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Combating Employee Misclassification under the FLSA

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Correctly classifying a worker as an employee or an independent contractor is critical. Misclassification of employees as independent contractors has been occurring in an increasing number of workplaces, and the Department of Labor's Wage and Hour Division is responding by bringing enforcement actions against employers who misclassify their workers.

In order to combat misclassification, the Administrator of the Wage and Hour Division of the U.S. Department of Labor recently issued an Interpretation providing guidance as to who the Department of Labor believes should be classified as an employee under the Fair Labor Standards Act ("FLSA"). It states that employer labels do not determine a worker's classification. Instead, courts use a multifactorial "economic realities test" to determine whether a worker should be classified as an employee or an independent contractor under the FLSA. By using this test, the goal is to determine whether a worker is economically dependent on the employer (and thus an employee) or whether the worker is in business for him or herself (and thus an independent contractor).

Although the Administrator's Interpretation does not have the force of law or regulation, it very well may be afforded deference by the courts, and we therefore recommend that employers review the following six factors identified by the Administrator under the economic realities test in order to ensure that they have accurately classified their workers. When reviewing these factors, it is important to remember that no single factor is determinative, and that courts may consider additional factors depending on the circumstances. These factors should simply be used as guides to answer the ultimate question of whether a worker is economically dependent on the employer, and thus an employee:

1.) The extent to which the work performed is integral to the employer's business: If the work performed is integral to the employer's business, like the work a carpenter would do for a construction company, the worker is more likely to be considered economically dependent on the employer, and thus an employee. Conversely, a true independent contractor's work is unlikely to be integral to the employer's business, such as a software developer who creates software that assists a construction company in tracking its bids and material orders.

2.) The worker's opportunity for profit or loss depending on his or her managerial skill: If the worker has an opportunity for profit or loss, and has an ability to make decisions to use his or her managerial skill and initiative to affect that opportunity for profit or loss, the worker is more likely to be an independent contractor. This factor does not focus on a worker's ability to work more hours, which does little to distinguish an employee from an independent contractor.

3.) The extent of the relative investments of the employer and the worker: In order to be considered an independent contractor, the worker should have made some investment or undertaken some risk which is significant in nature and magnitude relative to the employer's investment in its overall business. A relatively minor investment by the worker that does little to further a business beyond the employer's investment suggests that the worker and the employer are not on similar footings and that the worker is economically dependent on the employer, and thus an employee.

4.) Whether the work performed requires special skills and initiative: The fact that workers are skilled is not itself indicative of independent contractor status. Instead, the inquiry is whether the worker uses his or her skills in some independent way, such as demonstrating business-like initiative. If he or she does so, the worker is more likely to be an independent contractor.

5.) The permanency of the relationship: Permanency or indefiniteness in the worker's relationship with the employer suggests that the worker is an employee rather than an independent contractor, who typically works one project rather than on a continual basis. However, a lack of permanence does not automatically suggest an independent contractor relationship. The reason for the lack of permanence should be carefully reviewed to determine if the reason is indicative of the worker running an independent business.

6.) The degree of control exercised or retained by the employer: In order to qualify as an independent contractor, the worker must control meaningful aspects of the work performed such that it is possible to view the worker as a person conducting his or her own business. The nature and degree of the employer's control must be examined as part of determining the ultimate question of whether the worker is economically dependent on the employer.

The Administrator notes that any analysis of these factors must be consistent with the FLSA's expansive definition of "employ" as "to suffer or permit to work" and should be guided by the FLSA's statutory directive that the scope of the employment relationship is very broad. The Administrator claims that, under the FLSA's broad definition of employment, "most workers are employees" under the FLSA. Accordingly, employers should carefully review the above listed factors and consider their relationships with their workers in order to avoid liability resulting from misclassification under the FLSA, and a potential action by the Department of Labor to collect back pay for minimum

wages and overtime due to an employee who the Department of Labor believes has been misclassified as an independent contractor.

Moreover, although the test for independent contractor status differs somewhat in other contexts, the misclassification of employees as independent contractors has ramifications beyond the FLSA. For example, misclassification also implicates the IRS. Because an employer has to withhold certain taxes (i.e., income, Social Security and Medicare taxes) in the case of an employee but not an independent contractor, misclassifying an employee as an independent contractor may result in an action by the IRS to collect any and all withholdings that were due.

Misclassification is also likely to result in lawsuits instituted by misclassified employees themselves. For example, misclassified employees will claim such things as an entitlement to an hourly minimum wage, overtime compensation, family and medical leave, unemployment insurance and workers' compensation insurance. Misclassification of these individuals as independent contractors therefore places an employer at risk of being sued for enforcement of any employment rights that allegedly were denied to these workers.

Finally, employers also will have to consider and comply with the laws of the states in which they operate. For example, California has somewhat different tests that are applied in various contexts to determine whether a worker is an employee or an independent contractor.

In sum, while discerning whether a worker is an employee or an independent contractor may not be a simple task, the potential consequences of misclassification justify taking the time to review the classification of your workers. If you would like assistance in reviewing your policies or analyzing a worker's classification, contact counsel to determine the best course of action for your company.

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