

**PROFESSIONAL EMPLOYER ORGANIZATIONS:
BACKGROUND, ISSUES IN WORKERS' COMPENSATION,
AND RECENT COURT CASES**

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I. INTRODUCTION

The increased popularity of employee leasing¹ has given rise to challenges in the realm of workers' compensation insurance, administration, and dispute resolution.

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¹ See NAIC/IAIABC Joint Working Group, "Report on Employee Leasing and Professional Employer Organizations (June, 2002)." This report is an essential text providing background with regard to employee leasing.

See, e.g., J. Hopkins, "Putting a Band-aid on Small Firms' Health Costs," USA Today (April 19, 2006) (noting that "[m]any small firms are turning to ... [PEO's]" to control costs, as such organizations "combine dozens of small firms into big employee groups for discounted rates."). See generally H. Dennard & H. Northrup, "Leased Employment: Character, Numbers, and Labor Law Problems," 28 Georgia Law Review 683 (1994).

In the recent legal literature (2003), one commentator has made the following comments on the number of U.S. workers in the "contingent workforce," which he defines as leased employees, independent contractors, part-time workers and temporary employees:

In addition to the difficulty of determining who is a contingent worker, or perhaps because of that difficulty, it is almost impossible to ascertain the exact number of contingent workers in the U.S. economy. Reliable estimates, however, range upwards to 20 to 30 percent of all American workers, accounting for more than thirty million members of the American workforce. The proportion of contingent workers, moreover, is undoubtedly growing. One commentator asserts that the contingent workforce has grown approximately 75 percent faster than the overall workforce between 1980 and 1993. More recently, as the United States struggles to climb out of a recession, a

In the insurance realm, regulators anxious to preserve and promote efforts at proper risk classification and experience rating have been faced with major challenges when dealing with employee leasing firms – here also referred to as Professional Employers Organizations, or “PEO’s.”

How, in this regard, should insurance properly be written for a non-capitalized entity that is at least nominally employing a whole variety of employees often laboring in varied and unrelated enterprises? When the “client” joins or leaves the PEO, meanwhile, how is its, and/or the PEO’s, experience rating appropriately calculated?

Workers’ compensation administrators, meanwhile, face the task of ensuring that all employers bound by the law are in fact carrying insurance. When businesses utilize their own employees, this has at least the potential of being a straightforward task. How does an administrator hope to accomplish this, and related tasks, when businesses have *outsourced* the insurance-procurement responsibility to PEOs?

It is, perhaps, in expensive and time-consuming litigation where one observes most acutely the challenges employee leasing presents to the workers’ compensation community and legal systems as well.

In proceedings before administrative law judges and hearing officers, the system is often faced with an injured worker with a *bona fide*, even undisputed claim, but no employer or carrier willing voluntarily to accept liability or even *acknowledge employer status*. In other cases, feckless employers who *thought incorrectly* they had coverage through their PEOs, appear at compensation hearings, often unrepresented, and admit that they have no independent means of paying their worker’s claim.

In proceedings in state and federal court, meanwhile, injured PEO workers – honestly confused about their status, or strategically seeking a loophole in the exclusive remedy – have attempted time and again to sue their erstwhile employers, as if third

majority of the new jobs are of the contingent variety.

While a diverse group in some respects, contingent workers share several common characteristics. First, contingent workers tend to have a weak affiliation with their workplace. In contrast to “core” employees, these workers typically are not considered a part of the corporate family and have lower expectations of long-term employment with a single entity. Second, although not a universal characteristic, contingent workers often receive reduced pay and benefits compared to traditional employees. The benefit shortfall is particularly notable with respect to health care insurance. Finally, many contingent workers have not voluntarily chosen their work status. Some studies indicate that as many as 60 percent of temporary employees and 25 percent of part-time employees would prefer more traditional full-time jobs. As such, this subset of contingent workers essentially is underemployed.

S. Befort, “Revisiting the Black Hole of Workplace Regulation: A Historical and Comparative Perspective of Contingent Work,” 1 Berkeley Journal of Employment & Labor Law 153 (2003).

parties, in tort-based personal injury actions. How are courts to resolve this ubiquitous issue? (Many states have addressed the issues with statutory authority.)

State and federal courts have also been presented with a steady stream of insurance coverage disputes that arise out of employee leasing. For example, are carriers of employee leasing firms responsible, under Part 2 of the standard policy, to defend and potentially indemnify an employer when its employee has collected under Part 1 of the policy – but nevertheless sues the employer in tort? Another dispute fought out in the courts: do writers of Comprehensive General Liability (CGL) policies legitimately exclude coverage for claims made by leased employees?

This presentation introduces these issues and then sets forth some recent developments in these three areas. The author discusses how the NCCI, NAIC and IAIABC, and states, have analyzed the insurance underwriting issue; how some jurisdictions have required the registration and licensing of PEO's; and how legislatures and courts have treated immunity and liability issues.

This writer, at the conclusion of this paper, has summarized seven court precedents treating the employee leasing issue, in order to illustrate the nature of disputes that arise in this area, and how at least some courts have resolved them.

As a prelude to those discussions, however, this presentation first sets forth a background explanation of PEO's, and reasons for their increased popularity. This presentation defines employee leasing, and discusses how PEOs operate and market themselves. As part of further background, this paper discusses how problems with PEO's, vis-à-vis workers' compensation, have been publicized in the media and elsewhere, and how workers' compensation administrators have responded.

II. DEFINING EMPLOYEE LEASING AND THE PEO

Employee leasing is reflective of an agreement between a productive entity – such as a manufacturer of goods or provider of services – and a non-capitalized entity, formerly known as a “labor broker” (now known as a PEO), to supply the productive entity with employees. The productive entity in this relationship is usually the “client” of the PEO. The latter is known as the “employee *lessor*,” and its client, that is, the productive entity, is the “*lessee*.”²

Under the typical contract, and under many state statutes and court precedents, the worker is considered the employee of the PEO. The productive entity is usually (though

² A sample contract, which seems to be mainstream, can be found on the web at <http://contracts.onecle.com/ediets/pem.svc.2000.02.16.shtml>. A sample “Staffing Vendor Agreement” can be found at the website of the American Staffing Association. See <http://www.americanstaffing.net/index.cfm?>.

not always) analyzed as a borrowing or “special employer,” typically said to be entitled to the workers’ compensation immunity of the same.

This relationship is obviously reminiscent of that of the employer-temporary agency relationship. In the industry and under many aspects of law, however, the two are distinguished. The most critical *factual* distinction is that the employer-temporary agency relationship assumes that the worker is only going to be a “temporary” – no expectation usually exists of an indefinite relationship.

Insurance regulators take into account this distinction, as do states where PEO’S must be licensed. For example, the Florida statute excepts from the definition of “employee leasing company” a “temporary help arrangement, whereby an organization hires its own employees and assigns them to a client to support or supplement the client’s workforce in special work situations such as employee absences, temporary skill shortages, seasonal workloads, and special assignments and projects.”³

This temporary/indefinite employment distinction is quite essential. The productive entity in leasing employees is in many cases *not* seeking temporary help, but is procuring an indefinitely retained pool of labor.⁴ In some cases, this may be the entire workforce, in others only a portion. The business, through employee leasing, is not seeking out a group of temporaries but is instead “outsourcing” its personnel administration and human resource tasks to another entity.

The characterization of a PEO does not necessarily demand a legal definition. On the other hand, the concept of a PEO has become highly legalistic and one often examined by courts that have become obliged to sort out employer/PEO relationships. Thus, the following further explanation from an articulate California court (in a 2003 opinion), seems like an appropriate source from which to quote, for a basic definition:

BSC was an employee leasing company. Such an enterprise contracts with client companies to provide leased labor and labor-related services, *i.e.*, payroll, safety and tax services and employment benefits, including workers’ compensation insurance.

In a typical arrangement, the employee leasing company does not bring employees to the client company. Rather, the client company already has the personnel, and it selects which of its workers will become employees of the leasing company and which, if any, will be maintained as the client company’s direct employees.

