

KNOWING AND MANAGING YOUR WORKERS COMPENSATION RISK FOR EMPLOYEES, INDEPENDENT CONTRACTORS, AND SUBCONTRACTORS

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Employers usually undertake to carry workers compensation coverage to protect themselves from the financial consequences resulting from injuries to their employees. However, they must purchase workers compensation in one of two situations: when it is required by statute and/or when it is required by contract.

Some years ago, I became involved in a lawsuit in which a trade contractor filed suit against a large residential general contractor for purposes of establishing an employer-employee relationship to garner workers compensation benefits to pay the medical costs and lost wages suffered when the trade contractor fell off a ladder and broke both legs.

Several relevant facts must be known about this case before any theories of law can be applied to establish whether an employer-employee relationship existed between these two entities. The facts of this case are as follows:

- The legal entity under which the trade contractor operated was a corporation.
- The only employee of the corporation was the president, who was also the owner.
- The trade contractor entered into a contract with the general contractor that contained the following insurance and indemnification wording: “The subcontractor shall provide workers compensation insurance covering all employees and shall provide evidence of such coverage by presentation of a valid certificate of insurance.”

The contract also stated that the subcontractor would indemnify and hold harmless the general contractor from any bodily injury or property damage that may occur whether caused solely by the subcontractor or contributed to by the subcontractor.

- The trade contractor purchased a workers compensation policy for the trade contractor corporation and provided evidence of coverage to the general contractor.
- In this policy, the president, and only employee, excluded himself from workers compensation coverage, which, as we will discuss below, is allowed in some states.

- The president fell off a ladder while working at a house being built by the general contractor, breaking both legs.
- The injured president did not have a separate health or disability insurance policy.

Under these facts, does an employer-employee relationship exist? If not, could the general contractor still be held financially responsible for the injury to the employee of a subcontractor?

This article will answer these questions by investigating the general principles of many state workers compensation laws regarding who constitutes an employee for purposes of workers compensation and which employers must obtain coverage based on their legal structure. This article will also define the terms “independent contractor,” “general contractor,” and “subcontractor” and discuss the significance of their differences for workers compensation liability. Lastly, the article will examine the effect of contractual risk transfer.

TYPICAL STATUTORY WORKERS COMPENSATION REQUIREMENTS

Statutory requirements vary by state, but they generally require an “employer” with a specified minimum number of “employees” to provide workers compensation benefits to those employees, either through the purchase of a workers compensation policy or as a qualified self-insurer. Although this may sound simple, who is counted as an employee differs based on what the person is being engaged to do (and how) and the employer’s legal organizational structure.

Who Counts as an “Employee”?

Questions often arise regarding who is counted as an employee and how they are counted. The next section in this article will detail how sole proprietors, partners, managers and members of an LLC, and corporate officers are treated. And a later portion of this article presents the requirement placed on general contractors for injury to employees that are not their own, but which are employees of an uninsured subcontractor. But what about the “traditional” employees not fitting into one of those categories, when and how do they count?

When calculating the number of employees for statutory purposes, it does not matter if the individual is a full-time or part-time employee, he or she is counted as one employee. Thus, if the statute requires that workers compensation coverage be provided if there are three or more employees and the employer has three part-time employees, the employer is required to provide coverage.

The definition of an “employee” generally does not include those classified as “independent contractors” (which is defined in a subsequent section of this article). However, it must be noted that an individual treated as an “independent contractor” for tax purposes may actually be considered an employee for workers compensation purposes. Several “tests” can be applied to determine whether such employee will be

considered an employee or an independent contractor for workers compensation purposes. Some of these "test" questions are:

- Does the employer/contracting party control the individual's ways and means (i.e., does the employer tell the contractor when to show up, how to do the job and when to leave or is the contractor free to come and go as he or she pleases);
- Does the employer provide the materials and the tools to do the job; and
- Does the contracted party work for anyone else or does he contract solely with the employer?

There are many other questions that can be asked, but if the answers to the above sampling of questions are "yes," it is more likely that the individual will be considered an employee rather than an independent contractor and will have to count towards the total number of employees (regardless of the fact that the employer does not take out taxes, the IRS definition).

