

September 29, 2020

## U.S. Department of Labor Proposes Independent Contractor Regulation

On September 22, the U.S. Department of Labor (the “DOL”) announced a proposed rule (the “PR”)<sup>1</sup> revising its interpretation of independent contractor status under the Fair Labor Standards Act (the “FLSA”)<sup>2</sup> and adopting the “economic reality” test for determining such status. Once finalized, the PR would serve as the DOL’s “sole and authoritative interpretation of independent contractor status under the FLSA.”<sup>3</sup> In particular, the DOL noted that the PR seeks to address the legal uncertainty around the definition of independent contractor that “may deter innovative work arrangements by creating legal risks with respect to misclassifying workers as independent contractors instead of employees.”<sup>4</sup>

The “economic reality” test for distinguishing employees from independent contractors under the FLSA, as articulated in the PR, clarifies that “workers who are in business for themselves with respect to work being performed are independent contractors for that type of work.”<sup>5</sup> Under the PR, there are two “core factors” that are “highly probative” to the economic reality test: (1) the nature and degree of the worker’s control over the work; and (2) the worker’s opportunity for profit or loss.<sup>6</sup> In addition, three other factors may be considered: (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.<sup>7</sup> The PR also advises that “the actual practice of the parties involved is more relevant than what may be contractually or theoretically possible.”<sup>8</sup> The PR was published on the Federal Register on September 25 and the public will have 30 days from the date of publication to submit comments.

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<sup>1</sup> Independent Contractor Status Under the Fair Labor Standards Act (Sept. 22, 2020) (to be codified at 29 CFR Parts 780, 788, and 795), [https://www.dol.gov/sites/dolgov/files/WHD/flsa/IC\\_NPRM\\_092220.pdf](https://www.dol.gov/sites/dolgov/files/WHD/flsa/IC_NPRM_092220.pdf).

<sup>2</sup> 29 U.S.C. § 203.

<sup>3</sup> PR at 21.

<sup>4</sup> PR at 40. The DOL estimates that the total number of independent contractors in the country ranges from 6.1 % to 14.1 % of workers. According to the DOL, an expansion of independent contracting could lead to (i) increased job creation; (ii) increased competition and decreased prices; and (iii) a more flexible and dynamic work force.

<sup>5</sup> PR at 49.

<sup>6</sup> PR at 51.

<sup>7</sup> PR at 42.

<sup>8</sup> PR at 158.

The PR will only apply to the FLSA and does not apply with respect to other federal, state or local laws that may apply different tests for independent contractor classifications. Thus, even if the PR becomes final, states and localities may choose to maintain and/or establish more stringent standards that make it more difficult to classify a worker as an independent contractor.

## **I. Background**

The FLSA requires covered employers to pay their nonexempt employees at least the federal minimum wage for every hour worked and overtime pay for every hour worked over 40 in a workweek, and mandates that employers keep certain records regarding their employees.<sup>9</sup> These requirements do not apply to independent contractors, but the FLSA does not define that term. The FLSA does, however, define “employer” to include “any person acting directly or indirectly in the interest of an employer in relation to an employee,”<sup>10</sup> “employee” as “any individual employed by an employer,”<sup>11</sup> and “employ” as “includ[ing] to suffer or permit to work.”<sup>12</sup>

The DOL has never issued a generally applicable regulation addressing the question of who is an independent contractor and, thus, not an employee under the FLSA.<sup>13</sup> Instead, since 1954, DOL has issued and revised its guidance using different variations of a multifactor economic reality test that analyzes economic dependence to distinguish independent contractors from employees.<sup>14</sup> In April 2019, the DOL set forth the following six factors as being relevant to this question: (1) the nature and degree of the potential employer’s control; (2) the permanency of the worker’s relationship with the potential employer; (3) the amount of the worker’s investment in facilities, equipment or helpers; (4) the amount of skill, initiative, judgment or foresight required for the worker’s services; (5) the worker’s opportunities for profit or loss; and (6) the extent of integration of the worker’s services into the potential employer’s business.<sup>15</sup>

For decades, courts have put forward varying standards for determining whether a worker is an employee or an independent contractor. In 1947, the Supreme Court in *Rutherford Food Corp. v. McComb* acknowledged that while the definition of “employ” is “broad,” there “may be independent contractors . . .