³ Florida Statutes § 468.520(4).

⁴ See also S. Houseman, “The Benefit Implications of Recent Trends in Flexible Staffing Arrangements,” *Journal of Economic Literature* (2001) (“In the case of leased employees, a company leases all or a portion of its workforce on a fairly permanent basis from a leasing company professional employment organization (PEO). The workers are on the payroll of a PEO, but their work is typically directed by the client company.”).

For example, in a construction context, the client company might choose to retain direct employment of its white-collar workers, but place its work crews in the leaseback program.

An employee leasing company may have thousands of employees working at several hundred client companies.... [At its peak, BSC had 8,000 employees and 700 client companies.]⁵

Many different types of businesses retain their employees through PEO's. In the case above, the employer was a carpentry contractor. In the recent court precedents summarized below, among the employment entities involved were a moving company, a cleaner of refinery storage tanks, a hi-tech factory, a truck driver, a tire warehouser, and a roofer.

As the court opinion above explains, PEOs contract with client companies to provide, among other things, workers' compensation insurance. This is often identified as one of the most important services of the PEO, as such insurance is mandatory and the cost – in terms of both purchase and administration – can be very expensive. The same court explained this advantage as follows:

Because an employee leasing company becomes the employer of the workers leased to the client company, it must [under the California Act] “secure the payment of compensation” by obtaining workers' compensation insurance or a certificate of self-insurance for those workers.... An employee leasing company may have thousands of employees working at several hundred client companies. ... Therefore, it can purchase workers' compensation insurance at a more favorable rate than would be paid directly by the respective client companies themselves. The latter thus obtain an economic benefit since the fee they pay the employee leasing company covers the cost of the workers' compensation premiums.

PEO's on occasion actually try to *make money* from the securing and provision of workers' compensation insurance. One way is for the PEO to establish insurance under a “retro” plan. This, according to one analyst, “is a prime source of profit (or loss) for many leasing companies.”⁶ Under such plans, the insured, that is, the PEO, pays a set premium at the outset of the period of insurance. If, at the end of the policy period, losses are below a certain level, the PEO/insured receives a refund. If, on the other hand, the losses are greater than expected, an additional premium is assessed.

⁵ *Diamond Woodworks, Inc. v Argonaut Ins. Co.*, 135 Cal. Rptr. 2d 736 (Ct. Appeal CA 2003).

⁶ *IRMI's Workers Comp: A Complete Guide to Coverage, Laws, and Cost Containment*, p. XII.C.4. (1999).

This arrangement can have the beneficent effect of leveraging the PEO to encourage safe work practices by its clients,⁷ but may also leave a PEO in the lurch. This would seem to be the case, certainly, if the PEO is self-insuring all or a part of its risk and encounters losses that it cannot handle.

III. HOW PEOs DEFINE AND MARKET THEMSELVES

Competition between PEO's seems to be healthy, and an abundance of advertising appears in print media and, of course, on the Internet.⁸

An important source of information on PEOs can be found on the website of the National Association of Professional Employer Organizations (NAPEO).⁹ The organization, which has about 350 members, defines a PEO, expansively, as follows:

Professional employer organizations (PEOs) enable clients to cost-effectively outsource the management of human resources, employee benefits, payroll and workers' compensation. PEO clients focus on their core competencies to maintain and grow their bottom line.

Businesses today need help managing increasingly complex employee related matters such as health benefits, workers' compensation claims, payroll, payroll tax compliance, and unemployment insurance claims. They contract with a PEO to assume these responsibilities and provide expertise in human resources management. This allows the PEO client to concentrate on the operational and revenue-producing side of its operations.

A PEO provides integrated services to effectively manage critical human resource responsibilities and employer risks for clients. A PEO delivers these services by establishing and maintaining an employer relationship with the employees at the client's worksite and by contractually assuming certain employer rights, responsibilities, and risk.¹⁰

Importantly, NAPEO goes to great lengths to advance the proposition that it is in a "co-employer relationship" with the lessee. "The PEO relationship," the organization

⁷ *Id.*

⁸ *See links infra*, note 85.

⁹ Another invaluable source of industry information is the website of the American Staffing Association. The members of this group also include temporary services agencies. *See* <http://www.americanstaffing.net/index.cfm?>. *See also* <http://www.staffmarket.com>.

¹⁰ Retrieved from <http://www.napeo.org/peoindustry/definition.cfm>.

stresses, “involves a contractual allocation and sharing of employer responsibilities between the PEO and the client. This shared employment is called co-employment.”¹¹

Pitching its members’ services, the NAPEO website adds, “Businesses across America have discovered the incredible value of PEOs because they provide: (1) Relief from the burden of employment administration; (2) A wide range of personnel management solutions through a team of professionals; (3) Improved employment practices, compliance and risk management to reduce liabilities; (4) Access to a comprehensive employee benefits package, allowing clients to be competitive in the labor market; [and] (4) Assistance to improve productivity and profitability.”¹²

NAPEO reports that the *Harvard Business Review* characterized employee leasing firms as “the fastest growing business service in the United States during the 1990s” In addition, the group reports that the “PEO industry generates approximately \$51 billion in gross revenues annually” and that “about 700 PEOs that offer a wide array of employment services and benefits are operating in 50 states.”¹³

Another PEO, Millenium Employee Management Services, states that the industry “is growing in the US at a rate of 30% per year and some 10 million employees are now leased.”¹⁴

In September, 2005, NAPEO General Counsel William Schilling addressed an audience at the IAIABC Annual Convention in Philadelphia. Among other things, he argued that PEOs are an important resource for small businesses that are overwhelmed by government regulation, and “underserved” by the insurance industry.

In this latter regard, Schilling argued that the average NAPEO client “is a business with just 15 workers. These small businesses are too small to receive individual consideration or resources from insurers. It is not cost effective for carriers to devote the resources necessary to provide individual services and assistance to these companies. As a result, the workers’ compensation costs for these small employers are higher than large employers engaged in similar work. This competitive disadvantage translates into higher product and service prices, lower profits, and lower wages....”¹⁵

¹¹ Retrieved from <http://www.napeo.org/peoindustry/coemployers.cfm>. The NAPEO website on this issue sets forth an extensive and highly legalistic analysis of this proposition. Not all critics and courts are persuaded that this construct is legitimate. However, some legislatures have adopted this idea via statute.

¹² Retrieved from <http://www.napeo.org/peoindustry/definition.cfm>.

¹³ Retrieved from <http://www.napeo.org/peoindustry/industryfacts.cfm>.

¹⁴ Retrieved from <http://www.ss-designs.com/mems/leasing.htm>.

¹⁵ W. Schilling, “Professional Employer Organizations, Small Business, and Workers’ Compensation,” Seminar Paper, IAIABC 91st Annual Convention (Philadelphia, 2005).

He maintained that the better PEOs provide a valuable service in the form of risk management and safety counseling for their clients. These are services, he maintained, that otherwise might not make their way to small businesses. He pointed out that PEOs, because providing workers' compensation insurance, "have a financial incentive to do it right." In this regard, "The PEO's [risk management] efforts will determine its ability to maintain a positive relationship with its carrier and contain its premium costs. The investment of responsibly managed PEOs on proper determination of premium, workplace safety, and risk management is essential to the long-term success of the PEO."¹⁶

Schilling added that the operation of PEOs can actually benefit the government. For example, the IRS would prefer to secure tax revenue from a PEO than from small businessmen – many of whom, over the years, avoided paying.¹⁷ In addition, "States benefit from

- rapid and accurate revenue collections,
- increased compliance with employment law requirements,
- more citizens with benefits (including health coverage), and
- improved worker safety."¹⁸

Further, some PEOs actually provide health care, set up 401K plans, and are of such size that anti-discrimination laws apply to their collective employees.

