

State law requires an employer to provide workers compensation for all of its employees¹. State law generally does not require an employer to provide workers compensation coverage for the employees of other employers with which it contracts (independent contractors).

As a general rule, a workers compensation policy covers only the employees of the policyholder². In a PEO, co-employment arrangement, a policy written in the name of the PEO (a “Master Policy”) covers the employees of the PEO (i.e., the worksite employees and if desired, the PEO’s “core” employees).³ The Master Policy is not intended to cover individuals who are not employees (or co-employees) of the PEO⁴.

The question for discussion in this article is the obligation of a PEO client under state workers compensation laws for employees not on the PEO payroll (“Non-PEO Employees”) and independent contractors of the PEO client, and the risk to the PEO and its workers compensation carrier posed by such workers on the client’s premises.

The Potential Liability to the PEO

States have very broad powers in requiring employers to provide workers compensation insurance to employees. The states’ primary focus is on protecting employees who are injured during employment. As a result, the states will generally seek a way in which to find workers compensation coverage for an employee at a particular jobsite. What this means is that if there is a policy of workers compensation insurance in effect that covers some employees at a jobsite, and a claim is made by an employee that the employer and/or insurance carrier believes was not intended to be covered, it is not unusual for the state to argue that the policy in place must cover the claim nonetheless. Typically, the theory for coverage is that the policy covers the location where the employees are working, and any injury to an employee working at that location must be covered by a

¹ In the great state of Texas, an employer may “opt out” of providing workers compensation coverage, but must then provide private insurance to cover workplace injuries. See, Tex. Gov’t Code Sec. 406.002 (Vernon 1995). Please also note that many states exempt from the definition of employer anyone with less than a certain number of employees.

² This is generally covered in the policy under the definition of “employee” or “covered person”. It can also be covered in a separate endorsement that specifically addresses claims by “worksite employees” or “co-employees”. The PEO and its insurance agent should review the policy carefully to be sure that the definitions provided are accurate and are consistent with the PEO, co-employment business model.

³ A Worksite Employee is an employee who is co-employed by the PEO and the client, and who works at the client’s location and takes direction from a manager or supervisor located at the worksite (as opposed to employees who work solely for the PEO [“core” employees]).

⁴ This article assumes that a PEO has secured some form of Master Policy. As this author has discussed in other articles, PEO are able to secure workers compensation coverage for their co-employees in most states through policies issued in the name of the client. If the PEO opts to provide coverage in this manner, the PEO’s potential liability for a claim by a Non-PEO Employee or independent contractor is different. The PEO’s potential liability arises from a client failing to secure workers compensation coverage at all, and the state imposing liability on the PEO based on the co-employment relationship. If the client has workers compensation insurance in place, it is the client’s policy that would be required to respond to a claim made by a Non-PEO Employee or independent contractor of the client.

policy. Thus, if a PEO client fails to secure a separate policy for Non-PEO Employees or a client's independent contractor fails to secure such coverage, and someone is injured while working on the client's premises, the state may very well argue that because the PEO's policy is the only policy in effect, that policy must cover the injury⁵. Stated in a different way, the State would argue that policy of insurance covers the workplace, and it is the responsibility of the employer to secure additional policies to cover employees that the employer does not intend to cover under its policy.

The potential liability to the PEO could be quite large depending on the injury. It is almost a certainty that according to "Murphy's Law" a claim made in such a circumstance will be a serious injury. If such a claim is made, there are three likely liability scenarios: (1) the PEO has a "first dollar" policy and the carrier agrees to accept coverage; (2) the carrier agrees to accept coverage, but the PEO has a per-claim deductible under the policy; or (3) the carrier denies the claim and the PEO must cover the costs of the claim. Under the first scenario, there is no immediate cost to the PEO; however, such an incident could affect the PEO's ability to negotiate a favorable renewal or to renew at all. In the latter two scenarios, the PEO is faced with immediate costs, and such costs could continue for significant period of time.