<sup>9</sup> See DOL, “Minimum Wage,” “Overtime Pay,” “Hours worked,” and “Recordkeeping,” available at <https://www.dol.gov/agencies/whd>.

<sup>10</sup> 29 U.S.C. 203(d).

<sup>11</sup> 29 U.S.C. 203 (e).

<sup>12</sup> 29 U.S.C. 203(g).

<sup>13</sup> PR at 21.

<sup>14</sup> See PR at 21.

<sup>15</sup> PR at 139.

who would alone be responsible for the wages and hours of their own employees.”<sup>16</sup> Following the *Rutherford Food Corp.* decision, federal courts of appeals have adopted different multi-factored tests to determine whether a worker is an independent contractor under the FLSA. As the DOL noted, while most courts of appeals have articulated a similar test, the application of the independent contractor test between courts varies significantly.<sup>17</sup> The Fifth Circuit adopted a five-factor test to assess economic dependence.<sup>18</sup> The Second Circuit also adopted the five economic reality factor test, but “analyzed opportunity for profit or loss and investment . . . together as one factor.”<sup>19</sup> The Ninth Circuit, on the other hand, adopted a six-factor test involving: (1) the degree of the alleged employer’s right to control the manner in which the work is to be performed; (2) the alleged employee’s opportunity for profit or loss depending on his managerial skill; (3) the alleged employee’s investment in equipment or materials required for his task, or his employment of helpers; (4) whether the service rendered requires a special skill; (5) the degree of permanency of the working relationship; and (6) whether the service rendered is an integral part of the alleged employer’s business.<sup>20</sup>

### *Regulatory Alternatives Considered*

The DOL noted that it considered and rejected the following three alternatives to the PR, listed from least to most restrictive of independent contracting: (1) codification of a common law control test; (2) codification of the DOL’s traditional six-factor “economic reality” balancing test; and (3) codification of the “ABC” test,<sup>21</sup> as adopted by the California Supreme Court.<sup>22</sup>

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<sup>16</sup> *Rutherford Food Corp. v. McComb*, 331 U.S. 722, 729, 67 S. Ct. 1473, 1476, 91 L. Ed. 1772 (1947). In *Rutherford Food*, the Supreme Court held that the meat boners at issue were employees, not independent contractors, under the FLSA.

<sup>17</sup> PR at 15.

<sup>18</sup> *Usery v. Pilgrim Equip. Co.*, 527 F.2d 1308, 1311 (5th Cir. 1976) (identifying “[f]ive considerations [which] have been set out as aids to making the determination of dependence, vel non”); see also *Hobbs v. Petroplex Pipe & Constr., Inc.*, 946 F.3d 824, 829 (5th Cir. 2020). The Fifth Circuit’s test does not include the sixth factor in the Ninth Circuit’s test, which analyzes the integrality of the work.

<sup>19</sup> PR at 15; see *Brock v. Superior Care, Inc.*, 840 F.2d 1054, 1058 (2d Cir. 1988). More recently, a Second Circuit court has recognized that the Circuit “developed three tests—or, more accurately, three sets of factors—to guide [the] determination of whether a joint employment relationship exists,” one of which is the test adopted in the *Brock* case. *Greenawalt v. AT & T Mobility LLC*, 642 F. App’x 36, 37 (2d Cir. 2016).

<sup>20</sup> *Real v. Driscoll Strawberry Assocs., Inc.*, 603 F.2d 748, 754 (9th Cir. 1979). The Ninth Circuit endorsed the six-factor test as recently as in 2017 in *Iontchev v. AAA Cab Serv., Inc.*, 685 F. App’x 548, 550 (9th Cir. 2017).

