

# RISK EXPOSURES AND GUIDELINES FOR WORKING WITH INDEPENDENT CONTRACTORS



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The hiring of independent contractors, while beneficial because of the flexibility and cost savings, could lead to liability exposures which employers must consider before hiring independent contractors. This memo is a comprehensive, but in no way exhaustive, outline to the liability exposures when hiring independent contractors and risk management solutions to minimize those exposures.

## WHO IS AN INDEPENDENT CONTRACTOR?

An Independent Contractor is a self-employed person or entity that provides goods and services to another entity under terms specified in an Agreement. An independent contractor must be:

1. Free from the business' control and direction over how the service is performed; and
2. Customarily engaged in an independent trade, occupation, profession, or business related to the service being performed.

### INDEPENDENT CONTRACT VS. EMPLOYEE

An employee, like an independent contractor provides labor or services to another entity (employer). Unlike in an independent contractor relationship, an employer is responsible for the actions of their employees. An employer retains control over its employees and receives the primary benefit of their employment-related activities. Because the employer receives the primary benefit from the work performed by employees the employer also owes the employee certain rights such as Workers' Compensation benefits.

There are key points of differentiation between the hiring of an individual as an independent contractor rather than an employee. The following are a list of factors which an employer may consider when assessing an independent contractor. When asserting independent contractor status vs. employee status the employer must consider the ENTIRE relationship between the employer and individual. Under Colorado Law (CRS§§'s 8-40-202(2)(b)(II) and 8-70-115(1)(c)),for an individual to be considered an independent contractor the employer shall not:

1. Require the individual to work exclusively for employer;
2. Establish a quality standard for Contractor; except that employer may provide plans and specifications regarding the work but will not oversee the actual work or instruct individual as to how the work is to be performed;
3. Pay to individual a salary or hourly rate, but rather will pay the individual a fixed or contract rate;



4. Terminate the work during the contract period unless individual violates the terms of the agreement between the parties or fails to produce a result that meets the specifications of the Agreement between the parties;
5. Provide more than minimal training for individual;
6. Provide tools or benefits to individual; except that materials and equipment may be supplied;
7. Dictate the time of individual's performance;
8. Pay individual personally; instead, employer will make all checks payable to the trade or business name under which individual does business
9. Combine its business operations in any way with individual's business, but will instead maintain such operations as separate and distinct.

## RISKS ASSOCIATED WITH HIRING OF AN INDEPENDENT CONTRACTOR

### MISCLASSIFICATION OF INDIVIDUAL AS AN INDEPENDENT CONTRACTOR

There are many associated benefits with hiring an Independent Contractor. Savings in employment taxes and benefits, avoidance of minimum wage and overtime requirement, and reduction of lawsuits for wrongful termination and discrimination claims are all benefits which are achieved through the hiring of an independent contractor. The cost savings of hiring independent contractors has caused contractors to misclassify independent contractors. An employer that misclassifies an employee as an independent contractor with no valid basis for doing so may be found liable for:

- State penalties for failure to complete due diligence on independent contractor's status
- employment taxes, including amounts that would have been withheld in federal and state income taxes if the person were properly classified as an employee;
- back wages and penalties for violations of minimum wage, overtime and FLSA reporting requirements;
- violations of the Employment Retirement Income Security Act for failure to provide retirement and health benefits;
- Workers' Compensation benefits for misclassified injured workers; and
- Workers' Compensation premiums for the independent contractor's payroll for the project.

### EMPLOYER'S LIABILITY FOR INDEPENDENT CONTRACTOR'S NEGLIGENCE

Employers can be held vicariously liable under the doctrine of respondeat superior for damages arising out of their employees' tortious acts, if those acts occur within the scope of employment. Traditionally there was a complete exclusion to this doctrine for the liability for the tortious acts committed by independent contractors.

The reason for this exception was that the employer had little or no control over the means and methods of the independent contractor's performance. However, the evolution of the concept of an independent contract has demonstrated that the employer selects the independent contractor, benefits from the work, and is able to assume the potential risks as a cost of doing business. Therefore, exceptions to the exclusion of respondeat superior have developed. Exceptions to the independent contractor rule fall into three general categories.



These conditions under which an employer can be held liable for the contractor's negligence are as follows:

- Control of the Details
- Selection of the Contractor
- Dangerous Activity

## Control of Details

If the employer retains control over the manner and the means by which the independent contractor performed all or part of its work, the employer may be liable for the independent contractor's negligence. In general, liability will be found where the employer's actions impair the independent contractor's ability to execute the work as it desires. At the same time, however, general oversight or maintenance by the employer is not sufficient to establish a relinquishment of the contractor's control over a project.

