

New Court Decision Highlights Stringent Proofs Necessary to Establish Independent Contractor Status Under New Jersey Law

The New Jersey Supreme Court just issued a decision once again highlighting the extreme difficulty businesses face when attempting to establish a worker has been properly classified as an independent contractor and not an employee. The Court, in *East Bay Drywall, LLC v. Department of Labor* (A-7-21) (August 2, 2022) strictly construed the requirements of the ABC test for determining if a worker is an independent contractor or an employee, making clear that meeting this standard will require that employers be able to actually prove that its workers or subcontractors are actually engaged in independent businesses of the same nature and also actually regularly performing work for other entities to such a degree that such business would survive absent its relationship with the employer. While this decision does not represent an actual change in the underlying law, it does highlight the New Jersey Department of Labor's extremely strict interpretation of the law, and sends a message to reviewing courts that an employer's proofs must go far beyond formalities, such as agreements and other paper indicia of independent business status. As set forth below, moving forward, businesses employing independent contractors must ensure that they are able to prove, to the Department of Labor or a court, that these independent contractors, in actual practice, operate as their independent businesses.

Before addressing the particulars of the Supreme Court's *East Bay Drywall* decision, it is important to understand the legal framework in which it arose. Under New Jersey law, what is commonly referred to as the "ABC test" is used to determine whether a particular worker is properly classified as an independent contractor, or is, in fact an employee for several important legal purposes including the New Jersey unemployment laws, gross income tax, and the wage and hour laws. The ABC test is much more stringent than the tests used to determine employee versus independent contractor status for other legal purposes, such as the IRS test or the common law test.

The ABC test, as set forth in the New Jersey Unemployment Law, reads as follows:

Services performed by an individual for remuneration shall be deemed to be employment . . . unless and until

it is shown to the satisfaction of the division that:

- (A) Such individual has been and will continue to be free from control or direction over the performance of such service, both under his contract of service and in fact; and
- (B) Such service is either outside the usual course of the business for which such service is performed, or that such service is performed outside of all the places of business of the enterprise for which such service is performed; and
- (C) Such individual is customarily engaged in an independently established trade, occupation, profession or business.

It is critical to note that under the ABC test, all three prongs must be satisfied for a worker to be considered an independent contractor. Under the test, workers are presumed to be employees and not independent contractors, and further, it is the employer's burden to prove that each individual worker meets all three prongs of the test before such worker will be considered properly classified as an independent contractor. It is clear from longstanding New Jersey case law that failing to produce evidence sufficient to establish any one of the prongs will result in a failure to prove independent contractor status, even if there is overwhelming proof with respect to either or both of the other prongs. The Department of Labor or the courts will evaluate the actual substance of the evidence with respect to each prong, rather than focus on the formalities. Accordingly, the fact that a worker's income is reported via an IRS Form 1099 in lieu of a Form W-2, or the fact that the worker has signed an independent contractor agreement, will not be sufficient, but must be accompanied by sufficient facts to demonstrate that each prong is met in real life.

The dispute in *East Bay Drywall* arose out of a routine audit conducted by the New Jersey Department of Labor ("DOL"), and not, for example, based on a worker complaint. During the course of the litigation, *East Bay Drywall* ("East Bay") provided evidence that it contracts with home builders to provide drywalling for residential properties. When it is selected by a builder for a job, it contacted workers to see who was available and willing to work on a subcontractor basis. Workers were free to accept or reject any job, and even after they accepted

and began work sometimes workers would leave mid-job if they found better work. Before engaging any worker, East Bay would request an up-to-date certificate of liability insurance and a tax identification number “to ensure that the worker is an independent entity.” East Bay documented the compensation of these worker via an IRS Form 1099, rather than a Form W-2. With respect to the actual work, East Bay provided all the raw materials necessary for the drywall installation, but the workers supplied their own tools. East Bay claimed that at least some of these workers stated that they performed work for other business, but did not actually provide any evidence supporting such outside work.

After reviewing the facts, the DOL auditor determined that over a given period of time, East Bay had misclassified sixteen workers (four individuals and twelve business entities) as independent contractors under the ABC test, and that, as a result, it owed approximately \$42,000 in back unemployment and temporary disability contributions, as well interest and penalties. East Bay contested the audit and an Administrative Law Judge (ALJ), applying the same ABC test, determined that only three failed the test and were employees.

