

WHITE PAPER

Human Resources Outsourcing

Legislation and Legal Issues on Staff Leasing and Professional Employer Organizations

© Bierce & Kenerson, P.C. 2002

What is a "PEO"? Generically, a PEO acts as the nominal employer of personnel (sometimes referred to as "worksite employees") working for the customer organization. By assuming this role, the PEO becomes (or would like to become) legally liable for:

- compliance with statutory hiring, promotion, compensation, benefits and termination procedures under applicable U.S. tax, labor and immigration laws;
- collection and payment of employee wages for the worksite employees;
- registration and administration of unemployment insurance compliance; and
- optionally, support for and third-party administration of:
 - * group medical insurance plans sponsored by the customer organization, where medical services are provided by a third party;
 - * employee retirement plans, such as "401(k)" plans where employers contribute to separate accounts for each employee and employees may contribute as well (depending on the plan), profit sharing plans, and other plans eligible for special deferred income taxation under the Internal Revenue Code and the Employee Income Retirement Security Act ("ERISA") of 1974, as amended.

This document outlines key legal issues in this outsourcing model.

Historical Perspective. In the 1960's and 1970's, companies such as banks, Automatic Data Processing ("ADP") and PayChex began providing computerized batch processing of payroll checks and remitting payments of employee withholding taxes to governments. In the 1980's, processing companies began to offer additional services to lighten the administrative burden of compliance with laws governing employment, payroll taxation and insurance. Companies that offered such services called themselves "staff leasing" companies and, later, "professional employer organizations" ("PEO's"). They acted as employer to some extent, for payroll, employment tax, health insurance, life insurance, pension benefits and accounting functions. These functions conflict with the traditional functions of insurance brokers, ERISA benefits consultants and even the plaintiff's trial bar.

Legal Perspective

Co-Employment. Traditional legal theory of employment stems from the notion that an employee can be hired by only one employer who exercises supervision and control over the employee's work. But, in fact, the PEO does not actually exercise the degree of supervision and control that historically has been required to identify the "statutory employer." As a result, the marketing attempt by the PEO's to enlarge their market share required a novel theory, namely, "co-employment." Under this theory, the PEO and its customer enterprise are each legally responsible for certain, or all, elements of employment, including hiring, firing, promotion, compensation, tax administration and benefits administration. This theory has embroiled PEO's in a battle for survival, and their response has been to seek legislative recognition of their legal role in supporting the customer enterprise's worksite employees.

Joint Venture. To some degree, the PEO model resembles a joint venture, a common enterprise where both the PEO and its customer enterprise share risk for administration of the customer enterprise's employment matters. But the PEO apparently does not share in the fruits of the worksite employee's labor, so this analogy becomes strained.

Management Services. Unlike the classic "outsourcing," the PEO arrangement does not transfer the duties of the employer to the PEO. The traditional employer retains rights and privileges, as well as liability, for compliance with employment laws. As such, the PEO becomes akin to a management services company that performs a function for the benefit of the customer enterprise and, increasingly, as an agent for compliance with complex laws. It is this public service function that has attracted legislative support, until now, for the existence and public recognition of the positive economic role of the PEO in the United States. Indeed, state governments are beginning to look to the PEO as a private tax collector, a role discussed below.

PEO's Under Attack. Several constituencies have attacked the emerging legal status of PEO's. Such constituencies have sought, by political means, to increase the costs of a PEO's doing business, reduce the advantages that a PEO might offer to its customer, or force the PEO to disclose certain information about cost structures that might not otherwise be legally required to be disclosed. Such attacks have sought to deprive PEO's the legal status of "statutory employer" for purposes of enabling the PEO to assume the role of employer with respect to the worksite employees of the PEO's customers.

