SBCA - Major Alert - new DOL Administrator's Interpretation 205-1 on Independent Contractors

SBCA ALERT
JULY 24, 2015

DEPARTMENT OF LABOR TAKES ACTION ON INDEPENDENT CONTRACTORS

The issue of when a worker can be properly classified as an independent contractor (rather than an employee) is certainly not a new issue. However, we anticipate a publication from the Department of Labor (DOL) last week to have a significant impact on how businesses of all sizes handle independent contractors.

On July 16, 2015, the U.S. Department of Labor (DOL) Wage & Hour Division Administrator issued "Administrator's Interpretation 205-1" (AI) on the application of the Fair Labor Standards Act (FLSA) for identification of workers who are

misclassified as independent contractors.

The new AI which states that most workers qualify as employees under the FLSA, could cause significant misclassification problems for businesses, leading to more DOL investigations and enforcement actions and increased private litigation. Commentators are already disagreeing about whether the AI restates an existing precedent or breaks new ground. FWIW - we see this as breaking new ground to say the least. It is clear, however, that the AI is a one-sided review of the law. While it remains to be seen how courts will interpret this AI, its very issuance is a strong wake up call for businesses that use independent contractors, as undoubtedly more DOL enforcement and private litigation will be on the horizon. This issue becomes even more important as we see IRS being starved by Congress and DOL moving into the vacuum.

In 2011, the Administration began an initiative to rein in the use of independent contractors and improve the wages of working Americans. As we previously reported, at the end of June, the DOL issued a Proposed Rule and Request for Comment on certain exemptions from the FLSA's overtime requirements.

Now, the DOL has issued this AI which will sharply limit many businesses' use of independent contractors, transforming these workers into W-2 employees covered by Social Security, Medicare, benefits, FMLA and other rights.

In its recent budget request, the DOL asked for about $32 million to hire 300 full-time-equivalent enforcement employees and support staff. However, as outlined in our July 9 Alert, both the House and Senate labor, health and human services, and education appropriation bills currently under consideration would make significant cuts to last year's budget and be significantly lower than President Obama's 2016 budget request.

The 15-page WHD interpretation on the independent contractor issue makes the Department's animosity to the use of independent contractors very clear. As indicated above, the AI states the DOL's unequivocal opinion that "most workers are employees." It then relies on the FLSA's definition of "employ" which includes "suffer or permit to work," to assert the broadest possible reach for the FLSA. It goes on to articulate the narrowest possible view of the dividing line between an employee and someone who is running his or her own business, relying on the court cases most favorable to its position. Keep in mind that the new WHD Administrator who signed this AI came to office in 2014 after writing a book on the evils of corporate outsourcing. He has made it clear that he wants to create ripple effects throughout the employer community from the DOL's enforcement efforts against individual companies.

Of note, unlike with the newly proposed overtime rules, the DOL did not issue the AI guidance through the usual notice and comment rule-making process. It will not

lead to changes in regulations. It is, rather, non-binding guidance articulating DOL's interpretation of the FLSA. However, given the Supreme Court's 2015 decision in *Perez v. Mortgage Bankers Association*, which gave the DOL a green light for such non-binding guidance and then relied upon it to rule in the DOL's favor in an exempt/nonexempt classification case, there is a real risk that courts will, at least to some degree, defer to the AI despite its one-sided nature and lack of opportunity for comment.

While stating repeatedly that no one factor is determinative, the AI focuses on "economic independence," a phrase it uses throughout. It proposes to look primarily at whether the worker is truly in business for himself or herself or is economically dependent on the employer for which he or she provides services. The AI also goes out of its way to observe that the control factor which courts have traditionally used as a key test should not be given undue weight. It unambiguously states that the agreements or titles used by employers and independent contractors are wholly "irrelevant" to the determination.

The AI uses the most restrictive cases out there to narrow the scope of the economic realities test. A summary of the DOL's analysis of the six factors follows:

- The extent to which the work performed is an integral part of the employer's business. According to the AI, this factor is central to the analysis. If the work is integral to the business of the employers, it is more likely that the worker is economically dependent on the employer. The scope of the impact on businesses using independent contractors for core business functions and on the emerging on-demand business model remains to be determined, but DOL's intent is clear.