Schilling acknowledged an issue discussed below in this paper: the problem of "fly-by-night" entities that poorly service the interests of both their clients and employees. As a result, for a PEO to be a member of NAPEO it must subscribe to its "best practices" protocols. According to Schilling, the organization "does not in any way condone incompetent or fraudulent practices. Indeed, companies that engage in illegal or abusive practices damage the credibility of the industry.... NAPEO has worked actively with the IAIABC, NAIC, other regulatory organizations, and individual states in an effort to develop appropriate rules and mechanisms for PEOs."¹⁹

A typical Internet market pitch can be found in the advertisement of the Michigan based employee leasing firm "PML.":

Let's look at the real profit picture.... In today's competitive market, only the smart leader sees profit margins climbing. He/she realizes that one of the largest expenditures (which must be constantly addressed) is balanced and cost-effective staffing.

¹⁶ W. Schilling, *supra*.

¹⁷ W. Schilling, *supra* (verbal comments at presentation only).

¹⁸ W. Schilling, *supra*.

¹⁹ W. Schilling, *supra*.

[T]he successful leader realizes that a PEO provides a competitive edge.

A PEO arrangement is not a totally new concept. It has been tried and proven by some of today's leaders and most profitable companies. It can help to stabilize your costs and insulate you from unexpected increases, which can send your profit margins tumbling.

The PEO industry can be referred to by many different names: PEO (professional employer organization), employee leasing, staff leasing or human resource outsourcing companies just to name a few. These types of companies will handle many of the day to day tasks that can rob you and your staff of its valuable time, which could be redirected towards growing your business.

Services offered by most PEO companies are as follows:

1. Payroll Calculation and Processing 2. Employee Health Benefits And Administration (Health, Dental, Vision And Retirement) 3. Provide Workers Compensation and Administration 4. Provide Unemployment Compensation And Administration 5. Provide all the proper forms so that you are sure your employees are in compliance with all Local, State and Federal laws.

The best part about the PEO arrangement is that the business owner writes one check per payroll to cover all employee related expenses.

Furthermore, since the PEO becomes the employer of record the PEO is responsible for all Unemployment and Workers Compensation Claims and court appearances further reducing wasted time.

A PEO arrangement is not for every business owner, but for the majority a PEO is a viable solution to save money while freeing time to grow their business.²⁰

IV. DEVELOPMENT OF PEO'S

Many commentators have pointed out that the U.S. economy has long relied to some degree on temporary workers. Indeed, every middle-aged American can recall ads for "Kelly Girls" in the 1960's – though that term is now anachronistic, and the agency

²⁰ Retrieved from <http://www.powerhomebiz.com/News/052006/peo.htm>. See also <http://www.ss-designs.com/mems/leasing.htm>; <http://www.powerpeo.com/fabout.htm>; http://www.spherion.com/about_us/co_overview.jsp; <http://www.employersresource.com/>; <http://www.amsstaffleasing.com/>.

now calls itself Kelly Services. And, in fact, legal historians have pointed out that, “[a]lmost from the outset, America enjoyed a remarkable degree of labor mobility”:

The need of workers newly arrived on American shores or newly removed from farms or towns to find work matched the needs of prospective employers to find workers. How to match them up posed a problem. The first employment agency set up as such was operated by William Meyer in Philadelphia in 1756. He advertised that, for a fee, he could supply employers with apprentices, journeymen, day laborers, and slaves....²¹

While the fast-evolving employee leasing phenomenon is perhaps another example of a national heritage of labor mobility, it is nevertheless true that since World War I, “[l]ong-term employment constituted the predominant model of structuring work relationships well into the 1970s.”²²

Thus, employee leasing is plainly a new phenomenon.

The growth of the “contingent workforce,” as it is often called, has been widely studied and is often attributed to (1) the growth of the global economy; and (2) advances in technology. These developments have brought about a need for flexibility.²³ These needs have, in turn, led to increased use of both temporaries and independent contractors.

Two commentators, writing in 1994, also identified (3) the burden on small businesses complying with a variety of federal, state and local laws; and (4) the high cost

²¹ M. Finkin & S. Jacoby, “Employment Agencies: An Introduction to the Regulation of Leasing and Employment Agencies,” 23 *Comparative Labor Law & Policy Journal* 1 (2001).

The authors add, among other things: “Even then, as later, jobbers of labor had an odious reputation. Innkeepers on the waterport advanced money to sailors that they recouped by shipping their debtors out, earning them the sobriquet of ‘crimp’ (or landshark)... In the 1830s, private ‘intelligence’ offices were known for fleecing job seekers. ... In the 1880s, these agencies were called ‘leeches engaged in sucking the life blood from the poor,’ by one critic – though they were the prevalent means of securing work in a wide variety of occupations.... By 1930 ..., ‘To the extent that the disorganization that characterized the American labor market in the twenties could be called a system, it was dominated by private fee collecting agencies.’ Abuse was rampant. As he goes on to explain, ‘Frequently run by crooks, these exchanges were distinguished for such practices as misrepresentation of wages, extortionate fees, kickbacks to foremen, inducement of discharges to increase business, white slavery, and blacklisting of union members.’”.... (Footnotes omitted).

²² S. Befort, “Revisiting the Black Hole of Workplace Regulation: A Historical and Comparative Perspective of Contingent Work,” 1 *Berkeley Journal of Employment & Labor Law* 153 (2003).

See also B. Baugh, “Workers’ Compensation: Temporary Employees and the Exclusiveness-of-Remedy Doctrine,” 86 *Kentucky Law Journal* 163 (1997/1998) (summarizing research showing that corporate downsizing; global competition; technology; the need to “respond quickly to an ever-changing marketplace”; and the “savings associated with providing few, if any, benefits,” including workers’ compensation, fuel the desire for temporary workers).

²³ Befort, *supra*.

of workers' compensation insurance, as factors fueling the growth. While these factors also likely fuel the use of temporaries, and contracting-out, they are also in large part responsible for the popularity of *employee leasing*:

Employee benefit costs and government regulations are strong factors in creating the preference of companies for leased employees....

Employee benefits have risen substantially both in total and as a percentage of compensation. The annual survey by the Chamber of Commerce of the United States shows that in 1929, employee benefits for all industries ("supplements to wages and salaries") totaled \$ 662 million; by 1992, that figure had risen to \$ 629 billion, about evenly split between federal social insurance and privately determined benefits plus state workers' compensation.... In 1929, employee benefits averaged 1.3 percent of wages and salaries; by 1992, the percentage was 21.3....

Moreover, the cost of hiring, including selection and training, and the potential for antidiscrimination litigation (race, sex, age, handicap, etc.) resulting from hiring decisions, all can encourage leasing and discourage direct hiring.

Benefit costs may have considerable impact on deciding whether to utilize leased or traditional employees. Such considerations include exorbitant workers' compensation costs, particularly in states where the inflation of such costs is the greatest, such as California, New York, and Maine.

Seemingly ever-higher health benefits costs have a similar effect....

[G]overnment imposition of employee benefits and regulations can be particularly onerous to small business and can cause such firms to seek relief through leased employment. ...

[T]he 1993 federal Family and Medical Leave Act is applicable to companies with fifty or more employees. This has encouraged companies with less than that number to maintain their exemption by utilizing leased employees if their needs exceed the exemption's limit....²⁴

Another writer, writing a decade later, identifies these same factors as responsible for growth of PEOs:

American business entities have powerful legal and financial incentives to increase their use of contingent workers. This is particularly true for those contingent workers who fall outside of the legal definition of an "employee."

²⁴ H. Dennard & H. Northrup, "Leased Employment: Character, Numbers, and Labor Law Problems," 28 Georgia Law Review 683 (1994) (footnotes omitted).

Most statutes governing the workplace only apply within the context of the employment relationship.

For example, while an employer must comply with the legal mandates of such statutes as Title VII, the Fair Labor Standards Act, and ERISA or face the prospect of substantial monetary liability, these statutes are inapplicable to non-employee workers such as independent contractors, contracted workers, and leased workers.

Similarly, workers who are not employed by the entity for whom they provide labor are not covered by the National Labor Relations Act (NLRA) and have no legal protection in seeking to unionize.

Since the factors for determining whether a worker is an “employee” are prone to manipulation, many firms consciously structure work relationships in a manner that will avoid “employee” status and its accompanying legal strictures.

