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Risk Management Information

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INSURANCE AND LIABILITY CONSIDERATIONS WHEN HIRING CONTRACTORS

Workers' compensation

M.S. 176.182 requires that any contractor doing business with the city must provide evidence of compliance with the statutes that require employers to have workers' compensation insurance. Note that this does not mean all contractors must have workers' compensation insurance. A contractor could show that he is in compliance with the law in three ways: 1) by showing he has insurance; 2) by showing he does not have any employees, and is therefore not required to have workers' compensation insurance since he is not an employer; or 3) by showing he has been approved by the Commissioner of Insurance as a self-insurer for workers' compensation. See generally, M.S. 176.011, subd. 9; 176.012; and 176.041.

M.S. 176.182 specifies that the statute does not create any liability on the city's part for workers' compensation benefits. Nor does there appear to be any other penalty should the city fail to enforce the insurance requirement. However, this should not be taken to mean that there could be no consequences to the city if the requirements of M.S. 176.182 are not complied with. If the city employs a contractor who did not have workers' compensation insurance, there are a couple of ways the city could get stuck for paying workers' compensation benefits. A court might, under some circumstances, hold the city to be a general contractor employing a subcontractor, within the meaning of M.S. 176.215, and therefore liable for workers' compensation to the subcontractor's employees. See for example, *Moorhead v. Groule*, 254 Minn. 103, 93 N.W.2d 678, involving a similar situation.

Sole proprietors

The second and probably more common way to get stuck is in the situation where the city is dealing with an independent contractor who is a sole proprietor, with no employees, and who is therefore not required by law to have workers' compensation insurance. The problem is that these independent contractors are sometimes deemed to be "employees" when they are injured.

The courts have indicated there are five factors to be considered in deciding whether a person is an "employee" or an "independent contractor." Unfortunately, the factors themselves are a bit vague, and the courts don't seem to have been particularly consistent in applying them to particular cases.

1. *The right to control the means and manner of performance.* Generally with an independent contractor, the hiring party only specifies what the final result is to be. The contractor would be free to determine what equipment to use, in what order to perform the various tasks, the exact times he will do the work, etc. The court has stated that this is the most important of the five factors.
2. *Mode of payment.* If payment is made on a per-job basis, independent of the exact time involved, it will tend to support the conclusion that it is an independent contractor relationship. If payment is made on an hourly basis, the inference is that it is an employer-employee relationship.
3. *Furnishing of material or tools.* An independent contractor typically furnishes his or her own tools, equipment, and supplies.
4. *Control of the premises where the work is performed.* This factor looks at where the work is performed. If a person performs work on his own premises (e.g. repairing a vehicle brought to his garage), they are more likely acting as an independent contractor.
5. *Right to discharge.* The hiring party, without breaching the contract, can generally not terminate the relationship with an independent contractor. Theoretically, many employees can be terminated at will. The problem with this rule is that there are many employees (e.g., union personnel, veterans, etc.) whom a city may not terminate at will; and an agreement with an independent contractor might explicitly provide for termination at will by either party.

The Department of Labor and Industry has also adopted rules on the subject. (See, Chapter 5224 of the Minnesota Rules – located at <http://www.revisor.leg.state.mn.us/arule/5224/>.) The rules essentially codify and elaborate on the factors the courts have developed. In particular, Rule 5224.0330 clarifies that “[t]he most important factor in determining whether a person is an independent contractor is the degree of control that the purported employer exerts over the manner and method of performing the work contracted. The more control there is the more likely the person is an employee and not an independent contractor.” Despite the rules and court decisions, it is still sometimes difficult in particular cases to make a clear determination as to who is an "employee" and who is an "independent contractor."

It has been suggested that simply including in the contract a provision that the person will waive any claim to workers' compensation benefits could solve the problem of independent contractors. However, this doesn't work. It is clear that simply calling a person an independent contractor doesn't make him one; the courts will look to the substance of the relationship rather than the words used by the parties. And if the relationship is one of employer-employee, any signed waiver will be ineffective - since law prohibits an employee from waiving his right to workers' compensation benefits. See M.S. 176.021, subd. 4.

Thus, in dealing with an independent contractor who has no employees, the city really has two options. One is to simply require all contractors to have workers' compensation insurance, whether the statutes require it or not. Sample language is included at the end to this document to

accomplish this purpose. Ideally, the sample language should be included in the bid specification in order to clearly set forth the city's insurance and contract language requirements. This approach eliminates the city's exposure, but has the disadvantage of either increasing cost to the contractor, or alternately making it impossible for these individuals to qualify for city contracts. The other option is to make sure the contract is carefully drafted with an eye to the five factors cited by the courts.