<sup>21</sup> *Dynamex Operations W., Inc. v. Superior Court*, 416 P.3d 1 (Cal. 2018).

<sup>22</sup> PR at 135–36.

A common control test is generally used to determine independent contractor classifications arising under the Internal Revenue Code and various other federal laws.<sup>23</sup> According to the DOL, the test, which focuses on “the hiring party’s right to control the manner and means by which work is accomplished,”<sup>24</sup> would “increas[e] the overall number of independent contractors and reduc[e] the overall number of employees,” potentially “impos[ing] burdens on workers who might prefer to be employees subject to FLSA protections.”<sup>25</sup> Based on the Supreme Court precedents demanding a broader definition of employment than that exists under the common law,<sup>26</sup> the DOL concluded that it is “legally constrained” from adopting this approach.<sup>27</sup>

The DOL further rejected its own six-factor balancing test, described above, explaining that while its prior test is neither more nor less permissive than the PR, the new test has the potential to improve clarity and reduce FLSA litigation.<sup>28</sup>

The DOL also considered and rejected a more stringent alternative, the “ABC” test adopted under California’s state wage and hour law.<sup>29</sup> The ABC test “presumptively considers all workers to be employees, and permits workers to be classified as independent contractors only if the hiring business demonstrates that the worker in question satisfies each of three conditions: (a) that 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 the work and in fact; *and* (b) that the worker performs work that is outside the usual course of the hiring entity’s business; *and* (c) that the worker is customarily engaged in an independently established trade, occupation, or business of the same nature as that involved in the work performed.”<sup>30</sup> The DOL stated that “it is legally constrained” from adopting the ABC test because it is “inconsistent with the Supreme Court precedent interpreting the FLSA,” which applies the economic reality test to determine

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<sup>23</sup> PR at 137.

<sup>24</sup> PR at 137 (quoting *Community for Creative Non-Violence v. Reid*, 490 U.S. 730, 751 (1989) (quotation marks and alteration omitted).

<sup>25</sup> PR at 138.

<sup>26</sup> The Supreme Court has interpreted the “suffer or permit” language in section 3(g) of the FLSA as demanding a broader definition of employment than that which exists under the common law. *See, e.g., Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318, 326 (1992); *Walling v. Portland Terminal Co.*, 330 U.S. 148, 150–51 (1947).

<sup>27</sup> PR at 139.

<sup>28</sup> *See* PR at 140.

<sup>29</sup> PR at 141.

<sup>30</sup> *Dynamex Operations W., Inc.*, 416 P.3d at 34 (emphasis in original).

independent contractor status.<sup>31</sup> The DOL appears to have concluded that the ABC test is not be entitled to *Chevron* deference, unlike its own interpretation of the FLSA.<sup>32</sup> The DOL also noted that endorsing the ABC test would be “unduly restrictive and disruptive to the economy”<sup>33</sup> because it would “directly result in a large-scale reclassification of many workers presently classified as independent contractors into FLSA-covered employees.”<sup>34</sup>

Notably, Democratic presidential nominee Joe Biden has said that he would “establish a federal standard modeled on the ABC test for all labor, employment, and tax laws.”<sup>35</sup> Biden stated that the stronger three-prong ABC test would offer more protection and benefits to workers.

## II. PR

The DOL explained that the PR is intended to clear up confusion resulting from different judicial tests and to reassess the relative weight afforded to different factors in those tests in the modern economy.<sup>36</sup>

### *Independent Contractors Are Not Employees*

The PR reaffirms that an independent contractor is not an employee under the FLSA, and that its requirements with respect to employees do not apply with respect to independent contractors.<sup>37</sup>

### *Economic Reality Test*

Under the PR’s economic reality test, the “central inquiry” as to whether an individual is an employee or independent contractor under the FLSA is whether the individual is economically dependent on the potential employer for work.<sup>38</sup> The DOL explained that this inquiry codifies the Supreme Court’s statement

<sup>31</sup> PR at 143–44. See *Tony & Susan Alamo Found. v. Sec’y of Labor*, 471 U.S. 290, 301 (1985) (“The test of employment under the FLSA is one of ‘economic reality.’”); *Goldberg v. Whitaker House Cooperative, Inc.*, 366 U.S. 28, 33 (1961) (“‘economic reality’ rather than ‘technical concepts’ is . . . the test of employment” under the FLSA) (citation omitted).