Firms also can save costs through the use of contingent workers. Business entities are responsible for payroll taxes and contributions to unemployment insurance and workers compensation plans only for their “employees.” Firms avoid these expenses by replacing traditional employees with non-employee contingent workers.

Moreover, as noted above, firms tend to provide contingent workers with lower pay and benefits. Many companies view core employee status as a convenient and defensible eligibility threshold for conferring premium pay and benefits.²⁵

Analyst Christine Fuge has also identified certain aspects of the Tax Code which made use of employee leasing popular in the early 1980’s. In the 1982 law known as TEFRA, an employer could, under a safe harbor arrangement, “exclude leased employees from its pension plan as long as the leasing company was funding a pension plan with a minimum contribution of 7.5 percent of each employee’s total contribution.” Fuge explains that, by leasing workers such as nonprofessional staff, “an employer thereby was free to design a generous pension plan for its professionals and executives without losing its tax-favored status” under ERISA.²⁶

²⁵ Befort, “Revisiting the Black Hole of Workplace Regulation: A Historical and Comparative Perspective of Contingent Work,” 1 Berkeley Journal of Employment & Labor Law 153 (2003) (footnotes omitted).

²⁶ C. Fuge, “Employee Leasing” Chapter 7 of *IRMI’s Workers Compensation Insurance Guide*, p. 93 (IRMI 1999).

In 1986, however, the law was changed. The new law “stated that if leased employees constitute more than 20% of an employer’s total workforce, they must be counted as employees for purposes of meeting ERISA’s qualification requirements.”²⁷

Many observers have thus viewed employer desire for employee leasing as a cynical method of avoiding such things as fringe benefit requirements. Still, the economies of scale afforded by some PEOs can make possible *provision* of benefits such as healthcare. An article in *Entrepreneur* magazine pointed out, for example, that for years employers favored the use of temporary employees to avoid having to pay fringe benefits. “At the other end of the spectrum,” the writer noted, “stand thousands of small businesses leasing employees for the opposite reason”:

They want their employees to have health insurance and other benefits, which leasing companies can offer at affordable rates because they’re pooling thousands of employees. Typically, a business will turn its entire workforce over to the leasing company for purposes of payroll, taxes, benefits and so on.²⁸

In a 2006 newspaper article, similarly, a writer noted that “[m]any small firms are turning to ... [PEO’s]” to control costs, as such organizations “combine dozens of small firms into big employee groups for discounted rates.”:

Think of a PEO as an off-site personnel department. For an annual fee, often 2% to 7% of the dollar value of annual payroll, a PEO manages everything from recruiting and hiring to managing health benefits. They’re a boon to small businesses, many of which don’t need and can’t afford a full-time human resources department.

PEOs started in the early 1980s in Texas and Florida, says the National Association of Professional Employer Organizations trade group. There are now about 700.

PEOs combine small employee groups into bigger “pools” to get buying clout. Employco Group, a PEO near Chicago, started in 1996 with six employees. It now manages benefits and other personnel work for 17,000 employees of more than 400 companies in 38 states, says President Rob Wilson.

Buying insurance in volume, Employco’s average premiums for clients rose just 3% this year from 2005, Wilson says. That was lower than the overall average 9.2% for all employers in Kaiser’s survey.

²⁷ *Id.*

²⁸ S. Bahls, “Renter’s Rights – Legal Issues in Employee Leasing,” *Entrepreneur* (March, 2001).

In Milwaukee, Steven Iverson hired a PEO a year ago for his Iverson Language Associates. The 18-worker company translates manuals and other documents into foreign languages for U.S. firms doing business abroad. Iverson's PEO, Stueber Consulting near Milwaukee, helped Iverson keep his rate increase to just 5% this year from 2005, far below the 20% bump he says he would have faced.²⁹

V. PROBLEMS WITH PEO'S IDENTIFIED BY REGULATORS AND THE MEDIA

One legal scholar has pointed out that the existence of contingent workforce is a perhaps natural development given changing economic and social conditions. He counsels that, as a result, "a legislated return to the workplace of 1950 is as unwise as it is impossible."³⁰

Merit probably exists in this assertion. Still, virtually everyone agrees that room exists for regulation of employee leasing arrangements. Indeed, groups such as NAPEO support regulation and oversight.³¹

Many writers have documented, and many lawsuits have revealed, accounts of fraud by employers against employee leasing firms (underreporting of payroll and work projects, for example)³²; and employee leasing firms against workers' compensation

²⁹ J. Hopkins, "Putting a Band-aid on Small Firms' Health Costs," USA Today (April 19, 2006).

³⁰ S. Befort, "Revisiting the Black Hole of Workplace Regulation: A Historical and Comparative Perspective of Contingent Work," 1 Berkeley Journal of Employment & Labor Law 53 (2003).

³¹ See W. Schilling, "Professional Employer Organizations, Small Business, and Workers' Compensation," Seminar Paper, IAIABC 91st Annual Convention (Philadelphia, 2005).

³² In one reported court case, a PEO became convinced that it was being presented by client and worker with an illegitimate claim. There, the claimant had severed four fingers on his first day of work for the client, before he was recorded on the payroll and before his application had been received by the PEO. The PEO and its carrier denied the claim on the basis that he was not an employee. Ultimately, however, the claimant was successful with his claim. The court, in addressing the situation, explained that the PEO had a requirement that before a worker was considered an employee, he or she had to have been on the payroll. This requirement, the court related, existed because

[t]heoretically, an employee leasing enterprise can be the target of workers' compensation fraud by client companies who might conceal workers from the leasing company to avoid a leasing charge for that person, pay the worker in cash, and then if the worker is injured, submit to the employment leasing company an employment application along with the injury claim.... To mitigate that hypothetical risk, [the PEO's] standardized contract with client companies [in this case] ... contained a provision that no one would be a BSC employee until (1) the person completed and signed all pages of a hiring packet, and (2) BSC gave written approval for that person to be hired.

Diamond Woodworks, Inc. v Argonaut Ins. Co., 135 Cal. Rptr. 2d 736 (Ct. Appeal CA 2003).

insurance carriers (failure to disclose insured risks, for example).³³ Employers, meanwhile, have entered into contracts with PEOs that prove to be fly-by-night and/or unstable, and have later been held liable for wages and workers' compensation responsibilities.³⁴

According to IRMI, as of December 2005, 15 states required PEOs to be licensed, and 22 require registration. (The requirements of the Florida licensing statute are discussed below). These efforts at licensing and registration have usually come about because of legislative and regulatory concerns over the disruptions that have unfolded from totally freewheeling employee leasing practices.³⁵

Many of these disruptions have been reported in the mass media. In 2005, for example, the California State Fund widely publicized a lawsuit against the "Clancy PEO" which involved a PEO "shell game."³⁶ This was contrived by a PEO entrepreneur to avoid paying full workers' compensation premiums. The State Fund became alerted to the fraud, sued, and at the end of 2004 won a \$14.6 million judgment against the defrauding organizations.

³³ See, e.g., Krouse, Ingram et al., "Recent Developments in Workers' Compensation Law," 33 Tort & Insurance Law Journal 731 (1998).

³⁴ See, e.g., C. Gillespie, "Workers Lost Money and Benefits After Payroll Company's Bankruptcy," *Las Vegas Sun* (October 10, 2003) (discussing the bankruptcy of the large PEO "Team America").

³⁵ *IRMI's Workers Comp: A Complete Guide to Coverage, Laws, and Cost Containment*, p. XIII.C.18. (1999). Even where states do not require licensure or registration, however, the workers' compensation authorities caution the public against fraudulent or unreliable PEO's. Pennsylvania, for example, is a state where PEOs are unregulated. Still, an official of the State Workers' Insurance Fund in 2002 cautioned the workers' compensation community about the hazards of PEOs. His comments are typical of state agency comments about the industry:

Employee leasing refers to those firms that provide skilled and unskilled workers, on either temporary or permanent basis to client companies. Typically the leasing firm maintains the basic personnel administrative functions, such as hiring, payroll benefits, and they service a number of client companies.

