

Client Alert **Employment and Labor**

Classifying Workers as Contractors Becomes Tougher After New Jersey Supreme Court's Decision Interpreting the "Independent Business" Requirement

Last week the New Jersey Supreme Court upheld a finding by the New Jersey Department of Labor and Workforce Development ("DOL") that a drywall installation business failed to supply sufficient information to establish that 16 workers were independent contractors rather than employees. The *East Bay Drywall, LLC v. Department of Labor & Workforce Development* decision serves as an important reminder to New Jersey employers that a worker's status is premised on the presumption that a worker is an employee unless and until an employer can prove otherwise, and employers must demonstrate that the worker qualifies as a contractor under all three (3) prongs of the ABC test. The ABC test, described below, is a fact sensitive analysis where the burden of proof rests with the employer to support its treatment of the worker as a contractor. *East Bay Drywall* obligates employers to prove that their contractors have a functioning independent business and emphasizes that even engaging a worker with a formal independent corporate structure is not dispositive of a contractor's status. This decision demonstrates both how difficult it is for employers to justify a worker's independent contractor status, and the necessity of employers to document the support for a contractor's classification and be ready to produce it in response to DOL inquiries.

ABC Test

As we have previously explained, the New Jersey Supreme Court previously adopted the ABC test in its 2015 decision, *Hargrove v. Sleepy's, LLC*. In order to establish a worker's independent contractor status, *Hargrove* requires employers to prove **all three** (3) of the

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following prongs to establish that a worker is properly classified as an independent contractor:

(A) The 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;

(B) The service is either outside the usual course of the business for which such service is performed, or the service is performed outside of all the places of business of the enterprise for which such service is performed; and

(C) The individual is customarily engaged in an independently established trade, occupation, profession, or business.

Background Facts of the *East Bay Drywall Case*

This matter began in 2013 when East Bay Drywall, then registered as an employer, ceased reporting wages to the DOL. This change triggered a DOL “audit” to ensure that their subcontractors (four (4) individuals and 12 business entities) were properly classified. During such an audit, the DOL typically requests to examine the employer’s business records, including invoices, contracts, business licenses, and business cards, etc. In this case, the information East Bay Drywall provided to support their subcontractors’ status included certificates of insurance and business registrations for most of the entities it retained as subcontractors. East Bay Drywall’s owner also testified that the subcontractors were free to accept or decline work, and that he believed that some of the subcontractors worked for other businesses.

The DOL’s audit, conducted in 2017, reviewed the workers East Bay Drywall hired between 2013 and 2016, and concluded that 16 of the subcontractors were employees rather than independent contractors because the employer failed to provide sufficient evidence to conclude that the subcontractors were bona fide distinct entities. Four of the 16 contractors were individuals, and the remaining 12 did not respond to the auditor’s request for information, leading the auditor to conclude that they were nonoperative.

East Bay Drywall appealed the audit’s findings, and in accordance with the State’s regulatory process, the appeal first was heard by an administrative law judge and thereafter the recommendation was returned to the Commissioner of Labor (the “Commissioner”). East Bay Drywall’s appeal argued that its subcontractors met all three (3) criteria under the ABC test, and it ensured that each subcontractor it hired was an independent entity because it required certificates of liability insurance and tax identification numbers prior to hiring. The Commissioner ultimately upheld the DOL’s audit findings, citing to reasons including that East Bay Drywall had failed to supply sufficient information showing that its 16 subcontractors existed independently of East Bay Drywall. East Bay Drywall

subsequently appealed the Commissioner's decision to the New Jersey Appellate Division and temporarily won a partial victory. The Appellate Division disagreed with the Commissioner regarding 11 of East Bay Drywall's workers, noting that these 11 workers had supplied up-to-date certificates of insurance for the audit period, thus demonstrating they were properly classified as independent contractors.

The New Jersey Supreme Court's Decision

On appeal, in *East Bay Drywall, LLC v. Department of Labor & Workforce Development*, the New Jersey Supreme Court ("the Court") reversed the Appellate Division's decision and supported the DOL's findings, ruling that East Bay Drywall submitted insufficient proof that these workers were truly part of independent and separate businesses, as required by prong C of the ABC test.

Although East Bay Drywall had provided evidence showing that 11 of its subcontractors maintained a separate corporate form, the Court explained that East Bay Drywall had failed to present evidence that these subcontractors actually operated their businesses outside of their relationship with East Bay Drywall. The Court held that East Bay Drywall needed more than the presentation of certificates of insurance and business registrations to prove their contractors were truly part of independent businesses. For instance, the Court, citing its prior decision *Carpet Remnant Warehouse, Inc. v. Department of Labor*, 125 N.J. 567 (1991), listed several factors to be considered when evaluating whether a worker (the purported contractor) maintains a business independent of and apart from the employer. Such factors include the duration and strength of a worker's business, the number of customers and employees the worker has, the worker's volume of business, and the extent that the worker supplies tools, equipment, vehicles, and similar resources. In upholding the Commissioner's original decision, the Court emphasized that employers have the burden of proving that a worker is an independent contractor, and East Bay Drywall's submitted evidence was insufficient proof that its subcontractors actually *operated* a separate business.

In addition to expanding prong C's independent business proof requirement, employers should also take note of the Court's *East Bay Drywall* decision because the Court specifically declined to determine whether drywall subcontractors working on remote job sites constituted work "outside the employer's usual course of business," i.e., the ABC test's prong B. Although the Court acknowledged rising confusion regarding prong B's interpretation with regards to remote work sites, rather than rule on the issue, it suggested that the DOL promulgate regulations clarifying the "usual course of the business" in light of the prevalence of remote work since the COVID-19 pandemic. In short, those employers relying on the fact that a worker performs its services outside of the office to support prong B of the ABC test should also take heed.

Guidance for Employers

It is common for both companies and workers to enter a contractor relationship to obtain perceived tax benefits and flexibility. However, *East Bay Drywall* underscores that independent contractor classifications are subject to scrutiny in New Jersey, even when the workers have formalized separate legal business entities. Accordingly, employers must carefully review their worker classifications to ensure that such determinations are not just “in name only,” but that sufficient documentation supporting contractor status exists. For instance, does the worker supply services for other entities, have a list of other “customers,” use a separate email address apart from the employer’s domain for business purposes, have employees, business cards, and the like, all of which may be helpful to establish a contractor’s independence. An independent contractor agreement alone, and now a formal separate LLC or similar corporate structure, will not be dispositive of contractor status.

It should also be noted that the DOL audit initiating the dispute in *East Bay Drywall* was triggered when East Bay Drywall stopped reporting wages after previously doing so as a registered employer. Employers should tread carefully and seek legal counsel prior to making changes to worker classifications. For example, terminating an employment relationship and engaging the former employee as a contractor may raise a red flag to the DOL, especially when multiple workers are involved.

Worker misclassification can potentially lead to substantial penalties for employers, owners, and managers, especially in light of recent amendments to misclassification laws as we more fully described in [July 2021](#) and [January 2020](#). New Jersey has now established the Office of Strategic Enforcement and Compliance for the enforcement of proper worker classification, and it is anticipated that increased scrutiny of contractor relationships is likely.

Attorneys in our Employment and Labor Law Practice Group
can assist employers regarding the issues raised in this alert.

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