## Selection of the Contractor

An employer can be held liable for the negligence of an independent contractor if the employer was negligent in the selection of an incompetent contractor. This is referenced as the "contingent liability." The law provides that one who employs an independent contractor has a duty to exercise reasonable care in selecting one that is properly qualified for the job. Accordingly, an employer must diligently investigate a contractor's fitness and ability to perform the particular type of work for which it is hired.

## Dangerous Activity

An employer can be held liable for an independent contractor's performance of an inherently dangerous activity or peculiar risk for which certain precautions should have been taken.

- ***Inherently dangerous activity:*** An inherently dangerous activity are those in which unavoidable and foreseeable risks of harm are embedded in the very nature of the activity, demanding that either the employer or contractor take specific precautions to reduce these risks
- ***Peculiar risk:*** A peculiar risk is one in which a unique danger stemming from the nature of the work requires that special precautions be taken

The employer cannot escape liability by delegating to the independent contractor the responsibility for ensuring that adequate precautionary measures are taken. On the contrary, the employer can be held liable for the independent contractor's negligence in the performance of its work. Most states require an employer to ensure that its independent contractors take necessary precautions when the contractor performs a task involving a peculiar risk. An employer will be held liable if, in light of its knowledge and experience, the employer could have foreseen certain risks inherent in the methods of performance and the employer failed to ensure that appropriate safeguards were in place.

## WORKERS' COMPENSATION

An employer can be held responsible for Workers' Compensation coverage as related to the hiring of an independent contractor. Under certain situations, the law will hold the employer as a "statutory employer" whereby the Worker's Compensation of that employer would be subject to respond if an injury occurs. In addition to becoming a part of your permanent loss record and impacting your experience modification factor (for three full years), the carrier who paid the claim may also add the payroll for that worker, upon audit and at the next renewal, which could result in increased premium costs. The law will traditionally err on the side of providing coverage to the injured individual.



The two situations whereby an employer could be responsible for Workers' Compensation coverage of an independent contractor are:

- If the individual does not meet the legal definition of independent contractor
- If the independent contractor hires employees or enlists another individual to provide work for the benefit of employer

### **Individual does not meet the legal requirements to be an independent contractor**

A person hired to perform services for pay is presumed by law to be an employee unless they meet the definition of an independent contractor or qualify under a specific exemption provided by workers' compensation laws. As referenced above, if the employer misclassifies the individual or if the individual negligently or unknowingly identifies themselves as an independent contractor then the employer's Workers' Compensation policy could be subject to respond to an injury occur.

### **Employees of Independent Contractors**

Most states recognize independent contractors as one person/one individual. Many states do not require individuals to secure workers' compensation insurance, as they are the owner and have no employees. Once they have hired employees, they are no longer an independent contractor. However, each state differs on the number of employees one can hire, before they are required to obtain workers' compensation insurance. Some states allow the hiring of up to five employees, before requiring workers' compensation insurance. If the independent contractor hires employees and does not provide Workers' Compensation insurance, then the employer's Workers' Compensation policy, since it is the only policy in effect, will be subject to respond.

### **Third Parties brought on by Independent Contractors**

The Independent Contractor can create an exposure to employer by bringing third parties onto the site to perform work for the benefit of the employer. If the third parties do not properly fill out independent contractor forms AND disclaim their rights through contractual agreement, then since they are performing work which benefits the employer, the employer could be considered the "de facto" employer and employer's Workers' Compensation policy will be subject to respond.

## **MANAGING THE EXPOSURE OF INDEPENDENT CONTRACTORS**

It is important to manage the risk associated with independent contractor exposures in your company. The exposure to the risk of hiring independent contractors can be avoided or significantly limited through the following risk management procedures:

### **1. Using experienced, well-managed, and verified independent contractors**

Employers should take steps to investigate the background and years of experience of the independent contractor. Examine the contractor's experience and qualifications to determine whether the contractor is competent to carefully perform the required work.

Additionally, some states, such as Colorado, require that a person claiming to be an Independent Contractor register themselves on a formal state website. If they are not registered there, then the state does not recognize them as an independent contractor, and they will be required to provide workers' compensation insurance. A quick internet search on a specific state with "workers' compensation" and "independent contractors" in the search, often provides links to state requirements to start your search. Your legal counsel can also provide additional direction on state requirements in this arena.