[H]owever, a single company, or a group of similar companies, with an intent to defraud, may establish a proprietary leasing firm and transfer all their existing employees to that firm in an effort to use that firm as a front to disguise their own operations. This method is quite commonly used to avoid an experience modification surcharge for a company or the misclassification of job duties.

J. Glenn, "Employer Fraud", in *Collected Papers, Bureau of Workers' Compensation Annual Conference* (2002). For the California cautions, see <http://www.dir.ca.gov/peo.html>.

³⁶ See D. Torrey, *PEO's Run Amuck: "[California] State Compensation Insurance Fund Wins \$14.6 Million Judgment in Fraud Suit*," *ArriveNet Business Press Release* (December 27, 2004), Pennsylvania Bar Association WC Law Section *Newsletter*, Volume VII, No. 84 (March-April, 2005).

The two PEO's, owned by the same entrepreneur (Clancy) "enrolled workers in an alleged 'K-1 Dividend Distribution Plan' in which employees received two checks – one for what Clancy called 'W-2 wages' and another referred to as a 'dividend.'"

Further explanation: Clancy "claimed [to his clients, erstwhile employers who wanted to use a PEO] that he could reduce premiums by 50% and provide complete workers' compensation coverage through the State Fund. As part of the scheme, Clancy failed to disclose the amount of the so-called K-1 dividend paid to each employee, which usually amounted to more than half of the employee's income and thereby avoided paying correct premiums to the State Fund. State Fund uncovered Clancy's scheme during an audit. State Fund then cancelled his policy and filed suit for damages."

The California statute, notably, authorizes the State Fund in such cases to pursue a civil action for ten times the difference between the lower premium paid and the premium properly payable against an employer who knowingly procures a lower premium by willfully misrepresenting the amount of payroll.

Most recently, *Forbes* magazine presented an article on the subject which it titled "Workers' Con." This article was widely circulated among and publicized by trial lawyers in Pennsylvania, as it stood the conventional wisdom about insurance fraud on its head.³⁷ Instead of focusing on malingering *claimants*, it concentrated on *employer* misdeeds.

The article first noted that in the popular press it is conniving or malingering employees that are invariably fingered as committing workers' compensation fraud. In reality, however, employers often mislead workers' compensation carriers. Roofing firms and "work-leasing companies, the so-called professional employment organizations," were said to be the worst offenders. The worst problems were characterized as being in California and Florida.

These revelations were not terribly new, but the author ran nicely through a laundry list of what he called "favorite tricks." At the head of the list was the Clancy PEO shell game summarized above. Some other identified in the *Forbes* article were the following:

Shifting employees around to phony companies (a husband-and-wife enterprise, Border Maintenance, created a fake identity to hide staff at their Texas janitorial outfit, "thereby reducing workers' compensation premiums.... The allegedly bogus company, Del-Kleen, got fat state contracts by showing it had insured its workers against injury, a

³⁷ See D. Torrey, *PEO's Run Amuck II: Vardi*, "Insurance Heist: Workers' Con: Companies are Cheating on Workers' Compensation, Costing Billions in Added Premiums – and Leaving Their Employees at Risk," *Forbes* (February 28, 2005), at pp. 34-35, Pennsylvania Bar Association WC Law Section *Newsletter*, Volume VII, No. 84 (March-April, 2005).

requirement for state government jobs in Texas. But, according to the complaint, the work was actually done by Border Maintenance's 450 employees. The company managed to avoid nearly \$1 million in comp premiums.")

Underreporting the number of employees (a Mr. Yi reported to his carrier that his janitorial/building maintenance service, National Building Maintenance, painted dorm rooms at UCLA, and provided janitorial services at the Rose Bowl, utilizing a workforce of 18 – when in fact he had at least 300 employees).

Giving fake job titles to workers (a Mr. Duff, operator of the temp agency "Windy City Labor Service," categorized his warehouse and refuse center laborers as clerical personnel.)

Hiding wages (the Clancy shell game referred to above; the state of California proved "that by disguising half of the paid-out wages as distributions to partners, Clancy skirted \$1.3 million in premium payments.")

VI. CHALLENGES TO INSURANCE REGULATORS AND ADMINISTRATORS

A. ***Introduction.*** The growth of the PEO industry has presented major challenges to the workers' compensation insurance industry and its regulators. (One should note at the outset that it is the workers' compensation and employers liability policy that is implicated here, not the CGL policy.³⁸)

Regulators, in this regard, are anxious to preserve and promote efforts at proper risk classification and experience rating. At least two issues are, as a consequence, dependably on the front burner.

How should insurance properly be written for a non-capitalized entity that is at least nominally employing a whole variety of employees often laboring in varied and unrelated enterprises? When the "client" joins or leaves the PEO, meanwhile, how is its, and/or the PEO's, experience rating appropriately calculated?

Regulators and administrators are also anxious to meet their duties of ensuring that all employers governed by the law do indeed have insurance.

³⁸ The CGL policy almost invariably excludes claims of leased employees against insureds with regard to work-related injuries. Courts, to this writer's knowledge, have found nothing offensive in this exclusion. In Pennsylvania, the law is clear that no liability exists under a CGL policy for the claims of leased employees. *Occidental Fire & Casualty Co. v Reber Corp. et al.*, 2004 U.S. Dist. LEXIS 12774 (U.S. D.C. E.D. Pa. 2004).

They are, in this regard, responsible for keeping accurate databases of this information, and want employers, contractors and municipalities to be confident that the employees who are undertaking their labor on any particular date and project are in fact covered by insurance.

Similarly, when the need for active oversight or formal dispute resolution arises, administrators need immediate access to the identity of the PEO's insurance carrier.³⁹

These issues – and several others – were discussed at length at the 2005 IAIABC Convention in Philadelphia during a session, “PEOs: Why the Regulatory Hubub?” The comments of Mr. Daniel Sumner, a Florida workers' compensation official, and now President of the IAIABC highlighted many of these issues. He characterized PEOs as being “their own unique animal” for workers' compensation insurance purposes. Among the issues he identified (subject headings those of the writer), were the following.

1. Does the client really know where the insurance lies? On occasion, PEOs will represent to potential clients that *they* are the insurer, though they really are not. This is, of course, because they turn around and secure insurance from *carriers*. In a way, PEOs aren't really the insured, nor are they the insurer.

2. The PEO contract versus legal requirements. Problems have arisen with proof of coverage. Some PEOs talk about employees only being covered when they're “on the roster,” or “on the roster at the end of the first day.” (The workers' compensation law of a state, however, may well define “employee” more generously.)

3. PEOs and distortion in experience rating. If one hears some small employer say that “I got a good experience modification through my PEOs workers' compensation insurance,” it may mean that the good experience modification was “laundered through the PEO.”

4. PEO subcontracting clouds insurance coverage. Sometimes PEOs contract with other PEOs. Carriers often don't know who they're underwriting, and have received unwelcome surprises when casualties occur.

5. PEO self-insuring can be problematic. Some PEOs try to self-insure by having large deductibles. This becomes a big problem when the PEOs go bankrupt.

³⁹ In the Pennsylvania experience, where PEOs are not required to register or be licensed, it is not unusual for the state authorities to have difficulty identifying the proper PEO and carrier. Often, claim disposition and adjudication are delayed while the identity of the carrier is identified. Comments of Burke McLemore, Esquire, Panel, “PEOs: Why the Regulatory Hubub?”, IAIABC Annual Convention (September 10, 2005); Memorandum to the Writer from WC Judge Robert Vonada, Altoona, PA, April 26, 2006 (noting repeated instances where “we could not confirm coverage of the employee leasing agency.”).

A second speaker, Timothy Wisecarver of the Pennsylvania Workers' Compensation Rating Bureau, identified a key challenge, to wit, that:

6. PEOs throw off the rating process. How to price insurance for PEOs is difficult. The “master policy” approach for PEOs is “contrary to mainstream” insurance thinking. The multi-coordinated policy approach, which is perhaps more mainstream, is disapproved in some jurisdictions, including Pennsylvania.