Different Legal Structures

In all but a few states, sole proprietors and partners are exempted from the workers compensation law and do not count toward the total number of employees. However, sole proprietors and partners are generally allowed to elect to be covered by the benefits provided by workers compensation. As an example, in a jurisdiction that subscribes to this statutory precept a partnership with three partners and one employee has, by such statute, only one employee. If this jurisdiction does not require that workers compensation benefits be provided for only one employee, the entity is not required by law to provide workers compensation coverage; but such an employer may voluntarily choose to purchase such protection in most states.

However, corporate and executive officers, compensated or not, are generally subject to the workers compensation law and are included in the calculation of the total number of employees. Although most state statutes allow these corporate officers to exclude themselves from coverage, they are still included in the total calculation of employees.

If the previous example were a corporation with three officers and one employee, by statute the entity would have four employees and, depending on the state, may be required to provide workers compensation benefits even if the officers exclude themselves from protection.

Limited liability companies (LLCs) are mixed-breed entities designed to offer some of the benefits of a partnership and some of the legal protections of a corporation. This being the case, each jurisdiction dictates whether members and managers of an LLC are treated as partners (and thus not subject to the workers compensation statute) or as corporate officers (and thus subject to the law). Insurance or legal professionals familiar with a particular state should be consulted to confirm how these individuals should be treated in a particular jurisdiction.

The difference among these various legal structures lies in who is considered the "employer." An employer is always a person, whether a natural person or a legal one. If

the entity is a sole proprietor, the employer is the natural person holding the position of sole proprietor. If the entity is a partnership or (in most states) LLC, the natural persons holding the positions of partner or member (in the case of an LLC) are the employers. Conversely, if the entity is a corporation, the employer is the corporation itself, which is a legal person under the law. Thus, the corporate officers are considered employees and subject to the workers compensation law.

In the example presented at the beginning of this article, the trade contractor's employer is the corporation of which he is the president, and its sole employee. However, the trade contractor's injury occurred in a state that requires only employers with three or more employees to purchase workers compensation insurance. This employer had only one employee and was not statutorily required to purchase such protection.

THE EFFECT OF CONTRACTUAL WORKERS COMPENSATION REQUIREMENTS

Regardless of statutory requirements, owners or general contractors may contractually require any entity with which they contract to purchase and show proof of workers compensation insurance covering the subcontractor's employees. Anytime another contractor is hired to perform work on behalf of an owner or general contractor, good risk management practices necessitate that this requirement be contractually placed on the subcontractor.

Forty-four states and the District of Columbia statutorily address the general contractor-subcontractor relationship with respect to workers compensation benefits.¹ In essence, these states require that the employees of a subcontractor — and, remember, who qualifies as an employee is based on the organization's legal structure — will be provided workers compensation benefits if an injury occurs. Such required benefits will be paid either by the injured employee's direct employer (the subcontractor) or the general contractor that hired the subcontractor. If a subcontractor in one of these states does not provide workers compensation insurance (or the coverage lapses or expires without being renewed), the general contractor becomes responsible for paying the workers compensation benefits to the subcontractor's injured employee. Plus, in most states, it does not matter how many employees the subcontractor has; the general contractor will be responsible for paying benefits even if there is only one employee.

The subcontractor in our example was not statutorily required to purchase workers compensation insurance, but due to the fact that the general contractor could have been held legally responsible for an injury to any employee of the subcontractor, regardless of the number of employees, the general contractor wisely required all subcontractors to purchase and show proof of workers compensation coverage.

Keep in mind, we are talking about a general contractor-subcontractor relationship, not the relationship between a principal and an independent contractor. The differences between an independent and general contractor are as follows:

- An “independent contractor” is an entity with which the principal (owner) directly contracts to perform or have performed a certain task. Since independent contractors

are engaged to perform tasks not normally within the usual trade or business of the principal and the tasks are job-specific, independent contractors are not commonly considered employees of the principal.

- A “general contractor” is an entity with which the principal (owner) directly contracts to perform certain tasks *and* which subsequently contracts other entities (subcontractors) to perform some of the duties enumerated in the contract between the general contractor and the principal.

For there to be a general contractor, there must be three parties involved: a principal, an independent contractor, and a subcontractor hired by the independent contractor. The independent contractor’s status changes to that of a general contractor when any part of the work is subcontracted to another entity.