<sup>32</sup> *Chevron, U.S.A., Inc. v. Nat. Res. Def. Council, Inc.*, 467 U.S. 837, 844 (1984). The *Chevron* doctrine refers to the principle of judicial deference given to administrative actions when the Congress “has explicitly left a gap” for an agency to fill and the agency’s interpretation of the statute is not “arbitrary, capricious, or manifestly contrary to the statute.” *Id.*

<sup>33</sup> PR at 143.

<sup>34</sup> PR at 142.

<sup>35</sup> Joe Biden for President: Official Campaign Website, available at <https://joebiden.com/empowerworkers/> (last visited Sept. 29, 2020).

<sup>36</sup> See PR at 21–39.

<sup>37</sup> PR at 154–55 (§ 795.105).

<sup>38</sup> PR at 46.

in the *Darden* case that “suffer or permit” under the FLSA means something broader than the common law conception of control; namely, economic dependence.<sup>39</sup>

The PR measures economic dependence using two “core factors,” (1) the nature and degree of the worker’s control over the work and (2) the worker’s opportunity for profit or loss. Three additional factors may be considered: (3) the amount of skill required for the work; (4) the degree of permanence of the working relationship between the worker and the potential employer; and (5) whether the work is part of an integrated unit of production.<sup>40</sup> These factors are not exhaustive, and no single factor is dispositive.<sup>41</sup> However, if the two core factors, each of which is afforded greater weight, point towards the same classification, there is a “substantial likelihood that is the individual’s accurate classification.”<sup>42</sup> The non-core factors are less probative, and thus, are “highly unlikely, either individually or collectively,” to outweigh the combined weight of the two core factors.<sup>43</sup> The PR provides examples of an individual’s substantial control, which include setting his or her own work schedule, choosing assignments, working with little or no supervision, and being able to work for others, including a potential employer’s competitors.<sup>44</sup>

Under the DOL’s proposed rule, requiring an individual to comply with specific legal obligations, satisfy health and safety standards, carry insurance, meet contractually agreed-upon deadlines or quality control standards, or satisfy other similar terms that are typical of contractual relationships between businesses “does not constitute control that makes the individual more or less likely to be an employee” under the FLSA.<sup>45</sup> Furthermore, the PR explains that control exercised by a potential joint employer over a contractor’s employees to “ensure compliance with various safety and security regulations” is “qualitatively different” from control that indicates employer status.<sup>46</sup>

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<sup>39</sup> PR at 46 (citing *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318, 326 (1992) (“[T]he FLSA . . . defines the verb ‘employ’ expansively to mean ‘suffer or permit to work.’ This . . . definition, whose striking breadth we have previously noted, stretches the meaning of ‘employee’ to cover some parties who might not qualify as such under a strict application of traditional agency law principles.”)).

<sup>40</sup> PR 156–58.

<sup>41</sup> PR at 155.

<sup>42</sup> PR at 155–56.

<sup>43</sup> PR at 156.

<sup>44</sup> PR at 52.

<sup>45</sup> PR at 54.

<sup>46</sup> PR at 55.