Mr. Sumner, who is from a state where PEOs are already regulated, tended to favor *more* oversight to address the types of issues summarized above.

B. Current Approaches to Regulation. At least three categories of PEO regulation exist. They are, by this writer's conceptualization, divisible into three areas: registration/licensure, insurance placement/writing protocols, and immunity provisions.

The leader in this area has been the National Association of Insurance Commissioners (NAIC), which in 1991 proposed model regulations 935 and 936. Model Regulation 935 promoted licensure, while Model Regulation 936 addressed proper writing, reporting and rating protocols.⁴⁰

Of note is the fact that NAIC is currently considering a new model regulation regarding workers' compensation coverage for PEOs.⁴¹

1. Regulation via registration and licensure. As indicated above, researchers at IRMI, as of December 2005, reported that 15 states require PEOs to be licensed, and 22 require registration.⁴² (The number must be increased by one, to account for the recent addition of Alabama as a jurisdiction with employee leasing regulation.)

Several major states, including Pennsylvania, do *not* have PEO licensing or registration requirements.⁴³

Florida, however, does have such requirements. One statute defines “employee leasing” entities, and *excludes* from the definition such things as temporary agencies. The full definition (editing by the author) is as follows:

”Employee leasing company” means an employing unit that has a valid

⁴⁰ IRMI's *Workers Comp: A Complete Guide to Coverage, Laws, and Cost Containment*, p. XII.F.1 (2004).

⁴¹ See http://www.naic.org/documents/committees_models_workcomp_emp_leas.doc.

⁴² IRMI's *Workers Comp: A Complete Guide to Coverage, Laws, and Cost Containment*, p. XIII.C.18. (1999).

⁴³ IRMI's *Workers Comp: A Complete Guide to Coverage, Laws, and Cost Containment*, p. XIII.C.18. (1999).

and active license ... and, in addition,

maintains a listing of the clients of the employee leasing company and of the employees, including their social security numbers, who have been assigned to work at each client company job site.

Further, each client company job site must be identified by industry, products or services, and address. The client list must be provided to the tax collection service provider by June 30 and by December 31 of each year.

As used in this subsection, the term “client” means a party who has contracted with an employee leasing company to provide a worker, or workers, to perform services for the client.

Leased employees include employees subsequently placed on the payroll of the employee leasing company on behalf of the client. An employee leasing company must notify the tax collection service provider within 30 days after the initiation or termination of the company's relationship with any client company under chapter 468.

For licensure, the “controlling person” must meet certain criteria, and the leasing agreements promulgated by the licensee must show that the PEO is responsible for the following:

1. Maintaining accounting and employment records relating to all employee leasing activities for a minimum of 3 calendar years.
2. Reserving a right of direction and control over leased employees assigned to the client’s location. However, a client may retain such sufficient direction and control over the leased employees as is necessary to conduct the client's business and without which the client would be unable to conduct its business, discharge any fiduciary responsibility that it may have, or comply with any applicable licensure, regulatory, or statutory requirement of the client.
3. Assuming responsibility for the payment of wages to the leased employees without regard to payments by the client to the leasing company.
4. Assuming full responsibility for the payment of payroll taxes and collection of taxes from payroll on leased employees.
5. Retaining authority to hire, terminate, discipline, and reassign the leased employees. However, the client company may have the right to accept or cancel the assignment of any leased employee.

6. Retaining a right of direction and control over management of safety, risk, and hazard control at the work site or sites affecting its leased employees.
7. Performing safety inspections of client equipment and premises.
8. Promulgating and administering employment and safety policies.
9. Managing workers' compensation claims, claims filings, and related procedures.
10. Giving written notice of the relationship between the employee leasing company and the client company to each leased employee it assigns to perform services at the client's work site.⁴⁴

The statute does not require that every employee leasing contract include a provision that the PEO secure and carry workers' compensation. Instead, this seems to be governed by different statutes. One provides, in pertinent part, "The employer shall be liable for and shall secure the payment of compensation to all such borrowed employees ..., except when such payment has been secured by the help supply services company."⁴⁵ Another provision, Florida Statute § 468.529 (2006), provides as follows:

(1) A licensed employee leasing company is the employer of the leased employees, except that this provision is not intended to affect the determination of any issue arising under [ERISA] An employee leasing company shall be responsible for timely payment of unemployment taxes ..., *and shall be responsible for providing workers' compensation coverage* pursuant to chapter 440....

2. ***Regulation via insurance placement/writing protocols.*** As indicated above, some states such as Florida and California specifically address by statute how insurance is to be placed. Other states, such as Pennsylvania, have no statute on the subject.

Another form of regulation in this realm is found in detailed rules surrounding insurance *writing, reporting and rating* protocols.

In this realm, the regulator typically finds guidance in the rules of the NCCI or independent rating bureaus.

⁴⁴ Florida Statutes § 468.525 (as summarized and quoted in *Florida Workers' Compensation Handbook*, § 3.10[e] (Matthew Bender 2005)).

⁴⁵ Florida Statutes § 4401.11(b)(2).

The definitive 50-state listing of how insurance policies are written, how data is reported by insureds to insurers, and how experience rating is undertaken, is found on the NCCI website.⁴⁶ A narrative state-by-state discussion is also included in *IRMI's Workers Comp: A Complete Guide to Coverage, Laws, and Cost Containment*, § XII(J).

In a state such as Florida, where PEOs have been subject to significant regulation, for example, one finds that in the voluntary market the PEO may be underwritten using the “master policy” approach, whereas in the residual market the PEO and its clients “obtaining coverage for leased workers must secure coverage on a ... multiple coordinated policies ... basis.” Florida also has a number of endorsement requirements for the MCP policy. The protocols include rules for how data is reported and how experience modification is calculated when a client leaves an employee leasing arrangement.

In a state such as Pennsylvania, where PEOs have been subject to minimal regulation, one finds that a master policy may be used in all situations. Among other things, the protocol indicates that the “master policy is issued in the name of the employee leasing company. Commingled data of multiple clients is reported via single unit report applicable to the master policy.” The MCP approach is not approved in Pennsylvania, though perhaps preferred by regulators.⁴⁷ The protocol also addresses experience rating production when a client (1) enters; and then (2) leaves an employee leasing arrangement.⁴⁸

⁴⁶ See

<http://www.ncci.com/NCCI/Article.aspx?cat=ii&id=e12&articleUrl=web/industry/employee/employeeleasinghome.htm>

⁴⁷ Comments to the author of Mr. Bruce Decker, PRCB, May 12, 2006.

⁴⁸ NCCI records the Pennsylvania experience modification protocols as follows:

Experience Rating Production (Master Policy) When a client **enters** into an employee leasing arrangement ... wherein all or substantially all of their employees are thereafter employed by another employer through an employee leasing arrangement, the experience of the client is transferable to the PEO for the development of future experience ratings of the PEO. There is no separate client experience rating calculated unless the client's non-leased experience is sufficient to qualify the employer for experience rating.

Experience Rating Production (Master Policy) When a client **leaves** an employee leasing arrangement ... the experience of the client shall remain combined with the PEO for all future ratings ... provided that the leasing agreement remains in effect for a period of two years or more. If a client agreement terminates within two years (24 months), the earned experience of the client prior to entering into the leasing arrangement is removed from the PEO experience at the next anniversary rating date subsequent to the termination of the client contract. An experience modification will be calculated on the basis of that experience in combination with earned non-leased experience (if any) for the client.

3. ***The Master Policy/MCP Policy Debate.*** As suggested above, some regulators are of the view that PEO risks should not be written under the master policy. Instead, they advocate the MCP approach. The NAIC model regulation of 1991 provided that in the voluntary market, PEOs could be written with a master policy, but when the PEO was underwritten in the residual market (which was often the case), multiple policies were required. This dichotomy is reflected in the Florida protocols.

NCCI has explained the difference between these approaches as follows:

Multiple Coordinated Policy Model

The Multiple Coordinated Policy model uses separate policies issued to the PEO and each of its client companies.

