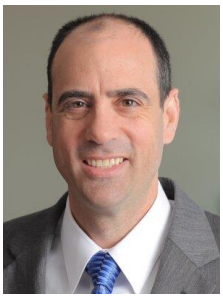
DOL's Contractor Rule Change May Cause Cos. Heartburn

By **Todd Lebowitz** (October 13, 2022)



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Have you ever gone to a new restaurant that took over the space where one of your favorite restaurants used to be?

You've been wanting to try the new restaurant. You get there and the menu looks similar, so you order the fettucine with shrimp because that dish was always really good at the old place. It arrives and it looks the same but you're not sure that it tastes quite the same.

Maybe the sauce tastes a little different, but it's hard to tell for sure. Then, you get home later that night and you feel a little queasy. You realize that the new restaurant must have put onions in the sauce. You probably didn't notice because when the dish was served it looked just like it did at the old restaurant.

But you're not supposed to eat onions, and now you have to wait and see if you're going to start cramping up from eating the onions or if you're going to be just fine. You really just don't know. It could just as easily go either way, and now all you can do is wait.

That's kind of how I feel after reading the U.S. Department of Labor's proposed new independent contractor rule, **released** earlier this week.

The rule would establish a new test for differentiating between employees and independent contractors under the Fair Labor Standards Act. It would replace the regulations issued in 2021 under the Trump administration.

On its face, the proposed rule looks similar to the test that's been applied by courts for decades. It's still an economic realities test, and the goal is still to determine whether, as a matter of economic reality, the worker is economically dependent on the hiring party or is in business for herself.

It's still a multifactor test, and the factors still look a lot like the seven factors listed in DOL Fact Sheet No. 13, which has been available online since at least 2002.[1]

In fact, if you compare the factors in Fact Sheet No. 13 with the factors in the proposed new test, they look almost the same. Both tests look at whether the work performed is integral to the hiring party's business.

Both tests consider the permanency of the relationship between the worker and the hiring party, the level of financial investment made by the worker, the degree of control exerted by the hiring party and the worker's opportunity for profit or loss.

But if you move all the shrimp over to one side of your plate and closely examine the sauce, you'll see that things are not quite as they seem. There are onions in there. Lots and lots of onions.

The 2021 Independent Contractor Rule

In January 2021, during the last days of the Trump administration, the DOL published a final rule titled Independent Contractor Status Under the Fair Labor Standards Act.

It was supposed to take effect in March 2021, but the Biden administration delayed implementation and formally withdrew the rule in May 2021. The following March, however, U.S. District Judge Marcia Crone of the U.S. District Court for the Eastern District of Texas ruled that the attempted withdrawal was unlawful and therefore ineffective. The court held that the 2021 independent contractor rule, therefore, became effective on the original effective date in March 2021.[2]

The 2021 independent contractor rule preserved the rhetoric of an economic realities test, but it differed from the traditional multifactor test by elevating two of the factors as core factors that are most likely determinative of the issue. The core factors are:

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

The control factor supports independent contractor status if the worker "exercises substantial control over key aspects of the work," including setting schedules, selecting projects and being allowed to work for others.

The profit or loss factor weighs in favor of independent contractor status if the worker has the opportunity to earn profits or incur losses based on the exercise of initiative, managerial skill, business acumen or judgment, or based on management of his or her own investments or capital expenditures. Example of investments may include hiring helpers or buying equipment.

Advocates of the 2021 independent contractor rule praised its simplicity and its honesty in recognizing that these two factors tend to be most persuasive when determining if an independent contractor relationship properly exists. Detractors of the rule condemned it for overemphasizing the control factor and for minimizing the importance of the other factors.

Courts, meanwhile, have not applied the 2021 independent contractor rule when determining contractor status under the FLSA. Courts have continued to apply the multifactor test described in Fact Sheet No. 13 or similar versions of that test.

The Proposed New Rule

Earlier this year, the DOL announced its intention to replace the 2021 independent contractor rule. Some speculated that the DOL would try to introduce an ABC test[3] or a modified right-to-control test.[4]

But the courts have consistently held that the economic realities of the relationship determine employment status under the FLSA, and so the DOL had little choice but to propose some version of an economic realities test.