In short, the principal is not necessarily financially responsible for an injury to the independent contractor’s employees or employees of any subcontractors hired by the independent contractor (now general contractor). But a general contractor is financially responsible for any injuries to the employees of a subcontractor if the subcontractor does not provide workers compensation coverage.

What This Really Means for Principals

If the general contractor, for whatever reason, does not have workers compensation coverage, the principal could potentially be sued by the injured person for the workers compensation benefits due. It is, however, unlikely that the principal will ultimately be held responsible for the payment of these benefits, as the principal does not statutorily qualify as an employer or a general contractor. (Of course, the principal could be sued under other theories of liability — for example, the principal’s negligence as a property owner.) If the principal is sued, its workers compensation policy (if one exists) or general liability policy should defend on behalf of the principal.

The best rule for the principal to follow is to contractually require any entity with which it contracts to provide workers compensation insurance. This solves several potential “gray area” problems and, further, avoids the question of whether an employee-employer relationship exists. The mere act of providing a certificate of insurance indicating that the contractor carries workers compensation insurance is evidence that the contractor does not believe it is an employee of the principal (or general contractor). This also keeps the principal from having to concern itself with whether the contractor is subcontracting any of the work.

Further, the insurance requirements section of the contract between the principal and general contractor should state that it is solely the general contractor’s responsibility to confirm that all subcontractors hired provide workers compensation coverage for employees; that if the general contractor does not require and confirm the presence of such insurance from subcontractors, the general contractor understands that it could be held statutorily responsible for the injury to any of the subcontractor’s employees; and that the general contractor will defend and hold the principal harmless in case of injury to any employee.

It is important to remember that a general contractor-subcontractor relationship is not confined to construction projects, although this is where it is most often seen; these relationships are created every day in other industries. A municipality hires a consultant to study traffic patterns and the consultant subsequently hires a survey crew to do on-site measurements; this creates a general contractor relationship. A company hires a business consultant and that consultant subcontracts the statistical work to another party; a general contractor relationship is created. The activities that create a general contractor relationship are endless.

Simply put, regardless of the number of employees and whether any work is being subcontracted by the contractor hired, principals should always contractually require any party with whom it does business to provide proof of workers compensation coverage.

The intent of the workers compensation laws is to create a safety net for any injured worker that assures that benefits will be paid by somebody. Thus, it is prudent for the principal to require the general contractor to carry workers compensation coverage. But a common contractual mistake is to address the workers compensation exposure only in the insurance requirements section of the contract.

CONTRACTUAL RISK TRANSFER

Beyond contractually requiring the independent contractor to maintain workers compensation coverage, a principal should consider incorporating other requirements into its agreement.

Up to this point, this article has focused primarily on who is considered an employee, who is considered an employer, who could be held financially responsible for an injury, and how the principal can protect itself through the proper use and requirement of workers compensation insurance. Insurance is not the only mechanism a principal should employ to protect itself from the financial impact of an injury to someone who is not a direct employee. The effective use of contractual risk transfer will be the subject of the balance of this article.

Effective contractual risk transfer requires that certain wording exist in the contract between the principal and independent contractor (i.e., the would-be general contractor, should any subcontractors be engaged). Since these disparate financing techniques (insurance and contractual risk transfer) are ultimately intertwined, understanding how workers compensation policies and insurers respond to contractual risk transfer language is necessary. As laid out in the facts of our opening example, the subcontractor contractually agreed to indemnify and hold harmless the general contractor for any bodily injury or property damage that may occur.

Commonly known as the “indemnification agreement,” all contracts between principals and contractors should contain some form of indemnification and hold harmless wording that may read as follows:

For and in exchange for fair and equitable consideration, transferee (name of the contractor or subcontractor) agrees to indemnify, hold harmless, and waive

any right of subrogation against transferor (name of principal or general contractor) from any and all loss or cost arising from bodily injury to (transferee's) employees or subcontractors hired by (transferee).

This sample wording deals only with the exposure for injuries covered by workers compensation. More generalized wording can be used to cover other exposures such as property damage or liability resulting from completed operations.