## 2. Have a Contract

Use legal counsel to develop a contract that you can use in subcontract agreements. A contractual agreement with an independent contractor should include, but is in no way limited to, the following:

- i. Language whereby the independent contractor acknowledges the independent contractor relationship. Independent Contractor should agree that they are not entitled to and waive any claim against employer for (i) UNEMPLOYMENT INSURANCE BENEFITS, (ii) WORKERS' COMPENSATION COVERAGE, OR (iii) HEALTH INSURANCE COVERAGE (NOTE: under Colorado State law this acknowledgement must be in bold font and larger than remainder of Agreement)
- ii. Language whereby independent contractor obligates to pay federal and state income tax on money earned pursuant to the Agreement
- iii. Insurance requirements (see discussion below)
- iv. Agreement to provide Worker's Compensation coverage if hiring employees. And an agreement not to bring other parties on the project site to provide services without the written permission from employer.
- v. A specific term of the agreement: start and end date
- vi. A provision outlining that independent contractor is free to work for others
- vii. A provision outlining the payment terms

If a claim is brought before an employer's workers' compensation carrier and they agree to dispute the case in court, the employer will have the burden of proof, to show that the injured party is NOT your employee. It will be crucial to produce detailed documentation showing employer's agreement with the independent contractor and understanding of how that independent promoted themselves to employer's company.

## 3. Requiring proof of Insurance

Independent contractors should provide proof of coverage to the extent required by the independent contract agreement. The certificates allow the employer to determine if the independent contractor can support the risks and obligations of the agreement. The agreement should at minimum require:

- General Liability Coverage. Employer should be included as additional insured and contractual liability coverage to cover the indemnification obligations of the agreement should be included.
- If bringing vehicles on the site, Business automobile liability coverage

Workers' Compensation coverage will not be provided by all independent contractors. In that case, employers will not be able to secure a certificate of insurance evidencing workers' compensation coverage.

## 4. Have all Parties Sign an Independent Contractor Form and Workers' Compensation Rejection Form

The independent contractor should fill out an independent contractor verification form (this is typically provided by employer's workers' compensation carrier) and the independent contractor "rejection of coverage by partners and sole proprietors performing construction work on construction sites" form. Again, while no single document will protect an employer from a legal action against them, this document reinforces the intent of the contractual relationship between the parties.



5. Do Not Provide Tools or Day-to-Day Direction on the Project  
Providing, replacing or repairing tools, or reimbursing the independent contractor for tools, can be pivotal in finding that a party was actually the employer of the independent contractor. In addition, while employers are expected to provide detail and performance expectations on the project, providing daily or frequent supervision could also create the perception that the independent contractor is actually an employee. Allow the independent contractor to maintain control over the means and methods of its assigned work.
6. Independent Contractors Should Always Be Free to Work for Others  
Having an exclusive agreement with a contractor could make them appear to be an employee. That's why employer's contractual agreement should have a written understanding that the independent contractor is free to work for others. Employers should also retrieve a tax ID# or invoice from the independent contractor and a business card. These represent that the independent contractor maintains a business, unrelated to employer's company.
7. Payment Terms of Your Independent Contractor Agreement  
If you an employer pays the independent contractor on a weekly or bi-weekly basis, just as they would pay an employee, it may portray the independent contractor as an employee. The employer's contract should denote if payment will be made as portions of the project are completed, monthly, or upon completion of the entire project. Consider having the independent contractor invoice you, each time payment is due. Your attorney can help you draft a final payment document that will memorialize the completion of the work and the contractual agreement/payment between parties. Consider the risk of paying the subcontractor in their personal name, versus their company name. In accordance with Colorado statutes, independent contractors should be paid in their business entity name or trade name, rather than being paid personally. Therefore, making checks payable to the business entity name or trade name would further evidence an independent contractor relationship. It is advisable to require independent contractors to file a trade name or form an entity.

## SUMMARY

The benefits of independent contractors can be great to employers and the use of independent contractors is not discouraged, however the exposure for liability of employer when hiring independent contractors should be managed accordingly. Use of the prescribed risk management procedures are not guaranteed to eliminate the exposure to employers but by establishing independent contractor agreement, evidencing independent contractor status, and establishing independent contractor protocol the exposure to risk can be significantly reduced.

## CONTACTS

To find out more how IMA can protect your assets and manage your risk, please contact your IMA associate or:

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