In auditing the city's payrolls to determine the final workers' compensation premium, the auditors look at these kinds of contracts, and whether the city has a certificate of coverage from the contractor. If not, amounts paid under contracts are treated as payroll unless there is good evidence the individuals are not in fact "employees" for purposes of the statutes. What this means is that when hiring a sole proprietor as an independent contractor, the city should make sure to have a written contract that is structured with an eye toward the five factors the court has listed. Without such a contract, the carrier must assume that the work involved represented a workers' compensation risk for which premium is appropriately charged.

Liability coverage

In addition to the workers' compensation question, cities also need to be concerned about a contractor's liability coverage. LMCIT strongly encourages member cities to make sure that every contractor has liability insurance – typically a commercial general liability policy (CGL). LMCIT recommends attempting to get the city named as an “additional insured” on the contractor's policy.

If someone is injured as a result of the contractor's activity, the injured party is likely to sue both the city and the contractor. If the contractor has adequate insurance that names the city, that insurance policy would respond to both of those claims. If the contractor does not have insurance, the city's LMCIT coverage would provide coverage of the claim against the city, but not of the claim against the contractor assuming, of course, that the particular claim is not excluded under the city's own coverage.

Making sure the city is named as an “additional insured” on the contractor's policy, however, is critical. This means that when the claim comes in and the city is named in the suit, the city and LMCIT can simply tender it to the contractor's insurance company to be defended. That way, LMCIT doesn't incur the expense of hiring an attorney to defend the city and to pursue subrogation against the contractor and his insurer. And since defense costs are a major part - nearly a third - of LMCIT's total incurred liability loss costs, anything cities can do to avoid and minimize defense costs is extremely important.

Another alternative sometimes used in the context of a building construction contract is to have the contractor purchase an insurance product known as an “Owners and Contractors Protective Liability Policy” (OCPLP). This coverage is distinct from the contractor's CGL insurance and is a separate policy purchased specifically for the benefit of the city. The coverage insures the city for claims that might be brought against the city arising out of the contractor's work. It also protects the city from claims arising out of the city's failure to properly supervise the work.

There is some debate as to whether it is better to use an OCPLP or to include the city as an additional insured on the contractor's CGL policy. On one hand, the advantage of the OCPLP is that it is for the sole benefit of the city and therefore the city does not have to share the insurance limits with the contractor. On the other hand, it is generally thought that a CGL policy affords a little broader coverage and, unlike an OCPLP, usually insures beyond the completion of the project. The point is not to recommend one insurance product over another, but rather to again stress the need for the city to demand some type of insurance from the contractor.

Other important considerations are making sure the city gets a certificate from the contractor and that the contract itself also supplements the insurance requirement with a properly worded defense and indemnification provision in the city's favor. These expectations should also be made clear in the bid specifications. (Sample language is included at the end of this document.)

It is important to remember there is a distinction between being listed as "certificate holder" and being listed as an "additional insured." A certificate holder does not automatically have "additional insured" status.

If the contractor does not have liability insurance the risk to the city, and therefore to the city's insurer, increases substantially. It is because of this increased risk that LMCIT's policy is to strongly encourage cities to require all contractors to have liability insurance. And if the city does not require that insurance, the rates charged by LMCIT to that city will ultimately have to increase accordingly.

(Note: that for professional service contractors – e.g., engineers, architects, attorneys, etc., - the city will not generally want to be listed as an "additional insured" on the firm's professional liability coverage. This type of insurance is primarily intended to cover claims the city itself might need to make against the firm for damages caused by the firm's errors. In such a scenario the city wouldn't want to be considered an "insured," because many professional liability policies may not cover a claim by an "insured." On a related matter, cities should also be wary of attempts by professional service contractors to limit a city's right to recover damages to a specified dollar amount. E.g., two times the contract amount.)

Contractor insurance limits

A very common question is what limits of liability coverage the city should require contractors to carry. LMCIT has not established any minimum limits requirement - although as a general guideline we suggest at least \$1,000,000. In some ways the question of limits is a secondary consideration. The more critical consideration is making sure the city requires the contractor to have at least some liability insurance.

The reason limits may be less significant than they may seem at first glance has to do with the loss patterns we've experienced. The overwhelming majority of liability claims we've seen are relatively small. Since 1980 only a very small percentage of all LMCIT's liability claims have exceeded \$100,000 in damages. Therefore, even a very low limit will probably take care of most problems.

While we generally recommend limits of at least \$1,000,000, there really isn't a "magic number" for insurance requirements for contractors and licensees. Even if the contractor were to carry a policy with a limit of \$1,000,000 per occurrence, there's no assurance this would be enough to fully protect the city.