Master Policy Model

With the Master Policy Model, a single standard policy for the PEO and all of its clients is issued in the name of the PEO.⁴⁹

According to the NAIC/IAIABC 2002 *Report on Employee Leasing*, “A Master policy arrangement is typically characterized by an insurer issuing a single policy covering the employees of all the clients, including the internal employees of the master policyholders....” PEOs, the report explains, “have generally sought to obtain coverage through this single policy arrangement.” The MCP approach is preferred by most regulators as it “raises fewer regulatory problems but more administrative burdens for insurers and [PEOs].” This is because the MCP approach is “characterized by having a single insurer issue a central policy for the employee leasing company with separate policies of each client company....”⁵⁰

Under a new proposed NAIC model regulation, both approaches are still offered as potential methods. At least one state, Maine, has a proposed regulation, based on the NAIC model, which provides only for writing under the MCP approach, regardless of whether the policy is being written in the voluntary or residual market.

4. ***Regulation via statute identifying PEO and employer as co-employers.*** Many states have statutes which address employee leasing as respects the determination of which party is the “employer.” This can have an effect on (1) which party will be held responsible for securing and/or “carrying” workers’ compensation; and (2) which party will have immunity under the workers’ compensation laws in the event of a personal injury suit by an injured worker.⁵¹

⁴⁹ See

<http://www.ncci.com/NCCI/Article.aspx?cat=ii&id=el2&articleUrl=web/industry/employee/employeeleasingshome.htm>

⁵⁰ NAIC/IAIABC Joint Working Group, “Report on Employee Leasing and Professional Employer Organizations,” at p.1 (June, 2002).

⁵¹ For a list of statutes, see B. Baugh, “Workers’ Compensation: Temporary Employees and the Exclusiveness-of-Remedy Doctrine,” 86 Kentucky Law Journal 163 (1997/1998).

This issue is frequently in litigation, as illustrated by some of the cases summarized below.

IRMI analysts report that 34 states have a statute, regulation, or ruling by the state workers' compensation administrative organization on the issue. The others, IRMI reports, have no statute, but most have a high court precedent on the issue.

Florida is a state that has addressed the issue by statute (editing by the author):

The immunity from liability described in subsection (1) shall extend to an employer and to each employee of the employer which utilizes the services of the employees of a help supply services company, as set forth in Standard Industry Code Industry Number 7363,

when such employees, whether management or staff, are acting in furtherance of the employer's business.

An employee so engaged by the employer shall be considered a borrowed employee of the employer, and, for the purposes of this section, shall be treated as any other employee of the employer.

The employer shall be liable for and shall secure the payment of compensation to all such borrowed employees as required in § 440.10, except when such payment has been secured by the help supply services company.⁵²

⁵² Florida Statutes § 440.11(2).

VII. CHALLENGES IN DISPUTE RESOLUTION

A. *Administrative proceedings.*

1. *Employer Identity.* A common issue in *workers' compensation* litigation involving employees of *temporary agencies* is whether the agency or client was the “employer” for workers’ compensation purposes.

Under Pennsylvania law, in this context the *borrowing entity* has been held by the state supreme court to be the employer. This holding followed as the court applied the familiar, and nearly ubiquitous, rule that the entity *controlling the worker’s labor* is the employer.⁵³ Obviously, this is rarely the temp agency.

This issue can also exist in the similar realm of employee leasing. In lieu of some statute, it is likely that, if the PEO has not carried insurance for the worker, the workers’ compensation authorities and courts in Pennsylvania, and in most states, will look to the client as the employer.

Employers are frequently cautioned that they must be sure that their employee leasing company has workers’ compensation insurance and will answer to claims. This is a very important caution. Certainly in Pennsylvania, in the event of default by the employee leasing company, the lessee employer that actually directed and controlled the employee’s work will be held responsible. The control test is alive and well.

2. *Identifying the defendant.* A technical challenge in workers’ compensation proceedings often can be simple identification of the PEO. On occasion, workers forswear any knowledge of having been “leased.” (Workers must apply for employment with the employee leasing firm, but often seem to have forgotten that act, and in any event do not understand the triangular nature of the employment relationship.)

In such cases, when workers suffer injury, they prosecute their cases against their actual employers. In such instances, such an employer may well refuse or otherwise fail to appear, denying any status as an employer. The PEO, meanwhile, may be unknown to the injured worker and his lawyer, and an investigation into the precise nature of the employment relationship, and the existence of any insurance, will be necessary.

In the Pennsylvania experience, certainly, one challenge is simply getting the employee leasing firm and its carrier to respond in the first place.⁵⁴

⁵³ *JFC Temps, Inc. v WCAB*, 680 A.2d 862 (Pa. 1996). See also *Reflex Systems, Inc. v WCAB (Ferrucci)*, 784 A.2d 217 (Pa. Commw. 2001) (fact that temporary service paid injured workers compensation insurance did not mean that it was responsible employer, where its client, a steel mill, controlled details of employee’s work.).

⁵⁴ Memorandum to the author from WC Judge Robert Vonada, Altoona, PA, April 26, 2006 (noting repeated instances where “we could not confirm coverage of the employee leasing agency.”).

3. PEO-client contract versus workers' compensation law. A seemingly common situation is where the PEO/client contract suggests that the injured worker in some situations is not considered an "employee," but the workers' compensation law, or common law, may well hold otherwise. This writer, in the *Ward* case discussed below, ruled that the workers' compensation law trumped the contract. A California case, *Diamond Woodworks*, meanwhile, held that the actual employment relationship, coupled with contract principles, worked to trump the contract.

4. Action by the ALJ or Hearing Officer to Assist in Discovery. To answer these unique challenges posed in dispute resolutions, ALJ's or hearing officers may wish to flex any available investigatory muscles they possess to aid in identifying the appropriate defendants and facilitating discovery.⁵⁵

The ALJ recognizing a difficult employee leasing situation may, while remaining neutral: (1) provide guidance to the parties; (2) use his or her subpoena power; (3) interface with other offices of the Bureau or commission (for example, enforcement and compliance personnel); (4) make direct contact with demurring or recalcitrant parties; and (5) undertake a field investigation.

B. Civil Proceedings

Employers that utilize PEOs, and carriers that underwrite them, may also find themselves embroiled in civil proceedings. Lawyers often warn potential PEO customers that, while the concept of leasing employees may appear simple, certain hazards exist. One of those is ambiguities in the law which may in turn lead to the need for dispute resolution in the courts. In the last two years, indeed, the researcher easily can find breach of contract, insurance coverage, and exclusive remedy disputes among the reported cases. Seven of these have been summarized in the next section of this paper.

1. Personal injury actions and the exclusive remedy. As discussed at the outset, in proceedings in state and federal court injured workers of PEOs – honestly confused about their status, or strategically seeking a loophole in the exclusive remedy – have frequently attempted to sue their erstwhile employers, as if third parties, in tort-based personal injury actions.⁵⁶ These disputes are well illustrated by two of the recent cases summarized below.

⁵⁵ Under the Pennsylvania Act, Workers' Compensation Judges have such broad powers of investigation. Section 420 of the Act, 77 P.S. § 831. In practice, they are rarely utilized given near 100% lawyer representation by a specialized claimants' bar.

⁵⁶ See M. Hale, "The Employee Leasing Exposure and the Exclusive Remedy Problem," 1997 Detroit College of Law Review 891 (1997); S. Dunn & K. Berkery, "Employee Leasing: The Risks for Lessees," 84 Michigan Bar Journal 22 (August, 2005).

As discussed above, some jurisdictions have addressed the issues with statutory authority. One such state is Florida, but as a recent case summarized below shows, such statutes will not necessarily be free of loopholes.

The majority rule plainly is that the PEO's client, that is, the borrowing employer, is *not* considered a third party amenable to suit. Courts recognize that PEO clients still control, in most case, the details of the worker's labor. Courts accept the idea that that the employer has simply contracted out, for a fee, the responsibility of procuring workers' compensation insurance. They reject the idea that the employer is receiving a windfall of immunity.

