U.S. Department of Labor Announces New Final Rule on Independent Contractors

January 11, 2024

On January 10, 2024, the U.S. Department of Labor (the "DOL") published a final rule that addresses whether workers can be classified as "independent contractors" rather than employees under the Fair Labor Standards Act (the "FLSA"). The final rule establishes a six factor "economic realities" test for determining the status of workers, which focuses on whether workers are economically dependent on the employer for work or in business for themselves. The final rule rescinds a prior rule proposed by the DOL on January 7, 2021 at the end of the Trump administration that never took effect following the change in administrations. The current final rule is set to become effective on March 11, 2024.

Independent Contractor Misclassification Explained. Independent contractors are not protected by most federal, state or local laws intended to protect employees. Their earnings are reported on Form 1099 and are not subject to tax withholding or employment tax remittances, such as FICA and state unemployment and disability insurance contributions, and independent contractors are not eligible for employee benefits, making it considerably more cost efficient for companies to retain workers as independent contractors, if possible. The "gig economy"—in which workers, particularly younger workers, engage in short-term projects with potential greater mobility and independence—has blurred the line between "employee" and "independent contractor" and has been a motivating force behind lawmaking and political rhetoric in recent years.

Misclassifying employees as independent contractors can result in significant liabilities for employers, including payment of back wages to misclassified workers, retroactive tax liabilities (including penalties and interest), legal penalties and fines and reputational risks.

The New Six-Factor Test under the DOL's Final Rule. The final rule applies the following six factors relevant to the economic realities test for analyzing employee or independent contractor status under the FLSA:

1. opportunity for profit or loss depending on managerial skill;
2. investments by the worker and the potential employer;

3. degree of permanence of the work relationship;
4. nature and degree of control;
5. extent to which the work performed is an integral part of the potential employer's business; and
6. skill and initiative.

These six factors should guide an assessment of the economic realities of the working relationship, but no one factor or subset of factors is necessarily dispositive. The DOL stated that these factors are "more consistent with the FLSA as interpreted by longstanding judicial precedent."

One of Many Tests. The DOL's final rule sets a new standard for classifying workers under the FLSA, which is the federal law governing minimum wage, overtime, recordkeeping and other standards for employers. However, the criteria for determining whether a service provider is an independent contractor or an employee vary by jurisdiction and legal authority and may change over time. The Internal Revenue Service, National Labor Relations Board and certain states apply different tests for independent contractor classifications. These tests generally involve considering and weighing multiple factors. While there are some common elements across the various federal and state tests, it is conceivable for a service provider to be classified as an employee under one law (such as the FLSA or federal tax law) and as an independent contractor under another (like state labor law). Employers must navigate and comply with both federal and relevant state laws to ensure proper classification of workers.

Recommended Actions to Ensure Proper Independent Contractor Classifications. It is possible that the DOL's final rule will face legal challenges from business groups. However, even if the DOL's rule is successfully challenged and invalidated, compliance with existing independent contractor laws, including the patchwork of applicable state laws, is critical as noncompliance can lead to significant liabilities. Employers should consider taking protective steps to prevent independent contractor misclassification, including the following:

- evaluating the business's need and use of independent contractors;
- conducting a privileged self-audit to ensure proper classifications of current independent contractors, particularly with regard to long-tenured 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;
- creating an evaluation and approval process for the retention of new independent contractors;
- 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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Please do not hesitate to contact us with any questions.

Jyotin Hamid
Partner, New York
+1 212 909 1031
jhamid@debevoise.com

Jonathan F. Lewis
Partner, New York
+1 212 909 6916
jflewis@debevoise.com

Tricia Bozyk Sherno
Counsel, New York
+1 212 909 6717
tbsherno@debevoise.com

Alison E. Buckley-Serfass
Counsel, Washington, D.C.
+1 202 383 8084
aebuckleyserfass@debevoise.com

Linda Lin
Associate, New York
+1 212 909 6268
llin@debevoise.com