The reason is that both the contractor and the city are insureds under the policy, and both could have some liability in a single occurrence. If the contractor's liability uses up some of the \$1,000,000 available under the policy, there wouldn't be enough limit left in the policy to cover the full potential amount of the city's liability (the city's current statutory liability limit is \$1,000,000), plus the contractor's liability for that occurrence. Since there is no statutory limit on the contractor's maximum liability, the same problem can exist regardless of what limits the contractor carries. For example, even if the contractor carries a \$2 million limit policy, the contractor might end up with \$1.5 million or \$2 million or \$10 million of liability, not leaving enough limits in the policy to cover the city's exposure. Regardless of what insurance limits the contractor purchases, the city can never be assured the contractor's insurance will be enough to cover the full extent of the city's liability. Thus, there's no special reason for pegging the amount of insurance required of a contractor to the city's statutory \$1,000,000 liability limit.

Another important point to review when considering contractor insurance amounts, is the presence of aggregate limits in the policy. For instance, while the policy on its face may appear to be sufficient, the presence of an aggregate limit could effectively reduce the insurance available. Essentially, what could happen is that claims against the contractor by other claimants relating to the firm's other projects could erode coverage. That is, if such claims occurred, it's conceivable there might be no limits or inadequate limits remaining for any claims the city might have to make.

Certainly it is true, though, that the higher the limits the contractor carries, the more likely it is the limits will be sufficient to cover both the contractor's and the city's liability. Besides protecting the city, higher limits also benefit the public; the higher the limit, the more likely it is that there will be adequate resources available to compensate a member of the public injured by the contractor's activities. Thus, having \$750,000 of coverage would be better than having \$500,000; but having \$1,000,000 would be better than having \$750,000, and so on. On the other hand, many small contractors may balk at the \$1,000,000 requirement, in which case the city might drop the requirement to \$500,000. Even at this level the city would be protected from the vast majority of potential claims.

There is of course a trade-off in that requiring higher limits will cost the contractor more money, which may or may not be reflected in an increased contract price to the city. The issue of how much insurance to require is really a classic matter for council discretion: balancing the burden imposed on the individual against the benefit to the city and to the public. Again, the most critical factor is to make sure the contractor provides evidence of some amount of liability insurance protection. The sample bid specification and contract language included at the end of this document can be used to address most of the insurance and limits issues discussed above.

Property Coverage

In discussing insurance issues with independent contractors the issue of first party property coverage generally arises only in the context of building construction projects. As a consequence, first party property insurance does not usually have to be addressed in contracts not involving construction projects. However, if the city is hiring an independent contractor to do building construction work, it is vitally important to address the subject of property coverage.

The issue becomes even more important when the city is asked to enter into one of the standard form construction contracts currently prevalent in the building trade. Depending on the size of the construction project, contracting parties may utilize “standard” contract forms developed by various trade associations. The most widely used forms are those promulgated by the American Institute of Architects (AIA). These forms, which are often in excess of 40 pages in length, have been interpreted by the courts and benefit the contracting parties by providing familiarity and consistency. However, because these forms tend to be written from a particular point of view, the language may often not be particularly favorable to the city. Also, because of their length, they can often be very intimidating to review for city officials and even the general practice city attorney. The following discussion will address some of the more significant first party property issues that come up in the typical construction contract.

As background, it is important to understand how LMCIT’s first party property coverage applies to construction projects. Unlike many commercial property policies, LMCIT’s standard coverage automatically provides a basic level of protection for building construction projects. Specifically, in addition to coverage for existing buildings, LMCIT provides protection for direct physical loss or damage to “Buildings in the Course of Construction, Alteration, or Repair.” The coverage also covers “Property in Transit,” such as building materials. The automatic coverage is limited to \$2,000,000 for “Buildings in the Course of Construction, Alteration or Repair” and \$250,000 for “Property in Transit.” Accordingly, from the city’s perspective, except for possibly having to purchase additional limits, it is not necessary to buy an additional policy to cover the value of buildings in the course of construction.

In reviewing the first party property insurance requirements in the AIA’s 1997 A201 form, paragraph 11.4.1 sets forth certain first party property insurance requirements. The clause requires the owner to purchase “builder’s risk,” “all risk,” or “equivalent coverage” in the amount of the contract sum for the entire project on a replacement cost basis. The most common means of satisfying this requirement is through procurement of a “builder risk policy.” By definition, a builders risk policy provides property loss coverage to the structure, or portion thereof, during the period of construction. It also addresses changes in value of the property as it proceeds from the beginning to the end of construction. While LMCIT’s first party property coverage is not specifically labeled “builders risk policy,” it effectively does the same thing and should be considered an “equivalent coverage.”

Within the construction industry, contractors have often been named as an additional insured on builders risk policies procured by owners. More recently, however, some owners, including some public sector entities, have been requiring contractors to procure the builders risk coverage

and name the owner as an additional insured. This alternative is recognized in the A201 form, subparagraph 11.4.1.2. While this approach has the advantage of putting the insurance procurement responsibilities with the entity that has direct control over the construction site, it has the possible disadvantage of increasing the overall cost of the construction project.