Pennsylvania⁵⁷ and California⁵⁸ are states that have court cases espousing the majority rule. Massachusetts appears to be a notable exception.⁵⁹

2. Disputes over insurance coverage. Employee leasing can also lead to insurance coverage disputes. These disputes are well illustrated by three of the recent cases summarized below.

One frequent type of case presents an injured worker, PEO client, or carrier seeking to have a CGL carrier liable for the injured worker's injury. This seems to be a reliably *unsuccessful* effort. This was the result for example, in one Pennsylvania case summarized below.⁶⁰

VIII. RECENT COURT CASES

Summary: Two Administrative Cases (Pennsylvania)

1. Coverage Determination – Failure of Client to Remit to PEO. *Tony Ellerbee v Triple L Construction, Employer's Resource Management Co. (Wausau Ins.)*, PA BWC Claim No. 108-4538 (filed July 11, 2000) (Judge Eric Jones, Pittsburgh), *aff'd*, WC Appeal Board (March 14, 2002) (PEO which had never received initial monies to make payroll

⁵⁷ *Dempster v Waste Management, Inc.*, 41 Pa. D&C4th 401, 1998 WESTLAW 1180021 (Ct. Common Pleas Allegheny County 1998); *Virtue v Square D Co.*, 887 F. Supp. 98 (M.D. Pa. 1995). See D. Torrey & A. Greenberg, *PA Workers' Compensation: Law & Practice*, §§ 3:31 et seq.; 7:9 (West 2d ed. 2002 & Pocket-Part 2005).

⁵⁸ *Wedeck v Unocal Corporation*, 69 Cal. Rptr.2d 501 (Ct. Appeals CA 1997).

⁵⁹ *Lang v Edward J. Lamothe Co.*, 479 N.E.2d 208 (MA 1985).

⁶⁰ *Occidental Fire & Casualty Co. v Reber Corp. et al.*, 2004 U.S. Dist. LEXIS 12774 (U.S. D.C. E.D. Pa. 2004).

and fund workers' compensation not liable for injury to its alleged client's employee – even though broker had issued certificate of insurance).⁶¹

2. Coverage Determination – Failure of Claimant to Punch-in. *Vincent Ward v AMS Staff Leasing*, PA BWC Claim No. 241-2426 (filed November 26, 2003) (Judge David B. Torrey, Pittsburgh) (PEO could not avoid responsibility for injury to its client's employee on grounds that worker had not punched in for the day).⁶²

⁶¹ In this case the claimant was a construction worker, Ellerbee, who suffered an injury on October 2, 1997. The employer was Triple L Construction. A month before the injury, a salesman for a PEO, Employer's Resource Management (ERM), made a proposal to Triple L for a "co-employment agreement."

This agreement was accepted, and the salesman immediately made a request of his home office that a certificate of insurance be issued. A broker for ERM's insurance carrier, Wausau, immediately obliged, and Triple L came into possession of the certificate.

As of October 2, 1997, the date of the accident, Triple L had still not submitted any monies to ERM so that it could make payroll payments. Presented with the Ellerbee claim, it was of the view that a critical contingency under the ERM-Triple L contract had not been triggered, and that in fact it had no binding agreement with Triple L. As a result, its carrier, Wausau, refused any responsibility for an October 2, 1997 injury.

In the litigation that followed, both claimant and Triple L argued that Wausau should be responsible. The ALJ, however, rejected this assertion. He stated, among other things, "stating it bluntly, although [ERM] was lax in issuing a certificate of liability insurance before receiving payment from Triple L, [ERM's] actions did not constitute a contract. That is so, because Triple L did not fulfill the conditions precedent to a valid co-employment agreement. Those conditions precedent required both the payment of monies for payroll and for workers' compensation insurance, as well as Triple L supplying [ERM] the proper documentation. Triple L had not met those conditions ... as of October 2, 1997."

⁶² In a case entertained by this writer (Torrey) in 2003, a dispute over employment status and insurance coverage demonstrates that Pennsylvania would benefit from regulation of employee leasing agencies.

The employer was a roofing company (Panther) that leased all of its employees, even its *president*, from a Texas-based employee leasing firm (AMS). Panther retained a worker, Ward, for an out-of-state job, and instructed him to drive from his Pittsburgh home to upstate New York. There, Panther was installing the roof of a new Wal-Mart.

On the way, Ward was injured in a motor vehicle accident. Panther did not challenge the existence of the accident, or the work directive, but the leasing firm (the nominal employer), rejected the proposition that the worker was an "employee," because he had not punched in that day, and had hence not appeared on its client's – the actual employer's – payroll.

Under its contract with the employer, the leasing firm only recognized as employees entitled to payment and insurance coverage, those workers who appeared on the employer's payroll for any given day.

This writer held the employee leasing firm liable, ruling that claimant was in the course of his employment, and that employment status – and the corresponding insurance coverage – was defined by the Pennsylvania Act. The employee leasing company, under the ruling, could not avoid workers' compensation coverage by pointing to restrictive terms of its contract with the actual employer. The latter had not, significantly, secured workers' compensation coverage on its own, given its exclusive reliance on leased employees.

Summary: Civil Cases

3. Insurance Coverage Dispute – Extent of Coverage of PEO’s Workers’ Compensation Carrier. *Stephenson v Argonaut Ins. Co.*, 23 Cal. Rptr. 195 (Ct. Appeal CA 2004) (carrier of PEO need not tender a defense or indemnify PEO client when employee sues client in tort action).
4. Insurance Coverage Dispute – Fleet Carrier. *Occidental Fire & Casualty Co. v Reber Corp. et al.*, 2004 U.S. Dist. LEXIS 12774 (U.S. D.C. E.D. Pa. 2004) (if employee leasing firms fails to carry workers’ compensation insurance, actual employer’s liability insurance will not provide workers’ compensation coverage).
5. Insurance Coverage Dispute – Massachusetts Law – CGL Carrier of Client versus WC/EL Carrier of PEO. *The Home Insurance Co. v Liberty Mutual Fire Ins. Co.*, 830 N.E.2d 186 (S. Ct. MA 2005) (CGL carrier for lessee employer could not, after personal injury lawsuit settlement with employee, secure indemnity from workers’ compensation/employers liability carrier of lessor PEO).
6. Breach of Contract – Bad Faith Claim by PEO Client Against PEO – PEO-Client Contract versus Requirements of the Workers’ Compensation Law – PEO Client as Third-Party Beneficiary of the Workers’ Compensation Policy. *Diamond Woodworks, Inc. v Argonaut Ins. Co.*, 135 Cal. Rptr. 2d 736 (Ct. Appeal CA 2003) (worker injured on first day of work, prior to submission of his application by lessee to lessor, was employee of PEO and, at least where PEO had never enforced contractual rules, carrier of same was liable for workers’ compensation; *and held also*: PEO client was third-party beneficiary of insurance contract between PEO and its workers’ compensation carrier).
7. Exclusive Remedy – Failure of PEO to Secure Workers’ Compensation Insurance. *Tu-Lane Investments, Inc. v Orr*, 889 So. 2d 961 (Ct. Appeal FL, 1st Dist. 2004) (if uninsured lessee client has not contracted with insured or legitimately self-insured PEO, it may be sued by employee in tort).
8. Exclusive Remedy – Policy Writing – Failure of PEO Carrier to Write Insurance Properly. *Garza v Exel Logistics*, 161 S.W.3d 473 (S. Ct. TX 2005) (lessee employer could be sued by employee in tort where it engaged in an employee leasing contract with a PEO which failed to comply with Texas Staff Leasing Act).
9. Lanham Act – Insurance Carrier Licensing – PEO as Additional Insured on another PEOs Policy – *Oriska Ins. Co. v The Power PEO, Inc., et al.*, 352 F. Supp.2d 291 (N.D. N.Y. 2004) (*procedural ruling*: PEO California clients who allowed PEO to secure workers’ compensation insurance from non-licensed New York insurer, via PEO’s creation of New York “shell corporation,” and alleged misrepresentations, were subject to jurisdiction of New York federal court).