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US Department of Labor Issues Final Rule on Independent Contractor Status

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On January 10, 2024, the US Department of Labor (DOL) published its final rule for modifying its existing test to determine whether a worker is an independent contractor or an employee under the Fair Labor Standards Act (FLSA). The rule will take effect on March 11, 2024.

As we previously reported, in October 2022, the DOL proposed a rule that would adopt a six-factor "economic reality" test, a framework the agency stated is more consistent with the FLSA. The final rule adopted by the DOL differs minimally from the proposed rule and formally rescinds the more employer-friendly five-factor test to assess a worker's economic dependence, issued during the Trump administration.

The final rule's six nonexhaustive 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 over the work.
5. Extent to which the work performed is an integral part of the potential employer's business.
6. Skill and initiative.

Unlike the prior rule, which had emphasized two core factors (the nature and degree of the worker's control over the work and the worker's opportunity for profit or loss), no one factor is intended to be weighed more heavily than another when analyzing whether a worker is properly classified. The economic reality test set forth by the final rule focuses more broadly on a worker's economic dependence on an employer, considering the totality of the circumstances.

Differences from the proposed rule

In response to receiving 55,400 comments, the final rule includes the following changes from the proposed rule:

Opportunity for profit or loss factor

This factor considers whether the worker has opportunities for profit or loss based on managerial skill, where a worker who has no such opportunity is likely to be considered an employee. Some comments raised concerns that the proposed rule failed to consider that a worker's ability to freely choose among jobs based on the worker's assessment of their comparable profitability could indicate contractor status. Thus, the final rule clarifies that "some decisions by a worker that can affect the amount of pay that a worker receives, such as the decision to work more hours or take more jobs *when paid a fixed rate per hour or per job*, generally do not reflect the exercise of managerial skill indicating independent contractor status under this factor." Where the hours or jobs are paid at a fixed rate, the DOL notes that the worker is more likely to not exercise managerial skill by taking such hours or jobs.

Degree of permanence factor

Where the work relationship is indefinite, continuous or exclusive, the worker is likely to be considered an employee, whereas work that is nonexclusive, definite in duration, sporadic or project-based indicates that a worker is in business for themselves. The final rule acknowledges that a lack of permanence may, in some cases, be due to the operational characteristics that are unique or intrinsic to particular businesses or industries. Thus, the final rule clarifies that the overall question under this factor is whether short periods of work are due to workers acting independently to obtain business opportunities or due to operational characteristics of particular industries: "[w]here a lack of permanence is due to operational characteristics that are unique or intrinsic to particular businesses or industries and the workers they employ, this factor is not necessarily indicative of independent contractor status *unless the worker is exercising their own independent business initiative*."

Nature and degree of control factor

The proposed rule stated that control implemented for purposes of complying with legal obligations may be indicative of employee status. Numerous comments expressed concerns that a hiring party cannot avoid certain legally required degrees of control because it is imposed by the government, not by a client or hiring party. In response, the final rule states, "Actions taken by the potential employer that go beyond compliance with a specific, applicable Federal, State, Tribal, or local law or regulation and instead serve the potential employer's own compliance methods, safety, quality control, or contractual or customer service standards may be indicative of control." Thus, actions taken by the potential employer for the **sole purpose** of complying with specific law or regulation would not indicate employer control.

Investments by the worker and the potential employer

The final rule addresses comments concerning the DOL's proposal to consider the relative investments of the worker and the potential employer. Investments that are "capital or entrepreneurial in nature" suggest contractor status. The DOL explains that investments should be compared not only on a quantitative basis, but also qualitatively. The final rule now states, "consideration of the relative investments of the worker and the potential employer should be compared not only in terms of dollar value or size of the investments, but should focus on whether the worker is making similar types of investments as the employer (albeit on a smaller scale) that would suggest that the worker is operating independently." In addition, in response to comments that some costs – which could be capital or entrepreneurial in nature – are posed unilaterally by potential employers on workers, the DOL also clarifies that such costs are not indicative of a worker's capital or entrepreneurial investments.

Skill and initiative factor

The DOL explains that the use of specialized skills is just one part of the inquiry, and workers who lack specialized skills may still be independent contractors. Indeed, the critical question in applying this factor is whether the worker uses their specialized skills in connection with business-like initiative, rather than merely considering whether a worker has specialized skills, as that focus is probative of the ultimate question of economic dependence.

Employer implications

The final rule is already being challenged in court. For example, freelance writers and editors promptly filed a lawsuit in federal court in Georgia, alleging, among other things, that the rule is inconsistent with the FLSA, is so vague that it violates the Administrative Procedure Act and the Constitution, and "obscures the line between contractor and employee in an impenetrable fog." While litigation is pending, however, employers should be prepared to face more challenges to their classification of workers, as the final rule will make it more difficult for certain workers to qualify as independent contractors under the FLSA.

Misclassifying employees as contractors can impose significant costs – including unpaid minimum wages and overtime, liquidated damages, and civil penalties. As such, employers may consider conducting an audit of their independent contractors, including reviewing independent contractor agreements and work descriptions and correcting any misclassifications. Employers also should ensure that their agreements with contractors are drafted in a way that will help establish that the individual is a contractor and not an employee. To the extent that smaller employers reclassify large numbers of contractors as employees, they also should be aware of any coverage thresholds for employee benefits and leaves under federal, state or local law that they may now be obligated to provide as a result of having a higher employee population.

While the final rule has a significant impact on classification under the FLSA, employers should note that courts are not required to follow the DOL's interpretation of the FLSA. Employers also should note that many states use different classification tests – such as the ABC test, which the final rule expressly declined to adopt. As the DOL itself noted, "The final rule only revises the Department's interpretation under the FLSA. It has no effect on other laws—federal, state, or local—that use different standards for employee classification. … The 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." As such, employers in states like California and Massachusetts must continue to comply with the ABC test and more stringent classification tests, despite the DOL's final rule.

If you have any questions about the final rule, please reach out to a member of the Cooley employment team.

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