The proposed rule identifies seven factors to consider when determining whether an independent contractor has been misclassified under the FLSA:

1. Opportunity for profit or loss depending on managerial skill;
2. Investments by the worker and the employer;
3. Degree of permanence of the work relationship;
4. Nature and degree of control;
5. Extent to which the work performed is an integral part of the employer's business;

6. Skill and initiative; and
7. Additional factors.

At a glance, this list of factors looks a lot like the factors traditionally used by the courts and listed in Fact Sheet No. 13. But, the onions.

The Onions

The proposed new rule does not just list the factors; it provides guidance as to how to interpret each factor. And that's where things start to look different.

The first proposed factor covers opportunity for profit or loss depending on managerial skill. That factor resembles the fifth factor in Fact Sheet No. 13, which is "The alleged contractor's opportunities for profit or loss."

But the proposed new factor is narrower. It considers the opportunity for profit or loss to be relevant to contractor status only if the opportunity for profit or loss depends on the worker's managerial skill.

The DOL explains its new take on this old factor: "This factor considers whether the worker exercises managerial skill that affects the worker's economic success or failure in performing the work."

What facts would demonstrate the managerial skill required under this factor? The DOL says that the following facts can be relevant to the first factor:

- Whether the worker determines or can meaningfully negotiate the charge or pay for the work provided;
- Whether the worker accepts or declines jobs or chooses the order and/or time in which the jobs are performed;
- Whether the worker engages in marketing, advertising or other efforts to expand their business or secure more work; and
- Whether the worker makes decisions to hire others, purchase materials and equipment, and/or rent space.

But then, in its commentary, the DOL narrows the relevance of some of these facts. Historically, a worker's ability to freely reject or accept proposed assignments has been relevant to the worker's ability to determine whether she earns a profit or incurs a loss, and the DOL seems to preserve the relevance of this flexibility in the second bullet point.

But then the DOL limits the importance of that flexibility by advising that the flexibility must be tied to managerial skill:
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, generally do not reflect the exercise of managerial skill indicating independent contractor status under this factor.

So does the ability to accept or reject work matter, or not?

The second proposed factor is also not what it seems. It covers investments by the worker and the employer. It looks similar to the third factor in Fact Sheet No. 13, "The amount of the alleged contractor's investment in facilities and equipment." But there are important differences.

The second factor would not just look at whether the contractor invests in the tools and equipment used to perform the work. Instead, to support independent contractor status under this factor, the investments would have to be "capital or entrepreneurial in nature."

They should "serve a business-like function, such as increasing the worker's ability to do different types of or more work, reducing costs, or extending market reach."

But not every independent contractor wants to conquer the world, expand into new markets and expand into new areas of work. The proposed interpretation of this factor would distort it in a way that makes it unrecognizable from past iterations.

The proposed guidance on the second factor also takes a shot at the rideshare industry, opining that purchasing an automobile is not necessarily a capital investment if the vehicle is also available for personal use. But personal use of company resources has never been a factor weighing in favor of employment status, and the DOL provides no good reason why it should become a factor.

In a world where employees can make personal use of their company's resources, if permitted by the employer, it makes no sense to create a rule that if independent contractors make personal use of their own business's resources, that is evidence they are employees of their client.

The DOL's insertion of the phrase "and the employer" in the second factor is also problematic.

The DOL advises that a worker's investment in her own business should be compared to the hiring party's investment in its own business. But that makes little sense. What is the relevance of the size of the hiring party, which is the contractor's client? And how is the client's financial investment in running its own business relevant to determining whether a particular contractor is in business for herself?

If the contractor and her client are running two separate businesses, then there is no relevance to their relative investments in their own businesses. The proposed guidance creates a nonsensical scenario where an independent contractor could provide the same service to two clients, one small and one large, and the worker's classification could be different based solely on the size of the client being serviced.

The text of the second factor, therefore, may look like the text in Fact Sheet No. 13 and may resemble an existing factor, but the DOL's proposed guidance on how to interpret that factor might lead to vastly different outcomes when applying that factor.

The fourth proposed factor, which covers nature and degree of control, raises similar concerns. While the text sounds the same in both Fact Sheet No. 13 and the proposed rule, the nature of control described in the proposed guidance is vastly different. The differences emerge when you consider the question, "Control over what?"