- **Insurance Agents.** From the insurance agent's standpoint, PEO's pose a threat to the ability to write multiple policies at different premium rates reflecting each insured business's loss rating and other underwriting parameters. By bundling small employers into groups, PEO's can obtain lower overall premiums if the law allows such bundling. Insurance agents have claimed that PEO's are unlicensed sellers of insurance. The policy debate is whether to treat each client company as a separate entity (even though "managed" by the PEO), or as part of an aggregate whose employees are all bundled under the PEO's aegis.
- **Organized Labor.** From the labor union's standpoint, a PEO might be used as a tool to strengthen the position of smaller employers, who otherwise might be subject to unionization efforts.
- **Employees and Pension Plan Administrators.** From the standpoint of employees and the traditional ERISA pension plan and benefits administrator, the concept of "co-employment" raises issues about compliance with applicable pension laws, notably ERISA.. This concern was resolved temporarily in the PEO's favor by IRS Revenue Procedure 2002-21, that protects the qualified status of multi-employer PEO pension funds with nondiscrimination and coverage testing for each PEO customer enterprise until pending federal tax and pension legislation, H.R. 2807 and S. 1305 (for the congressional term during 2002) is adopted. Federal legislation is considered necessary to "clarify" rules applicable to PEO "cafeteria" benefits plans, obligations on termination of employment under the "COBRA" employment benefits law and payroll tax administration, the distribution of PEO employee benefits plan assets on termination of the relationship between the PEO and its customer enterprise, and startup accounting rules for FICA (social security) and FUTA (unemployment tax) credits of new clients that enter into a "PEO arrangement" in the middle of a calendar year.
- **Trial Bar.** From the trial bar's standpoint, a PEO might result in fewer opportunities to engage in litigation relating to workers' compensation and other cases where the PEO's role as "statutory employer" or "co-employer" would make a difference.

PEO's on the March for Legitimacy and Modest Regulation. As a result, the national trade association of PEO's has been promoting the adoption of state and federal legislation that regulates the PEO functions, but only lightly. For example, in North Carolina in early 2002, legislation was proposed, but not adopted, that would have curtailed PEO operations, or increased costs, by imposing a bonding requirement with a minimum of \$100,000 in bonding, regardless of size, restrict the access of a PEO to insurance markets for workers' compensation coverages and imposed quarterly reporting requirements with audited financial statements conforming to generally accepted accounting principles ("GAAP").

Recently, PEO's have succeeded in obtaining, or is in the process of obtaining, state legislation that codifies their role.

New York Legislation Regulates PEO's.

New York enacted the New York Professional Employer Act (hereinafter, the "NY PEO Act"), effective 180 days after signature by Governor George Pataki on September 24, 2002. The new legislation imposes moderate regulatory compliance requirements, including registration, reporting and bonding, on companies that serve as staff leasing companies or "professional employer organizations."

Description of the New York PEO Regulatory Legislation.

Scope of Regulation - Affected Service Providers. The New York law covers organizations that refer to themselves as a "professional employer organization," a "PEO," or other similar name associated with the business of providing employees as dual employers with other companies.

Registration Formalities. Effective in March, 2003, "PEO's" must now register with the New York Department of Labor. Registration forms must be accompanied by financial statements together with a letter from an independent certified public accountant ("CPA") attesting to the facts that the CPA has reviewed the financial statements and, based on such review, the PEO has satisfied the minimum net worth requirements under the NYPE Act. As any CFO will know, an accountant's review letter does not reflect the same degree or disciplined of investigation that an audit requires. On this basis, the New York legislation is much more accommodating, and less costly, to the PEO's than the North Carolina legislation that was averted earlier in 2002.

Conditions of Operation - Financial Bonding. For the protection of customers, the New York law requires licensed PEO's to obtain financial bonding from a licensed surety or bonding company, or equivalent, to cover the risk of a PEO's misappropriation of the monies of its customers that are collected for the benefit of customers.

Period Reporting Requirements. In addition to the initial submission of CPA-reviewed financial statements showing financial capacity, each PEO operating in New York must also provide a statement prepared by a CPA within 60 days after the end of each calendar quarter, attesting to the fact that the PEO has paid all federal and state payroll taxes on a quarterly basis.

Penalties for Non-Compliance. Failure to comply will result in loss of the right to conduct business in New York as a PEO. In addition, penalties could be imposed on both the PEO and its managers for non-compliance. Finally, a customer organization that suffers a loss due to misappropriation of a customer organization's funds will get regulatory support to "make good" on any loss incurred as a result.

Rationale for the New York PEO Regulatory Legislation.