- The worker's opportunity for profit or loss depending on his or her managerial skill. The AI flatly rejects the ability to control one's own hours as an indicator of such an opportunity, but looks instead to whether the worker exercises managerial skills which require the use of judgment or initiative to affect the opportunity for profit or loss. It describes the lack of the ability to schedule assignments, solicit additional work from other clients, advertise services, or endeavor to reduce costs as factors that are inconsistent with independent contractor status.

- The extent of relative investments of the employer and the worker. The AI describes the investment of a real independent contractor as one which furthers the independent contractor's capacity to expand, reduce its cost structure or extend the reach of the market for its business. It states that investing in tools and equipment does not necessarily indicate that the worker

is an independent contractor where the tools and equipment are only needed to do the work. It then requires that the worker's investment must be significant in *nature and magnitude* relative to the employer's investment. Notably, in one example, it dismisses the investment of $35,000 to $40,000 by a worker as inconsequential where the employer invests hundreds of thousands of dollars in each work site. It flatly rejects using a comparison between the worker's investment and the company's investment in the particular job being performed.

- Whether the work performed requires special skills and initiative. The AI seems to reject this factor outright, emphasizing instead that a worker's *business* skill, judgment and initiative will help determine if the worker is economically independent. Technical skills, in the view of the AI, are not indicative of any independence or business initiative.

- The permanency of the relationship. The AI assumes that if an independent contractor wants more than one assignment from a company, then he or she must be eschewing independence. It describes this factor as a worker who typically works one project for an employer and does not necessarily work continuously or repeatedly for that employer. This assumes, with no basis, that an entrepreneurial independent contractor would not want more work from a good client.

- The degree of control exercised or retained by the employer. According to the AI, control should be analyzed in light of the ultimate determination whether the worker is economically dependent or not. The worker must control meaningful aspects of the work to view the worker as conducting his or her own business. Here too, the guidance sharply restricts the usefulness of what many have considered a key factor in the analysis. According to the AI, the employer's reasons for exercising some control are irrelevant even if due to the nature of the business or regulatory requirements. If there is control, the worker is an employee. Moreover, even where there is no control, the FLSA covers workers who are economically dependent.

The examples provided in the AI present situations where there are clear-cut distinctions between independent contractors and employees. Unfortunately, the AI gives no examples or meaningful guidance for the grey areas. Against this uncertainty, the risks for businesses are significant if they improperly classify workers as independent contractors instead of employees. The liability can be enormous and changes to business models incredibly disruptive.

If independent contractors are to be treated as employees, many things change. These include compliance with the FLSA (record keeping, minimum wage and

overtime), tax withholding, payroll taxes for Social Security/Medicare, unemployment compensation, an workers' compensation. Others include inclusion in group health insurance plans, eligibility for FMLA, leave and other benefits, calculation of leave entitlement, eligibility for meal and rest breaks, reimbursement for business expenses, immigration compliance, plus statutes such as Title VII, ADEA, the ADA, other anti-discrimination laws, and a host of state and local laws that traditionally do not cover independent contractors. One significant issue that will require ongoing analysis is that, even if employers change their use of independent contractors, the risk of various liabilities from prior practices still remains.

The DOL has emphatically warned employers: the DOL is making currently exempt employees eligible for overtime with its modification of the salary basis test and is going to turn most independent contractors into employees, many of whom will be eligible for overtime under the proposed new guidance.

The AI has left employers with many unknowns and yet employers need to start analyzing their workforces and risks to come to decisions regarding classification of current non-employee workers. For some employers, no action will be necessary. For others, large portions of their workforce could be subject to misclassification claims.

Some of the factors that businesses would be well advised to consider in assessing the independent contractor issue are:

- How the business currently use independent contractors.
- How the independent contractors manage their businesses and the extent to which an independent contractor is running a business.
- Whether the business can defend its past independent contractor classifications.
- Whether the business can defend the retention of these classifications after the issuance of the AI.
- The cost of converting independent contractors to employees versus the risk of keeping them classified as independent contractors.

There is a timing element to all of these considerations. If the employer converts any questionable independent contract early, it starts running the statute of limitations on past practices. In contrast, waiting exposes the company to more

damages, but the courts may provide some clarification as they grapple with the amount of deference to give to the AI. Watching the enforcement actions the DOL takes will also provide further clues.