With LMCIT's property coverage structured the way it is, we believe the most cost-effective way to address the builders risk exposure is to simply allow the City to carry the risk on its LMCIT coverage. If the builders risk coverage is handled in this way, we recommend modifying the standard AIA form to allow the city and LMCIT to seek recovery from the contractor in the event the contractor's negligence has caused property damage to adjacent structures.

In particular, as written in the Standard AIA document, subparagraphs 11.4.5 and 11.4.7 would likely be construed to waive LMCIT's right to recover from a negligent contractor for damages that might be caused to existing property. For example, during the course of construction of an addition to city hall, the contractor negligently leaves the site unprotected so that rain leaks into the existing site and damages it. Absent a modification of the waiver of subrogation provisions, the city and LMCIT would have no recourse in recovering from the contractor. In this regard, we have included at the end of this memo, some suggested modifications to the Standard AIA form. The modifications should also be included in the bid specifications. Use of the sample language will likely preserve the city's and LMCIT's right to recover from the contractor and others who have caused damage to non-project related property.

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Sample Language to Include in Bid Specifications and Contract Provisions

Language Requiring Workers' Compensation Insurance:

Contractor shall provide a certificate of insurance showing evidence of workers' compensation coverage or provide evidence of qualification as a self-insurer of workers' compensation

Indemnification Provision:

Contractor shall defend and indemnify the city against claims brought or actions filed against the city or any of its officers, employees or agents for property damage, bodily injury or death to third persons, arising out of or relating to contractors work under the contract.

Liability Insurance Requirements (Liability and Auto):

Contractor shall maintain commercial general liability (CGL), and if necessary commercial umbrella insurance, with a limit of not less than \$1,000,000 each occurrence. If such CGL insurance contains a general aggregate limit, the general aggregate limit shall be not less than \$2,000,000 and the aggregate limit shall apply on a per-project basis. The CGL insurance shall cover liability arising from premises, operations, independent contractors, products-completed operations, personal injury and advertising injury, and contractually-assumed liability. The city shall be named as an additional insured under the CGL.

Contractor shall maintain automobile liability insurance, and if necessary, umbrella liability insurance with a limit of not less than \$1,000,000 each accident. If such insurance contains a general aggregate limit, the general aggregate limit shall be not less than \$2,000,000. The insurance shall cover liability arising out of any auto, including owned, hired, and non-owned autos.

A certificate of insurance acceptable to the City shall be filed with the City prior to the commencement of the work. The certificate and the required insurance policies shall contain a provision that the coverage afforded under the contract will not be canceled or allowed to expire until at least 30 days prior written notice has been given to the city.

Modification to 1997 AIA Document A201. (Changes bolded.)

11.3 [This paragraph, including all subparts, should be deleted in its entirety.]

11.4.5 [This subparagraph should be deleted in its entirety.]

*11.4.7 Waiver of Subrogation. **Except as otherwise provided herein**, the Owner and Contractor waive all rights against (1) each other and any of their subcontractors, sub-subcontractors, agents and employees, and (2) the Architect, Architect's consultants,*

*separate contractors described in Article 6, if any, and any of their subcontractors, sub-subcontractors, agents and employees, for damages caused by fire or other causes of loss to the extent covered by property insurance applicable to the Work, except such rights as they have to proceeds of such insurance held by the Owner as fiduciary. The Owners or Contractor, as appropriate, shall require of the Architect, Architect's consultants, separate contractors described in Article 6, if any, and the subcontractors, sub-subcontractors, agents and employees of any of them, by appropriate agreements, written where legally required for validity, similar waivers each in favor of other parties enumerated herein. The policies shall provide such waiver of subrogation by endorsement or otherwise. A waiver of subrogation shall be effective as to a person or entity even though that person or entity would otherwise have a duty of indemnification, contractual or otherwise, did not pay the insurance premium directly or indirectly, and whether or not the person or entity had an insurable interest in the property damaged. **Notwithstanding the above, Owner does not waive its rights to subrogate against (1) contractor, any of its subcontractors, sub-subcontractors, agents or employees, or (2) the Architect, Architect's consultant, separate contractors described in Article 6, if any, or any of their subcontractors, sub-subcontractors, agents or employees, for damages caused to non-Project related property, real or personal or both, at or adjacent to the site of the Project, caused by the negligent, intentional or other willful act or omission of the (1) contractor, any of its subcontractors, sub-subcontractors, agents or employees, or (2) the Architect, Architect's consultants, separate contractors described in Article 6, if any, or any of their subcontractors, sub-subcontractors, agents or employees.***