The Misclassification Conundrum: US DOL Attempts to Bring Clarity and Predictability to the Economic Reality Test, but Should Companies Rely Upon It?

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Determining who is an employee seems like a simple concept, but actually requires a complex analysis that varies depending on the applicable state and statute. The federal Fair Labor Standards Act (FLSA) does not define whether a worker is an independent contractor. Since 1947, the US Supreme Court and the Department of Labor (DOL) have provided guidance on how to make this determination, culminating in what is known as the "economic reality test." Historically, this inquiry into economic dependence was conducted by applying several factors, with no one factor being dispositive, and often analyzing what may be contractually or theoretically possible. On January 6, 2021, the DOL issued a final rule that sharpens this inquiry on five distinct factors, instead of the five or more overlapping factors previously used by the Department and most courts.

Predictability in determining worker classification is critical as the American workforce continues to evolve in response to technology and workplace innovations. The recent growth of the gig economy is a derivative of this evolution. The response to this growth varies, but many states responded by passing legislation restricting the use of contractors and increasing the penalties for contractor misclassification. *See* Is the Gig Economy on Life Support? New York Proposes Process for Sweeping Changes to Worker Classification; The Gig is Up – New Jersey Misclassification Laws Create Extreme Risk for Anyone Utilizing Independent Contractors; AB 5, Codifying Dynamex and Broadening the ABC Test's Application, Passes California Legislature.

Additionally, within the last few years, targeted misclassification lawsuits and government audits were commenced to challenge well-established industry practices using contractors. Examples include challenges to the use of independent owner-operators in the transportation industry, last-mile delivery drivers and contractors working for online delivery services. The new rule addresses these industry

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practices by providing examples of how such contractors may remain independent. See 29 CFR §795.115. However, prior to being lulled into a false sense of security, businesses should keep in mind that:

- many state law tests are still more restrictive than the federal rule,
- courts may refuse to follow the federal rule as the SDNY did with the DOL's recent joint employment regulation (*New York v. Scalia*, No. 1:20-CV-1689-GHW, 2020 U.S. Dist. LEXIS 163498, 2020 WL 5370871 (S.D.N.Y. Sep. 8, 2020),
- President-elect Biden expressly disagrees with the rule and promised he "will put a stop to employers intentionally misclassifying their employees as independent contractors. He will enact legislation that makes worker misclassification a substantive violation of law under all federal labor, employment, and tax laws with additional penalties beyond those imposed for other violations," https://joebiden.com/empowerworkers/, and
- the Democratic Congress intends to amend the FLSA to address this issue.

The New Rule

The DOL rule begins by reaffirming the economic reality test, rescinding any prior DOL guidance or ruling that is inconsistent with the rule and stating that businesses who rely on the rule are entitled to the good faith defense. Sec. 795.105(a). The next section defines an independent contractor as anyone who is "*as a matter of economic reality, in business for him- or herself.*" The rule goes on to provide factors to assist in determining whether an individual is properly classified as an employee or independent contractor. Though the factors are neither exhaustive nor dispositive, the rule makes clear that two factors are the most probative and carry greater weight than any other factor. These factors are:

(1) the nature and degree of control over the work and

(2) the worker's opportunity for profit or loss based on initiative and/or investment.

If these two factors clearly indicate either employee or contractor status, there is a substantial likelihood that the indicated status is accurate. The first factor focuses on who controls the worker's performance of services. For example, who controls the individual's schedule or workload - whether the individual is required to work exclusively for the business. Significantly, the DOL explicitly rejected the contention that compliance with specific legal obligations, such as satisfying health and safety standards, requiring insurance, meeting contractually agreed-upon deadlines, maintaining quality control standards, or satisfying similar contractual terms, may be considered evidence of employee control. The analysis of opportunity for profit and loss should focus on two subfactors: the contractor's exercise of initiative and capital expenditure/investment. The contractor does not need to show that profit or loss are based on both subfactors to be considered an independent contractor. This factor weighs in favor of the individual being an employee if they are unable to affect their earnings or can do so only by working more hours or working faster.

In instances where these factors conflict or it is unclear, three other factors may be used as additional guideposts for the analysis. These factors are: 1) the amount of skill required for the work, 2) the degree of permanence of the working relationship between the worker and the potential employer; and 3) whether the work is part of an integrated unit of production. These are the only factors that should be used to determine economic dependency, but the rule allows any other factor demonstrating that the

contractor is in business for itself to be considered. Finally, when performing this analysis, the actual practices between the worker and the business should be given more weight than what may be contractually or theoretically possible. For example, if the contract allows a business to supervise a worker but in practice the business never supervised the worker, then the analysis should focus on the actual practice and not the authority provided by the contract.

What Does the Future Hold for Independent Contractors?

As some may recall, during the Obama administration the DOL's Wage and Hour Administrator issued a written interpretation creating a presumption that all workers were employees. This interpretation and all other administrator interpretations were subsequently rescinded by the Trump administration. Within that same year, the Democrats proposed legislation, the Employee Misclassification Act of 2015 and Payroll Fraud Protection Act of 2015, proposed to restrict a business' ability to use contractors; however, both attempts failed. The new Democratic Congress is expected to amend the FLSA, which may include a presumption of employee status (as advocated by the Obama administration), adopting an ABC test similar to the tests used in California and New Jersey (a Biden campaign promise) and substantial penalties for violations. Therefore, misclassification liability is likely to increase over the next few years and not decrease. Reliance solely on the DOL's new rule should provide a good faith defense under the FLSA against liquidated damages and a finding of willfulness that will limit liability to two years, but will not absolve a business of all liability. For example, this rule would not mitigate liability under New Jersey state law that uses the more restrictive ABC test, provides for a six-year statute of limitations and allows for triple damages as well as additional fines and penalties.

In its preamble to the Rule, the DOL discussed why it is not able to adopt the ABC test, noting doing so would be "unduly restrictive and disruptive to the economy" and "inconsistent with the more flexible economic reality test adopted by the Supreme Court, as it would cover workers who have been held by the Supreme Court to be independent contractors under the economic reality test." The DOL also discussed the change to a predominant two factor test, and emphasized that it is clarifying an existing standard, not "radically transforming it," meaning rescinding the rule will likely be more challenging to the Biden appointed agency. Our prediction is that the modification of this rule will be made by new legislation passed by the Democratic Congressional majority, rather than a revised regulation issued by a Biden-appointed DOL.

The take away for businesses is that this rule has limited applicability, particularly in those jurisdictions (e.g., California, Massachusetts and New Jersey) that have much more restrictive state law. The rule may provide businesses with a good faith defense, but even in these situations, there may be FLSA liability for minimum and overtime wages. More importantly, businesses should pay particular attention to state laws where they operate, which may impose stricter standards and substantial penalties.

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