The DOL Commissioner (“Commissioner”), who has final say on such issues at the administrative level, rejected the ALJ’s determination and found that the DOL Auditor had correctly found all sixteen workers to be employees, and not independent contractors. The Commissioner found that all sixteen failed prong A because East Bay set the terms of work, and also failed prong B because although the work was done at residential homes, this was not outside East Bay’s place of business since this is where East Bay’s work must necessarily be completed. Lastly, the Commissioner found that all sixteen workers failed prong C in that East Bay failed to prove that each of the workers had a business independent of East Bay and which could survive the termination of the relationship with East Bay.

East Bay appealed the Commissioner’s decision to the New Jersey Superior Court, Appellate Division. The Appellate Division rejected much of the Commissioner’s decision. First, it determined that East Bay did not control the workers’ work and that the relationship did not fail prong A. Second, it found that prong B was met, relying on established case law stating that places of business are only “those locations where the enterprise has a physical location.” Lastly, as to prong C, it agreed with the Commissioner that five of

the sixteen alleged subcontractors failed to show they actually operated as independent business entities. However, regarding the other eleven other alleged subcontractors, the Appellate Division focused on the existence of certificates of insurance and business registrations to conclude that these were independent businesses.

The Department of Labor appealed to the New Jersey Supreme Court, arguing that all sixteen alleged subcontractors (individuals and entities) were actually employees. Although the DOL argued that all sixteen failed each of prongs A, B, and C, the Court determined that because it could affirm the Commissioner’s original decision based on prong C alone, it did not need to address prongs A or B. However, in a footnote regarding prong B, the Court did urge the Department of Labor to adopt regulations clarifying, particularly for the era of increasing remote work, what constitute the “usual course of the business” and where an enterprise “conducts and integral part of its business.”

In affirming the Commissioner’s determination that all sixteen workers failed prong C, the Court explained that this prong “broadly asks whether a worker can maintain a business independent of and apart from the employer” and is satisfied “when a person has a business, trade, occupation, or profession that will clearly continue despite termination of the challenged relationship.” Such an independent business must be “stable and lasting,” capable of “surviving the termination of the relationship.”

It was in this regard that the Court determined that the Commissioner correctly concluded that East Bay’s evidence was lacking. Proving prong C requires actual evidence in support of the claim that workers are actually truly independent businesses. Thus, simply proving that a worker (or entity) has a certificate of insurance or can provide business registration information is not enough. In fact, according to the Court,

A business practice that requires workers to assume the appearance of an independent business entity -- a company in name only -- could give rise to an inference that such a practice was intended to obscure the employer’s responsibility to remit its fund contributions as mandated by the State’s employee protections statutes.

According to the Court, the types of evidence that an employer must also be able to supply in defense of its classification of a worker as an independent contractor would be along the lines of evidence that

the business maintained an independent office or work location, advertised its services to others, or had its own employees, as well as other indicia of an ongoing business, such as business stationary, a telephone number, or owning business equipment. One of the most important pieces of information lacking in this case was evidence from (or about) the purported independent contractors that established that such entities were actually in an independent business, such as tax documentation or other proof showing substantial outside earnings attributable to such independent business.

As a practical matter, the Court's East Bay Drywall decision makes clear that any business wishing to safely engage independent contractors as part of its regular business practices must, before entering into such relationships, closely review each of the three ABC test prongs and ensure that each prong can be met. The facts necessary to establish prongs A and B, while also critical, are largely within the control of the business. However, businesses must recognize that the facts associated with prong C are not in their control, and therefore it is critical to obtain, at the inception of the relationship and periodically during the course of any longer-term relationship, sufficient proof of prong C. While proof of an independent tax identification number, business registration, corporate documentation, insurance certificates, or an independent contractor agreement are all helpful, they will not be sufficient. These must be accompanied by proof that the subject business is real and actually operates independent of its relationship with your business. This evidence could include the types of evidence referenced above, in terms of documents associated with the formation of a business, but should also include actual evidence that such business actually derives substantial revenues from outside work.

If you have any questions regarding independent contractor relationships, please contact David Rapuano at 856-354-260 or drapuano@archerlaw.com, or any member of Archer's [Labor and Employment Group](#).

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