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Employment Law Note

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U.S. Department of Labor Narrows the Scope of Independent Contractor Classification

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The U.S. Department of Labor (DOL) issued its Final Rule in January 2024, defining "independent contractor" under the Fair Labor Standards Act (FLSA). The new rule, which takes effect March 11, 2024, emphasizes a more employee-focused approach to worker classification.

Background

In January 2021, the DOL published a rule identifying five economic reality factors to consider when determining whether a worker is properly classified as an independent contractor under the FLSA. The 2021 rule highlighted two "core factors"—control over the work and the worker's opportunity for profit or loss—as carrying greater weight in determining the status of independent contractors. The 2021 rule stated that the three remaining factors—the amount of skill required for the work, the degree of permanence of the working relationship, and whether the work is part of an integrated production unit—were less probative of determining worker classification. This test was viewed as an employer-friendly approach to the independent contractor standard.

In October 2022, the DOL published a Proposed Rule regarding independent contractor status under the FLSA, proposing to rescind and replace the 2021 rule's more business-friendly approach for determining worker classification with a more employee-friendly "totality of the circumstances" standard. Fifteen months later, the 2024 Final Rule—which takes effect on March 11, 2024—is mostly consistent with the DOL's proposed version released in 2022.

The Final Rule – Six-Factor Test

The DOL's Final Rule includes a six-factor test focused on the "economic reality" of the relationship between a potential employer and a worker. With the new rule, the DOL has moved away from considering the exercise of control and the opportunity for profit and loss as the "core factors" in the economic realities analysis. Instead, employers would use a totality-of-the-circumstances analysis, in which none of the factors carry greater weight. The six factors include:

1. The worker's opportunity for profit or loss depending on managerial skill. The Final Rule sets forth a non-exhaustive list of facts relevant to this inquiry, including: (1) whether the worker determines the pay for the work provided (or can meaningfully negotiate it); (2) whether the worker accepts or declines jobs or chooses the order and/or time in which the jobs are performed; (3) whether the worker engages in marketing, advertising, or other efforts to expand their business or secure more work; and (4) whether the worker makes decisions to hire others, purchase materials and equipment, and/or rent space. The worker's ability to earn more by working more is not an entrepreneurial opportunity, however, when the worker is paid a fixed rate per hour or per job. In other words, where the hours or jobs are paid at a fixed rate, the worker is more likely to not exercise managerial skill by taking such hours or jobs.

2. Investments by the worker and potential employer. The Final Rule provides that only worker investments that are capital and entrepreneurial—and not unilaterally imposed by a potential employer—will weigh in favor of an independent contractor finding. For example, the DOL states that to support contractor status, investments must "serve a business-like function, such as increasing the worker's ability to do different types of or more work,

reducing costs, or extending market reach." In comparison, the DOL does not view expenses incurred by the worker to perform the job (*e.g.*, tools and equipment to perform a specific job, use of a personal vehicle already owned, costs unilaterally imposed by the company) as capital or entrepreneurial investments supporting contractor status.

3. The degree of permanence of the work relationship. A more permanent or exclusive relationship suggests employee status, while a temporary or project-based one indicates independent contracting. The Final Rule states that this factor favors employee status "when the work relationship is indefinite in duration, continuous, or exclusive of work" for other companies. In contrast, this factor weighs in favor of contractor status "when 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." The Final Rule also states that although a worker's economic dependence on multiple employers may be relevant, it is not determinative of independent contractor status.

4. The nature and degree of the potential employer's control over work performance and working relationship. In contrast to the 2021 rule, which designated this as a "core" factor, the Final Rule does not place heightened emphasis on the "control" factor. The Final Rule provides that setting a worker's schedule, compelling attendance, or directing or supervising the work are examples of "direct" control; however, the worker's power to decline work and maintain a flexible schedule is not alone persuasive evidence of independent contractor status. Further, where the nature of the employer's business or the work to be performed makes direct supervision unnecessary, a lack of physical supervision does not automatically compel a contractor finding. In addition, the Final Rule notes that a worker's ability to set their schedule provides only minimal evidence of independent contractor status if the worker's ability to choose their hours or "arrange the sequence or pace of the work" is dictated by strict requirements imposed by the potential employer that limit the number of available hours or indicate a lack of meaningful scheduling flexibility. The Final Rule also notes that companies may exercise control indirectly, such as setting prices for services, restricting a worker's ability to work for others, and relying on technology to supervise a workforce. Finally, the Final Rule states that the control necessary to comply with specific legal requirements does not necessarily indicate that the worker is an employee. Thus, businesses can take steps to comply with state, federal, tribal, or local laws without affecting the worker's classification.

5. The extent to which the work performed is an integral part of the potential employer's business. The Final Rule focuses this factor on whether "the potential employer could not function without the service performed by the workers." Thus, the new rule shifts the focus of the analysis to whether the business function the worker performs is integral or important rather than whether the individual worker is integral to the organization. The Final Rule suggests that courts should consider "whether the work is important, critical, primary, or necessary." According to the DOL, where a potential employer's primary business is to make a product or provide a service, the workers who make the product or provide the service are integral.

6. The amount of skill and initiative required for the work. The Final Rule states that specialized skill alone does not indicate that the worker is an independent contractor. What is relevant is whether the worker uses a specialized skill "in connection with business-like initiative." Where the work does not require previous experience, the worker is dependent on training from the potential employer to perform the work, or the work requires no training at all, the DOL states that such work likely does not require specialized skill and initiative.

The above six factors are not exhaustive, and the Final Rule allows employers to consider additional factors relevant to the overall question of economic dependence.

Final Thoughts

Employers should note that the DOL's test applies only to the FLSA. The Final Rule does not define who may qualify as an independent contractor under state law, other federal statutes, the Internal Revenue Code, or the National Labor Relations Act. Many states, including Washington, have their own tests to determine worker classification for state-level wage and hour claims. In fact, Washington already factors the Final Rule's elements into the state's independent contractor test, which tends to classify workers as employees.

The implications of misclassifying workers are significant and can lead to DOL complaints and investigations, financial penalties, threatened or actual litigation, monetary damages, and damage to reputation. Although the DOL's Final Rule is not controlling authority for federal courts, the rule will inevitably be cited as persuasive authority for courts considering classification issues. Therefore, employers should consider taking the following actions to mitigate the risk of misclassification:

- Conduct a comprehensive review of existing worker relationships and independent contractor agreements and assess those relationships using the DOL's six-factor test;
- Review and update policies to reflect the new standards;
- Regularly review worker classifications to ensure ongoing compliance, especially when job roles or business models evolve; and
- Train managers on best practices for navigating independent contractor relationships.

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