber, Lyft, Amazon delivery, and other service businesses. Based upon the decision in *Dynamex*, as now codified in AB5, California utilizes a three part “ABC Test” to determine if “a person providing labor or services for remuneration” is an “employee rather than an independent contractor.” Under AB5, to establish that services rendered are by an independent contractor, the recipient has the burden of satisfying *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 person (worker) performs work that is outside the usual course of the hiring entity’s business.
- C. The person (worker) is customarily engaged in an independently established trade, occupation or business of the same nature as that involved in the work performed.

While most valid sales rep-principal relationships likely will satisfy these three conditions, AB5 does have some inherent ambiguities which could create some unintended questions and issues. For instance, can condition A be satisfied if a principal requires its sales representatives to provide regular reports as to their sales activities, such as through the use of CRM programs, and, if so, how detailed and how often is too much? Further, can condition B be satisfied if a principal utilizes both a network of independent sales representatives and its own direct selling force? In such instances, it would seem that at least part of the manufacturer’s usual course of business involves sales activities. Is that enough to fail condition B? Ultimately, it will be up to a regulatory agency or court to determine if the activities of a bona fide sales representative under such circumstances satisfy conditions A and B of the ABC Test.

AB5 also expressly provides that its ABC Test *does not* apply to a number of professions and business relationships. Unfortunately, there is not a specific exemption for independent sales representatives, even though California long ago recognized the unique and valuable role independent sales representatives play in commerce, stating

in its “Sales Representative Act,” in part, that “wholesale sales representatives are a key ingredient to the California economy....” Although AB5 doesn’t provide a specific exception for independent sales representatives, it does provide an exception to its ABC Test “to a bona fide business-to-business contracting relationship,” but only if the contracting business (the principal) can demonstrate that the business relationship with its service provider (the independent sales representative) satisfies *all* of the following 12 criteria:

1. The business service provider is free from the control and direction of the contracting business entity in connection with the performance of the work, both under the contract for the performance of the work and in fact.
2. The business service provider is providing services directly to the contracting business rather than to customers of the contracting business.
3. The contract with the business service provider is in writing.
4. If the work is performed in a jurisdiction that requires the business service provider to have a business license or business tax registration, the business service provider has the required business license or business tax registration.
5. The business service provider maintains a business location that is separate from the business or work location of the contracting business.
6. The business service provider is customarily engaged in an independently established business of the same nature as that involved in the work performed.
7. The business service provider actually contracts with other businesses to provide the same or similar services and maintains a clientele without restrictions from the hiring entity.
8. The business service provider advertises and holds itself out to the public as available to provide the same or similar services.
9. The business service provider provides its own tools, vehicles and equipment to perform the services.
10. The business service provider can negotiate its own rates.
11. Consistent with the nature of the work, the business service provider can set its own hours and location of work.
12. The business service provider is not performing the type of work for which a license from the Contractor’s State License Board is required, pursuant to Chapter 9 (commencing with Section 7000) of Division 43 of the Business and Professions Code.

While it would appear that most valid rep-principal relationships would satisfy these conditions, many of them, like the ABC Test itself, are somewhat ambiguous and this means that many will require judicial or regulatory review and interpretation or legislative amendment to determine if this exception covers the business relationship

that exists between independent sales representatives and both their principals and their sub-representatives.

If such relationships are exempt from the ABC Test, they will be examined under and governed by California's pre-existing law (the "Borello Test") which remains in force and effect for those business relationships that are not governed by AB5's ABC Test. The Borello Test examines eleven fact-specific factors to determine if a worker is an employee or an independent contractor. Some of them are similar to the factors included in AB5 (such as whether the work is part of the receiving company's regular business), but others are not (including the degree of permanence of the working relationship, how long the services are to be performed, and the worker's financial investment in equipment and materials). As with the tests used in other jurisdictions, no single factor is determinative of the existence of an employment relationship.

Most at risk under AB5 are those companies that intentionally misclassify their workers/service providers in California as "reps" or "sub-reps" in order to avoid taxes, benefits and other employer obligations. Even if those relationships are the subject of formal rep or sub-rep agreements, and even if the service provider is a business and not an individual, it is doubtful those relationships will withstand scrutiny under AB5's ABC Test, or under any other similar tests.

It also should be noted that California's AB5 is impacting other states whose legislatures presently are exploring similar legislation to address and control the new "gig economy." Therefore, even if your company doesn't use sales representatives or sub-representatives in California and is not directly affected by AB5, it nonetheless should actively monitor developments on this issue in those states where it does.

Coming next month in Part 2:

An equally exciting look at Proposition 65 and its potential impact on your business.

MANA welcomes your comments on this article. Write to us at mana@manaonline.org.



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