Proposed DOL Rule to Help Define "Employee" vs. "Independent Contractor"

Companies that use independent contractors can cut costs and boost productivity. But some businesses have run afoul of federal and state laws by classifying workers as independent contractors when they are really employees. Because various definitions of "independent contractor" have emerged under federal and state laws, determining whether workers are independent contractors or employees is confusing, causing courts—and businesses—to inconsistently classify workers.

To bring clarity and consistency to this process, the Department of Labor's (DOL's) Wage and Hour Division has proposed changes. On September 25, 2020, it published a notice of proposed rulemaking to help define "employee" under the Fair Labor Standards Act (FLSA), which sets the standards for minimum wage and overtime payments. This change should "promote certainty for stakeholders, reduce litigation, and encourage innovation in the economy."

FLSA Economic Reality Test

Currently, the FLSA defines "employee" as "any individual employed by an employer" and defines "employ" as "to suffer or permit to work." These circular and vague definitions are decidedly unhelpful and have led to numerous rule changes and court cases dating back to 1947. The Supreme Court has ruled that these definitions rely on the "economic reality" of the relationship between the parties: is the worker dependent on someone else's business or in business for himself? This determination was generally based on the following six factors.

1. Degree of control over the work performed
2. Worker's opportunities for profit or loss
3. Worker's investment in equipment or facilities
4. Permanency of the working relationship
5. Special skill required by the task or service
6. Whether the work was part of the integrated unit of production

Since these factors have emerged—and have been refined—the courts have generally considered them when determining the economic reality of the relationship. But decisions were still inconsistent because different courts would give more or less weight to different aspects of the test; no factor had been clearly identified as being more important than another. Some of the factors overlapped, so the same facts could be considered under multiple factors, resulting in a skewed analysis. For example, a worker's investment in equipment (one factor) could also have a direct effect on the worker's profit or loss (a separate factor).

New Economic Reality Test

The DOL's proposed rule adds a simpler "economic reality" test to the FLSA regulations, which will replace its previous interpretations. Five of the six factors remain, supporting the DOL's intent "to clarify the existing standard, not to radically transform it."

1. Degree of control an individual has over his or her work
2. Opportunity for individual profit or loss

3. Amount of skill required to do the work
4. Degree of permanence of the working relationship between the worker and employer
5. Degree to which a worker's output is integrated into other elements of the employer's products or services

The big difference is that now, the first two factors—control and opportunity for profit or loss—will be given greater weight. The DOL considers these "core factors" as most likely to determine whether a worker is an employee or an independent contractor. After all, the extent by which workers can exercise substantial control over key aspects of their work performance—such as setting their own hours or choosing what projects to work on—and how much they can earn tend to be the main reasons for working as an independent contractor.

If both core factors point toward the same classification, that classification is probably accurate. On the other hand, if these two factors point to different classifications, the other three factors will help determine the correct classification. In applying all of these factors, the DOL advises that actual work practices are more important than a contractual arrangement when determining "employee" or "independent contractor" status.

ERISA Impact: Common Law Still Applies

The DOL's proposed rule applies in the context of the FLSA. Different standards for determining independent contractor status may apply in different contexts or under other laws. For retirement plans and employee benefit plans covered by ERISA Title I, the term "employee" is defined as "any individual employed by the employer." And because ERISA uses the same circular definition that the FLSA contains, the practical definition for ERISA purposes has also been determined by the courts.

The most relevant ERISA case on the subject is *Nationwide Mutual Insurance Company v. Darden*, 503 U.S. 318 (1992). In this case, the Supreme Court determined whether certain workers were either *employees* that were eligible for ERISA-covered benefit plans or *independent contractors* who could be excluded from those plans. ERISA's definition of employee was not helpful. So the Court held that where Congress failed to provide a meaningful definition of "employee," the term would be defined by incorporating traditional agency law criteria for identifying master-servant relationships. This common law test focuses on the hiring party's right to control the means and manner of the work performed. It considers factors that are similar to the DOL's newly proposed "economic reality" test, as well as others, like the location of the work and the method of payment.

This common law standard also must be used in other contexts when no clear statutory or regulatory definition of "employee" applies. For example, this standard is used for the Consolidated Omnibus Reconciliation Act (COBRA), which requires employers with 20 or more employees that maintain a group health plan to offer employees the right to continue their coverage under the plan after their employment ends. The IRS also uses the common law standard when considering whether businesses have properly classified workers for federal tax withholding purposes. In addition, the IRS considers the degree of control and independence by looking at facts that fall under three categories, each with additional underlying considerations: behavioral control, financial control, and relationship.

Although the new economic reality rules are proposed in the FLSA context, they may have a more far-reaching impact. To the extent that these rules provide a clear, practical method for evaluating the employer-employee relationship, they may help courts to apply a common law standard more consistently.

FMLA Impact; Economic Reality Applies

The proposed rule directly applies to the Family Medical Leave Act (FMLA), which uses the FLSA definition of "employee." As a result, the new economic reality test applies. FMLA is a federal law permitting eligible employees

of covered employers to take job-protected, unpaid leave for specified medical and family reasons. It also requires that health benefits be maintained during the leave period as if the employee had continued working instead of taking leave. Employers that are public employers (including state and federal employers and educational institutions) and private-sector employers that employ 50 or more employees are required to offer FMLA benefits.

In addition to the FMLA, the proposed rule affects other laws that use the economic reality test to determine employee status. These include the Age Discrimination in Employment Act (ADEA), which prohibits discrimination against employees age 40 and older, and the Equal Pay Act (EPA), which prohibits discrimination on account of sex in the payment of wages by employers.

State Law Standards May Apply

The proposed rule will not change how many states determine independent contractor status under their own wage and hour statutes. Certain states have their own standards for defining whether an employer-employee relationship exists—standards that may be more restrictive than the proposed rule—adding to the complexity that employers face when classifying workers. Employers should carefully review how applicable state laws apply to their workers, and, if the proposed rule becomes final, whether and how the rule would apply.

A Step in the Right Direction

Hiring contract workers is commonplace today. There are good reasons to do this, just as there are good reasons to favor hiring workers as employees. And it's sometimes difficult to distinguish between "employee" and "independent contractor." But the cost of misclassifying workers makes it critically important to have a clear standard.

Historically, the various tests that have evolved—either through statutes and regulations, or through case law—have added to the confusion. Clearer direction is needed for businesses to accurately classify workers. The DOL's proposed rule is a step in that direction, giving companies additional guidance under the FLSA. But to minimize risk, employers will want to ensure that they classify their workers to satisfy any test that applies so that they do not have to manage workers that are classified as independent contractors for certain purposes, but are considered employees for others.