Historically, the right-to-control portion of the analysis has examined the right to control the manner and means by which the work is performed. The right-to-control analysis historically

looks at the hiring party's right to control essential terms and conditions of the engagement, such as the right to directly supervise the work and to dictate when and how the work is to be performed.

Legally required control is generally disregarded since that is control imposed by the government, not by the hiring party. The hiring party is not choosing to exercise legally required control; it is required to do so.

The proposed new rule would include consideration of new types of control, and these new types of control relate to subjects that are not generally regarded as relevant to differentiating between employees and independent contractors.

The proposed guidance says that relevant control may include actions "that exert control without the traditional use of direct supervision, assignment, or scheduling."

As examples of relevant control, the DOL lists "relying on technology to supervise a workforce, setting prices for services, or restricting a worker's ability to work for others." While the latter two examples are self-explanatory, the reference to using technology to supervise is vague, open-ended and confusing.

More troubling, the new rule proposes that relevant control may include "control that is due to an employer's compliance with legal, safety, or quality control obligation."

The DOL says that this type of control may be evidence that the worker is not entrepreneurial enough to comply with legal and other requirements on her own.

That is not a commonly held view — not by the courts, not by the National Labor Relations Board and not even by the more worker-friendly states like New York. As the U.S. Court of Appeals for the D.C. Circuit explained in Local 777, Democratic Union Organizing Committee, Seafarers International Union of North America, AFL-CIO v. NLRB in 1978, "Government regulation constitutes supervision not by the employer but by the state."[5]

The proposed new rule not only adds new twists to old factors, it also omits one traditional factor entirely and it omits the guidance in Fact Sheet No. 13 about information that is not relevant.

In Fact Sheet No. 13, the seventh factor covers the degree of independent business organization and operation. Historically, facts in support of independent contractor status under this factor would include incorporation as a business, registration with state or local regulatory bodies, and other indicia that demonstrate the contractor is running a business.

The DOL inexplicably omits this important factor entirely, despite its obvious relevance in determining whether someone operates as a legitimate independent contractor.

The DOL's proposed rule also ignores the list of facts that are identified in Fact Sheet No. 13 as not relevant to the analysis. Fact Sheet No. 13 advises:
There are certain factors which are immaterial in determining whether there is an employment relationship. Such facts as the place where work is performed, the absence of a formal employment agreement, or whether an alleged independent contractor is licensed by State/local government are not considered to have a bearing on determinations as to whether there is an employment relationship. Additionally, the Supreme Court has held that the time or mode of pay does not control the determination of employee status.

The proposed rule omits this helpful guidance and takes no position on the relevance of these facts. The DOL's silence on this point is unhelpful. The purpose of a regulation is to provide clarity, not to remove clarifying text.

Conclusions

The DOL's new test would narrow the circumstances under which a worker could be an independent contractor under the economic realities test, not only in comparison to the 2021 independent contractor rule but also in comparison to Fact Sheet No. 13 and the economic realities test historically used by the courts.

The public has until Nov. 27 to submit comments to the proposed rule. In response to the comments, the DOL can modify the rule or release it in its proposed form.

While the DOL's proposed rule is designed to resemble the historical economic realities test, a closer examination of the ingredients shows that the DOL is looking to change the recipe. Courts might use the new recipe, or they might stick to the old formulation of the test.

Whatever the DOL decides for the final version of its rule, the new recipe may cause serious indigestion for businesses using independent contractors. Beware of the onions.

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[1] https://www.dol.gov/agencies/whd/fact-sheets/13-flsa-employment-relationship.

[2] https://whoismyemployee.com/2022/03/15/its-there-even-if-you-cant-see-it-court-reinstates-trump-era-independent-contractor-test-and-its-effective-now/.

[3] https://whoismyemployee.com/2018/05/07/what-is-californias-new-abc-test-and-what-does-it-mean-for-businesses/.

[4] https://whoismyemployee.com/2016/12/29/what-are-right-to-control-tests/.

[5] Local 777, Democratic Union Org. Comm., Seafarers Int'l Union of N. Am., AFL-CIO v. NLRB, 603 F.2d 862, 875 (D.C. Cir. 1978).