The Client's Responsibility

As an employer, the Client has a duty to provide workers compensation insurance for its employees. In most states, a client can agree to "delegate" this obligation to a PEO pursuant to a PEO agreement; however, the Client remains legally responsible to secure such coverage, either on its own or through a PEO. Hence, a PEO client that has some employees who are not covered under the PEO agreement has a legal duty to secure workers compensation coverage for these employees. The PEO client also has an independent legal duty to verify that an independent contractor on its premises has secured workers compensation insurance. As a result, the PEO client is primarily liable for failing to secure workers compensation coverage for its employees and independent contractors.

Unfortunately, the existence of a legal duty to provide such coverage is, in and of itself, not enough to shield the PEO from potential liability. Although the PEO has no legal duty to provide workers compensation coverage to Non-PEO Employees, it is an employer in most states for purposes of workers compensation insurance, and must provide such coverage to its employees. Hence, the PEO is an employer at the client's worksite, and for this reason, is potentially subject to liability for injuries to Non-Employees. This is so because a Non-Employee may attempt to file a claim under the PEO policy in that the PEO policy was the only policy covered the worksite. Although the PEO could ultimately prevail against the client to recoup its expenses for paying such a claim, the PEO would have to pursue the client legally, and then collect from the client (this assumes the client is in existence and solvent).

⁵ I am not suggesting that the state will be successful; however, I have personally seen a state take such a position, and an insurance carrier agree to provide coverage.

An Ounce of Prevention ...

So, what is a PEO to do about this potential risk? Because the PEO cannot change the legal obligation imposed on an employer (i.e., client) to secure workers compensation insurance for its employees, the PEO can only manage this risk. The first and best place to manage this risk is the PEO contract.

The PEO contract must specifically address the extent to which the PEO has agreed to provide workers compensation coverage, which employees are covered, and which employees and third parties are not covered. Such language must be clear and unequivocally. The contract must clearly provide that only employees of the client on the payroll of the PEO are covered by the PEO policy, and that the Client is solely responsible for covering Non-PEO Employees under a separate policy of insurance in the name of the client. The contract must also clearly provide that the client may not engage an independent contractor without written confirmation that the independent contractor is at the time of the engagement in compliance with the state's workers compensation insurance requirements⁶. Failure to comply with these provisions should be grounds for automatic termination of the PEO agreement⁷. In addition, the indemnity clause should clearly apply to the Client's failure to provide workers compensation insurance. In my opinion, representatives of the PEO must discuss these provisions with the Client prior to execution, and must be very clear with the client regarding its obligations.

The PEO should also consider inserting a provision in its contract that requires the client to notify the PEO of the presence of an independent contractor on the client's premises. The purpose of this provision is to allow the PEO to confirm that the independent contractor has the required workers compensation coverage. It has been my experience that few, if any, PEOs actually enforce such provisions, and generally do not audit clients for compliance. Typically, a PEO discovers an uninsured independent contractor at a client's location only after a claim is filed against the PEO's workers compensation policy. To make matters worse, it is not unusual for the independent contractor to have gone out of business or otherwise vanished by the time the PEO receives notice of the claim. Although practically it may be difficult for a PEO with many clients to monitor such activity, the potential exposure to the PEO and its carrier is significant. For this reason, the PEO should impose internal controls to verify compliance, and at least conduct systematic audits of clients, particularly those more likely to use independent contractors (i.e., clients in the construction business).

The second place to manage risk is in the PEO policy. The PEO and/or its insurance agent should verify that the PEO policy is clear as to what employees are covered and

⁶ Some states exempt employers with less than a certain number of employees from obtaining workers compensation insurance. The PEO must obtain from the independent contractor proof that the independent contractor qualifies for such an exemption, or the PEO must require a Certificate of Insurance showing coverage in place.

⁷ I would also recommend a provision in the PEO agreement that allows the PEO to collect premiums incurred to pay such a claim from the client in the same manner in which the PEO collected fees from the Client (i.e., ACH or other electronic means).

what employees are not covered. Follow-up with the insurance agent to confirm that the PEO policy contains the appropriate language and endorsements.