The indemnification and hold harmless agreement is the essence of contractual risk transfer and is required in order for such transfer to be effective. Indemnification deals with the financial consequences of the loss and the hold harmless wording provides protection from the legal process and any accompanying liability that may result from an injury. Unlike the contractual requirement to purchase workers compensation coverage, the indemnification wording is not affected by, nor does it affect, the transferee's insurance coverage. It is purely a contractual issue.

An Example

The importance of contractual risk transfer cannot be underestimated. A recent conversation with a representative of the construction industry underscored the need for proper and consistent contractual risk transfer. As the suit is still in discovery, names and other particulars cannot be released, but some of the details relating to the operation of the properly constructed contractual risk transfer that was in place can be shared.

There are three parties involved in this suit — the general contractor, the subcontractor, and a sub-subcontractor. The general contractor bid out all the work on a commercial building and awarded the contract for part of the work to my client. My client supplied the materials and coordinated the timing of delivery and installation at the construction site. The actual installation was subcontracted to a third party (the sub-subcontractor).

The general contractor required that the subcontractor sign a contract containing indemnification wording requiring the subcontractor to indemnify and hold the general contractor harmless for any bodily injury or property damage resulting solely from the acts of the subcontractor or contributed to by the subcontractor. In turn, the subcontractor required the sub-subcontractor to sign a contract containing the same wording.

During construction, an employee of the sub-subcontractor fell and was injured. The injured worker has sued the general contractor for gross negligence and disregard for safety. The general contractor called upon the subcontractor to defend (by use of the "hold harmless" wording) and indemnify, as was required by the contract. Since the subcontractor had contractually transferred this risk down to the sub-subcontractor, the employer of the injured worker has now been pulled into the suit.

Had the general contractor not contractually required the subcontractor to indemnify and hold it harmless, the general contractor would have been responsible, in whole or in part, had the charges made by the injured worker been proven in court. The same is true with the subcontractor — had it not contractually transferred this risk down to the employer of the injured worker, it may have been required to pay for any jury awards.

The above case is a perfect example of the true goal of contractual risk transfer — to make the entity closest to the activity (and thus with the most control over the situation) financially responsible for any injury that occurs.

Waiver of Subrogation

Many contracts in recent years have required the contractor or subcontractor to endorse a “waiver of subrogation” onto its workers compensation policy in favor of the principal or the general contractor respectively. This is no longer a recommended practice, as most insurers are now refusing this request for various reasons outside the scope of this article. Waiver of subrogation language endorsed to the insurance policy should not be necessary if the contract between the parties waives such rights.

Subrogation rights flow from the paying party’s right to be made whole by the party directly responsible for the loss. If the right to subrogate against the principal or general contractor for injury to any person on the job site is waived by contract prior to an injury, the insurer of the direct employer (the transferee) of the injured party has no right to subrogate either. This waiver of the right to subrogate should be included in the indemnification and hold harmless section of the contract unless a particular state’s statute affects the level of indemnification allowed, in which case the waiver of subrogation wording may need to be addressed in a separate paragraph within the contract.

CONCLUSION

Based on the facts of the subject case and the application of the statutory and contractual law presented in the preceding paragraphs, did an employer-employee relationship exist between the general contractor and the subcontractor in our opening example? Also, could the general contractor be held statutorily responsible for the injuries?

Because the subcontractor undertook to purchase workers compensation insurance and presented evidence of such insurance to the general contractor (even though the subcontractor excluded its sole employee), the subcontractor established that it was a separate entity and that its employee was not the employee of the general contractor. Further, the general contractor did not inherit any legal responsibility because workers compensation coverage had been purchased. It does not matter that the president chose to exclude himself; that was a business decision.

Of course, if a worker is injured, he or she likely will sue all parties involved. This cannot be avoided. However, the goals of both the contractual insurance requirements and the use of contractual risk transfer are simply to place the ultimate financial burden on the party most directly related to and responsible for the injured party.

ENDNOTE

1. These 44 states are: Alabama, Alaska, Arizona, Arkansas, Colorado, Connecticut, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Kansas, Kentucky, Louisiana, Maryland, Massachusetts, Michigan, Minnesota,

Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, South Dakota, Tennessee, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, Wyoming

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