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Labor & Employment Alert

January 16, 2024

DOL narrows definition of "independent contractor" under FLSA

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What's the impact?

- DOL announced new test for determining worker classification under the FLSA.
- The new rule goes into effect on March 11, 2024.
- Companies should review current (and future) independent contractors to ensure compliance with new framework.

On January 9, 2024, the Department of Labor (DOL) announced a six-factor test for determining whether a worker is an employee or an independent contractor under the Fair Labor Standards Act (FLSA). This new rule takes effect on March 11, 2024. This final rule rescinds the proposed 2021 rule, which was held in abeyance in 2021 and is the subject of litigation in the 5th Circuit.

Why is this rule important?

Whether a worker is an employee or an independent contractor matters because being classified as an employee carries with it protections under the FLSA. The same protections do not apply to independent contractors. Moreover, misclassified independent contractors can expose employers to significant potential liability.

What has changed under this final rule?

Prior to 2021, the DOL issued informal guidance on classifying independent contractors with a framework of seven factors, but the ultimate focus was on the specific relationship between worker and employer. In 2020, under the prior administration, the DOL sought to add more structure to this framework and proposed a new five-factor test, which focused on the employer's right to control the work and the worker's opportunity for profit or loss. This rule was finalized in January 2021, but implementation was delayed when the Biden administration took office and has been the subject of litigation over whether the new administration could simply withdraw the rule. In the end, the DOL decided to promulgate a new final rule, which rescinds the 2021 rule.

This new final rule adopts a six-factor test to determine whether a worker qualifies as an independent contractor. This test is similar to guidance issued and case law decided prior to 2021. The six factors are:

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 factors, however, are not exhaustive. The analysis utilizes a totality-of-the-circumstances economic reality approach, which allows consideration of other relevant, but not named, factors, which "in some way indicate whether the worker is in business for themself." Where the worker is dependent on the employer for work, they will not qualify as an independent contractor under this rule.

How will these factors be applied?

This new rule goes into effect on March 11, 2024. The DOL provided some guidance which will help in applying these factors and making determinations regarding whether a worker can lawfully be classified as an independent contractor:

FACTOR 1—OPPORTUNITY FOR PROFIT OR LOSS DEPENDING ON MANAGERIAL SKILL

Facts such as:

> whether the worker determines or can meaningfully negotiate the charge or pay for the work provided; whether the worker accepts or declines jobs or chooses the order and/or time in which the jobs are performed; whether the worker engages in marketing, advertising, or other efforts to expand their business or secure more work; and whether the worker makes decisions to hire others, purchase materials and equipment, and/or rent space

should be considered when evaluating the opportunity for profit or loss. However, a decision to work more hours or take more jobs when paid a fixed rate per hour or per job typically do not require the exercise of managerial skill that would be required for an independent contractor classification.

FACTOR 2—INVESTMENTS BY THE WORKER AND THE POTENTIAL EMPLOYER

Under this factor, employers should consider whether the worker's investments are capital or entrepreneurial—that is, whether they "support an independent business and serve a business-like function, such as increasing the worker's ability to perform different types of or more work, reducing costs, or extending market reach"—and how they compare relative to the employer's investment in the overall business. Costs incurred by a worker for tools and equipment to perform a specific job, of worker's labor, and that the potential employer imposes unilaterally on the worker counsel toward employee, not independent contractor, classification.

FACTOR 3—DEGREE OF PERMANENCE OF THE WORK RELATIONSHIP

To qualify the permanence of a work relationship, employers should review the duration and exclusivity of the work. Where the work relationship is "definite in duration, non-exclusive, project-based, or sporadic based on the worker being in business for themself and marketing their services or labor to multiple entities," then this factor weighs in favor of classification as an independent contractor. Contrarily where "the work relationship is indefinite in duration, continuous, or exclusive of work for other employers," it weighs in favor of classification as an employee. Importantly, seasonal or temporary work alone does not necessarily favor classification as an independent contractor.

FACTOR 4—NATURE AND DEGREE OF CONTROL

Employers should review whether it:

> sets the worker's schedule, supervises the performance of the work, . . . explicitly limits the worker's ability to work for others, uses technological means to supervise the performance of the work, reserves the right to supervise or discipline workers, . . . places demands or restrictions on workers that do not allow them to work for others or work when they choose[, and/or] controls economic aspects of the working relationship. . ., including control over prices or rates for services and the marketing of the services or products provided by the worker.

However, where the employer is acting with the sole purpose to comply with specific, applicable federal, state, local, or tribal law or regulations, this activity alone is not indicative of control such that a worker would have to be classified as an employee.

FACTOR 5—EXTENT TO WHICH THE WORK PERFORMED IS AN INTEGRAL PART OF THE POTENTIAL EMPLOYER'S BUSINESS

Determining whether work is "integral" to the employer's business requires an evaluation of whether the function the worker performs is "critical, necessary, or central" to the company's primary business. This inquiry focuses on the work performed in relating to the business of the company rather than whether the worker themselves is integral to the business. Where the work is not critical or necessary for the company's primary business, then this factor favors classification as an independent contractor.

FACTOR 6—SKILL AND INITIATIVE

Where the worker uses specialized skills for the work and "those skills contribute to business-like initiative," this factor will favor classifying as an independent contractor. Importantly, a specialized skill, which an independent contractor or an employee may have, alone is not determinative. Moreover, where workers rely on the employer for training to perform the work, this factor will favor classification as an employee.

Employers should note that no one factor is determinative and should consider the totality of the factors and which classification each favors to determine whether a worker is properly classified as an independent contractor.

Is the new rule the same as the "ABC Test"?

Some states utilize the so-called "ABC Test" to determine whether a worker is an independent contractor or an employee. The ABC provides a worker can be lawfully classified as an independent contractor *only if all three of these criteria are satisfied*:

1. 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
2. The worker performs work that is outside the usual course of the hiring entity's business; AND
3. The worker is customarily engaged in an independently established trade, occupation, or business of the same nature as that involved in the work performed.

Notably, the new DOL six-factor test discussed above differs from the ABC test. The DOL specifically declined to adopt this three-factor test and chose to

> rely on the long-standing multifactor "economic reality" test used by courts to determine whether a worker is an employee or independent contractor. This test relies on the totality of the circumstances where no one factor is determinative.

That being said, the DOL also specified that the new final rule "only revises the Department's interpretation under the FLSA." The final rule has "no effect on other laws—federal, state, or local—that use different standards for employee classification," including states such as California, Illinois, Massachusetts, New Hampshire, or New Jersey, which use the ABC Test. Because "[t]he FLSA does not preempt any other laws that protect workers, so businesses must comply with all federal, state, and local laws that apply and ensure that they are meeting whichever standard provides workers with the greatest protection."

What's next?

While there is some uncertainty surrounding the new rule and the effect of the pending litigation, as employers review the new rule, they should consider existing and future independent contractor arrangements and how those fit within the new framework as well as existing applicable state and local frameworks. Companies which are heavily reliant on independent contractors or for which their numbers of independent contractors have grown without consideration of some or all of these factors should consider conducting a worker classification audit using the framework provided in this new six-factor test. When reviewing and analyzing their independent contractor relationships, employers should remember that the law presumes every worker is an employee and the employer has the burden of overcoming that presumption for lawful classification of a worker as an independent contractor.

For more information on classification of independent contractors and other FLSA relate issues, please contact your Nixon Peabody attorney or:

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