Businesses Will Struggle to Classify Workers as Independent Contractors Thanks to New DOL Rule: 5 Takeaways

Insights
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Businesses will soon find it harder to classify workers as independent contractors thanks to key changes made by the U.S. Department of Labor (DOL) today. The Biden administration officially rescinded a rule that made it easier to classify workers as independent contractors under federal wage and hour rules. In its place, businesses will be forced to follow an outdated standard that will likely result in more workers being classified as employees. What do you need to know about the new rule before it takes effect on March 11? Read on for our five key takeaways.

1. New Rule Tilts Playing Field Against Businesses

The new rule will reinstate a more complex analysis that focuses on the "totality of the circumstances" to determine whether a worker is an employee or independent contractor. But it will also use an employee-friendly interpretation of how each of the factors in the test should be applied – leading to more workers being classified as employees.

The prior rule applied the traditional economic realities test by weighing five factors and determining whether the worker is in business for themselves (and thus a contractor) or economically dependent on the hiring entity (and thus an employee):

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

Under the old rule, the first two points were key to the analysis and therefore were afforded greater weight than the other factors. Moreover, when evaluating the individual's economic dependence on the potential employer, "the actual practice of the parties involved" was more relevant than what may be contractually or theoretically possible. But this is all changing under the new rule – and becoming more difficult for businesses that rely on contractors.

2. Totality Test Will Lead to More Workers Being Classified as Employees

The rule that is about to be scrapped primarily focused on two "core factors":

- The extent of control exercised over key aspects of the work; and
- The opportunity for profit or loss.

The new rule scraps the use of these factors and returns to a "totality-of-the-circumstances analysis." Under the rule, "the factors do not have a predetermined weight and are considered in view of the economic reality of the whole activity." The six factors set forth in the new rule are:

- The worker's opportunity for profit or loss depending on managerial skill;
- The relative amount of investment made by the worker in comparison to investments made by the potential employer;
- The permanency of the worker's relationship with the potential employer;
- The nature and degree of the potential employer's control;
- The extent to which the work performed is an integral part of the potential employer's business; and
- Whether the worker uses specialized skills indicative of business-like initiative.

In addition, the new rule states that "additional factors may also be considered if they are relevant to the overall question of economic dependence."

3. State Rules Still Apply

Employers should note that the DOL's test applies only to the Fair Labor Standards Act (FLSA), and many states have their own tests that are applied to state-level wage and hour claims. While some states such as Arizona have laws protecting the independent contractor relationship if certain criteria are met, other states have laws making it harder to establish an independent contractor relationship.

For example, California, Illinois, New Jersey, and Massachusetts are among the states that apply a stringent "ABC test." A worker is considered an employee under the ABC test unless the hiring entity establishes all three of these prongs:

- The worker is free from the control and direction of the hirer in connection with the performance of the work, both under the contract for the performance of such work and in fact;
- The worker performs work that is outside the usual course of the hiring entity's business; and
- The worker is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed for the hiring entity.

The ABC test makes it much more difficult for many companies to treat workers as independent contractors, and more difficult for businesses to hire smaller, entrepreneurial businesses.

You should also recognize that, at the federal level, the National Labor Relations Board and other agencies may apply different tests than the DOL uses for FLSA cases.

4. Businesses Will Face Increased Liability Risk

Under federal wage and hour law, employees are entitled to certain benefits such as a minimum wage and overtime premiums. But most businesses do not provide these benefits to independent contractors. These forms of compensation do not always square with the way contractors carry out work compared to typical employees, and the law does not require businesses to provide them.

Once this new rule takes effect, the risk of misclassification will skyrocket. Which means that more businesses face potential liability for not paying these benefits to their workers. The ramifications can be staggering: class-action lawsuits, large settlement demands, backpay, liquidated damages, interest, penalties, and attorneys' fees can all quickly add up.

5. What Should You Do?

Businesses that rely on use of independent contractors are at substantial risk of having that classification challenged by the DOL or in private litigation and should proactively take steps to mitigate the risk of a misclassification. Compliance is key for many organizations, and you should consider taking the following actions:

- **Conduct audits:** Businesses that are part of the gig economy or have freelancers or independent contractors should perform internal audits to assess their level of risk for misclassification.
- **Determine any classification changes:** Since the new rule will make it harder to classify workers as independent contractors, some of your existing contractors may no longer meet the criteria and you'll need to make changes to comply.
- **Update policies and procedures:** Review your workforce planning model – as well as your protocols for engagements with gig workers and other independent contractors – to see if updates need to be made in accordance with the DOL's final rule.
- **Train managers:** Take the opportunity to train your managers on best practices for navigating independent contractor relationships.
- **Work with Counsel:** Classification issues are complicated, and errors can result in major consequences with huge costs for businesses. So, it's a good idea to work with experienced counsel before the new rule takes effect to evaluate your programs and minimize your risks.
- **Attend Our Webinar on January 10 to Learn More:** This webinar will cover the benefits and risks of employing independent contractors with the primary focus on the applicable legal standards that apply at the federal, state, and local levels. *Register here.*

We expect business groups to immediately challenge the new rule in court. However, while it is possible that the rule gets stalled by litigation, businesses cannot rely on such an outcome and need to prepare for the new standard. And employers in states such as California, Illinois, New Jersey, and Massachusetts need to closely analyze their relationship with contractors and freelancers since those states follow the stringent ABC test.

Conclusion

We will monitor these developments and provide updates as warranted, so make sure that you are subscribed to Fisher Phillips' Insights to get the most up-to-date information direct to your inbox. If you have compliance questions, consult with your Fisher Phillips attorney, the authors of this Insight, or any member of our Wage and Hour Practice Group or Gig Economy Team to assess and minimize potential risks.

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