### *Primacy of Actual Practice*

While acknowledging that “[c]ontractual and theoretical possibilities are also part of the economic reality of the parties’ relationship,” the DOL emphasized that actual practice of the parties involved—both of the worker (or workers) at issue and of the potential employer—is more relevant than those possibilities.<sup>47</sup> The DOL explained that this approach is derived from and comports with the Supreme Court’s ruling in *Whitaker House* that “‘economic reality’ rather than ‘technical concepts’ is to be the test of employment” under the FLSA.<sup>48</sup>

### **III. Interaction with Other Standards**

Even if the economic reality test as articulated in the PR is adopted as the final rule for determining independent contractor status the FLSA, it would not affect how independent contractor classification is determined under other federal laws. For example, a common law agency test determines whether a worker is an independent contractor under the NLRA, a federal law that grants employees the right to form or join unions and engage in protected activities to address working conditions.<sup>49</sup> The Supreme Court applies the “principles of general common law of agency”<sup>50</sup> to determine independent contractor status under the Copyright Act of 1976 and has adopted “a common-law test”<sup>51</sup> for determining who qualifies as an “employee” under ERISA.

Additionally, the FLSA does not preempt state wage and hour laws,<sup>52</sup> and states are permitted to set more stringent standards that make it harder to classify a worker as an independent contractor, as long as they are not inconsistent with the general goals of the FLSA.<sup>53</sup> It remains to be seen whether and how different states may react to the DOL’s proposal. For instance, in California, Proposition 22 is on the ballot, which would establish different criteria for determining whether app-based transportation and delivery drivers

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<sup>47</sup> PR at 88.

<sup>48</sup> PR at 88–89 (quoting *Goldberg v. Whitaker House Cooperative, Inc.*, 366 U.S. 28, 33 (1961)). The PR notes that *Whitaker House* is the only post-*Rutherford Food* Supreme Court decision analyzing whether workers were employees or independent contractors under the FLSA. PR at 76.

<sup>49</sup> See *SuperShuttle DFW*, N.L.R.B., 16-RC-010963 (January 25, 2019). The NLRA excludes from the definition of a covered employee “any individual having the status of an independent contractor.” 29 U.S.C. § 152(3).

<sup>50</sup> *Community for Creative Non-Violence v. Reid*, 490 U.S. 730, 751 (1989).

<sup>51</sup> *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318, 323 (1992).

<sup>52</sup> See *Hart v. Rick’s Cabaret Int’l, Inc.*, 967 F. Supp. 2d 901, 922 (S.D.N.Y. 2013) (“The Second Circuit, however, has recently noted that the FLSA and NYLL analyses may differ.”); *Hayward v. IBI Armored Servs., Inc.*, 954 F.3d 573, 575 n.2 (2d Cir. 2020).

<sup>53</sup> See *Metro. Life Ins. Co. v. Massachusetts*, 471 U.S. 724, 757 (1985).

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are “employees” or “independent contractors,” and, among other things, would require companies with independent contractor drivers to provide specified alternative benefits, including: minimum compensation and healthcare subsidies based on engaged driving time, vehicle insurance, safety training, and sexual harassment policies.<sup>54</sup>

#### **IV. Implications for Employers**

- As the PR and the final rule would only address classification of workers under the FLSA, employers should maintain compliance with all other potentially relevant federal, state and local law concerning classification of employees under other statutes.
- Employers should consider reviewing and updating independent contractor agreements with an eye toward the two core factors identified in the PR.
- Employers should consider evaluating the economic reality/actual practice surrounding their independent contractor and employee relationships against the PR test to ensure proper classifications under the FLSA.
- Employers should review ERISA benefit plans to ensure misclassified independent contractors are not covered under the plans.
- As the DOL may make adjustments to the test articulated in the PR based on public comments, employers should monitor for additional developments to ensure proper classifications under the FLSA.

The PR can be found [here](#).

The DOL news release announcing the promulgation of the PR can be found [here](#).

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<sup>54</sup> Proposition 22, 1883. (19-0026A1), Changes Employment Classification Rules for App-Based Transportation Drivers. Initiative Statute, available at <https://www.sos.ca.gov/elections/ballot-measures/qualified-ballot-measures>.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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