# Department of Labor Proposes New Rule Regarding Independent Contractor Classifications

**September 24, 2020**

On September 22, 2020, the U.S. Department of Labor ("DOL") announced a proposed rule, which, if finalized, would make it easier for companies to classify workers as independent contractors under the Fair Labor Standards Act ("FLSA"). Under the FLSA, independent contractors are not eligible for minimum wage and overtime compensation. The new rule proposes a five-factor "economic reality" test for distinguishing employees from independent contractors, clarifying that the concept of economic dependence turns on whether a worker is in business for herself (and therefore an independent contractor) or is economically dependent on a potential employer for work (and therefore an employee).

The risks associated with classifying workers as independent contractors are not abated by this proposed FLSA rule change. Even if the rule change becomes final, employers must in any event still comply with the myriad of other state and local laws applicable to independent contractor classifications in the states where they engage workers (as we previously discussed here). The Internal Revenue Service, National Labor Relations Board and certain states, apply different tests for independent contractor classifications. For example, under California's so-called "ABC" test, the focus largely centers on whether the worker performs work that is outside of the usual course of a hiring entity's business rather than the economic realities. The publication of the proposed rule at the federal level may also trigger states, such as New York, which has been considering legislation in this area, to act faster to enact their own revised tests.

**The Proposed Economic Realities Test**. Currently, to determine whether an individual is an employee or an independent contractor under the FLSA, courts and the DOL look at the "economic reality" of the arrangement. The courts and the DOL analyze the economic realties by applying a multi-factor test with many overlapping facets, and the fact-finder must focus on the totality of the working relationship rather than any specific factor.

The proposed rule sharpens the "economic realities" test by articulating a five-factor test and emphasizing two "core factors" that should be afforded greatest weight. The two core factors are:

- The nature and degree of the worker's control over the work; and
- The worker's opportunity for profit or loss.

These factors, according to the DOL are "highly probative" to the inquiry of economic dependence because the ability to control one's work and earn profits or risk losses are at the center of what it means to be an "entrepreneurial independent contractor."[1] If these factors both point toward a classification that the employee is an independent contractor, the DOL takes the position that that classification is likely accurate.

The other three factors are:

- The amount of skill required to perform the work;
- The degree of permanence of the working relationship between individual and the potential employer; and
- The importance of the services rendered to the company's business.

The proposed rule is expected to move through the rulemaking process on an expedited basis. Once the rule is published, the public will have 30 days to file comments.

**What This Rule Change Could Mean for Employers**. According to the Secretary of Labor, Eugene Scalia, "The department's proposal aims to bring clarity and consistency to the determination of who's an independent contractor under the Fair Labor Standards Act." While the test will lend some clarity to the analysis under the FLSA, the landscape applicable to independent contractor classifications is complex and evolving, especially at state levels.

California passed Assembly Bill 5 last year, which took effect in January 2020, and codified the "ABC" test that generally makes it more difficult to classify workers in the gig economy and many other industries as independent contractors. Several other states have already enacted or are considering similar bills. An ABC test generally provides that a worker is an employee rather than an independent contractor unless the hiring entity can establish that (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. Factor "B" whether the

[1] To read more about the proposed rule, visit the DOL's website here: https://www.dol.gov/newsroom/releases/whd/whd20200922.

worker performs work that is outside of the usual course of a hiring entity's business—is the most difficult factor for businesses to satisfy and is the subject of frequent litigation.

It therefore remains possible for a service provider to be deemed an employee under one law (*e.g.*, FLSA) and an independent contractor under another (*e.g.*, state labor law).

**Recommended Actions to Ensure Proper Independent Contractor Classifications**. Practically speaking, the proposed rule is not likely to decrease the risk of misclassification that is especially heightened for employers in those states where a form of the ABC test applies. To mitigate the risks and liabilities arising from independent contractor misclassifications, companies should consider taking the same protective steps that we have previously recommended here, including:

- Conducting a privileged self-audit to ensure proper classifications under the laws in all jurisdictions where independent contractors are engaged to perform services, particularly with regard to long-tenured independent contractors;
- Evaluating the degree of control that the company maintains over its independent contractors;
- Reviewing and updating independent contractor agreements, or implementing them if none were previously in existence;
- Considering requiring mandatory arbitration agreements with these workers that include class action waivers;
- Reviewing ERISA benefit plans to ensure misclassified independent contractors are not covered; and
- Monitoring for legal developments in those jurisdictions where independent contractors are providing services.

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We will continue to monitor this rule and any changes in law. Please do not hesitate to contact us with any questions.

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