Collection of Deposits. In many respects, a PEO acts like a bank. A PEO collects "deposits" from its customer organizations. The PEO undertakes to pay such amounts to the worksite employees as wages, federal and state authorities as taxes imposed on both the employee and the employer, and other payments for unemployment, workers' compensation, medical health and life insurance plans. The PEO does not pay interest on the monies but acts in the same manner as if it were an agent, or paymaster, for its customer organization.

Fiduciary Duties. As nominal employer, the PEO also bears other fiduciary and legal responsibilities to its customer organizations, the covered worksite employees, the federal and state (and sometimes local) taxing authorities, state and local departments of labor and other regulatory agencies and businesses providing services, directly or indirectly, to the customer organizations and covered worksite employees. Governments frequently regulate fiduciaries and middleman, especially when money is collected to pay taxes.

Risk of Misappropriation. Without such registration requirements and regulatory supervision, a PEO could more easily divert monies collected from its customer organizations, or use the advance payments of one customer organization to fund the payment of obligations for another customer organization.

Limited Scope of the New York PEO Act. The New York legislation does not treat the PEO's monies as a trust fund, which would require segregation of assets among different bank accounts for the various customer organizations. Nor does the New York law prevent a PEO from "cross-subsidizing" one customer organization by paying from funds received from another customer organization. But in the end, the tax liabilities incurred by the PEO in respect of all customer organizations must be paid.

Risk of Bankruptcy. The new legislation imposes personal liability on the PEO for acts that might otherwise be discharged in bankruptcy of the customer organization. Unpaid federal and state tax collectors have a priority in bankruptcy, 11 U.S.C. 507 (a)(8), but unpaid worksite employees and unpaid providers of medical plans and other unregulated employee benefits do not. And even a priority in bankruptcy does not assure that the available funds will be sufficient to pay 100% of the amount of the priority.

Implications of the New York PEO Act and Other Regulation of PEO's.

PEO's as Regulated Private Tax Collectors. The New York PEO Act puts teeth into the collection of employment taxes. While a PEO is legally liable under existing federal and state law governing collection of employment taxes and payments by employers, the New York law adds an ongoing monitoring program under the supervision of the independent certified public accountants. The PEO's become a regulated privately-owned tax collector.

PEO's as Debt Collectors for Unpaid Employment-Related Income Taxes. While the U.S. federal government has debated the wisdom of hiring private enterprises to collect past-due taxes, this New York law puts the PEO directly in the position of acting as a private tax collector, particularly if a customer organization should fail to pay the full amounts due. PEO's that become saddled with this unfortunate legal liability must also consider the application of the federal Fair Credit Reporting Act and other state and federal laws governing the privacy of a person's liability to pay taxes and the methods by which a private debt collector may intrude upon the privacy of a delinquent customer organization and its management.

PEO's as Guarantors of Customer Liabilities. The New York PEO Act will force all PEO's serving customer organizations in New York to act like a bonding company or insurance company and make certain financial demands on their customers. The prudent PEO must now ensure that the customer will deposit with the PEO all applicable taxes. The new law could be used to

justify a demand that the customer organization deposit monies in advance. To date, most New York PEO's have taken the position that advance deposits are not required, so long as the PEO has delegated authorization to draw down, by instructions for wire transfers, on the customer organization's bank account simultaneously with the issuance of employee salary payments.

Trade Association for PEO's. Depending on the size of the average outsourcing service provider and the concentration of such providers in the industry, trade organizations may develop to establish standards to inspire customer confidence, provide a forum for debate on common issues, to petition the government for redress of grievances and thereby eliminate unscrupulous operators. Trade organizations are often established *ad hoc*, to respond to special problems.

PEO Model: A Template for Other Types of Outsourcing? The PEO model differs materially from the classic outsourcing model. Traditional outsourcing involves a complete transfer of the employer's rights and responsibilities from the outsourcing customer to the outsourcing service provider. The PEO model involves no such complete transfer; indeed, it involves the customer enterprise's express retention of rights and responsibilities.

Accountability for SLA's. Designers of service models may inquire about the feasibility and desirability of a PEO model for other types of outsourcing. Features that suggest the PEO model is *sui generis* to employment law, and not generally applicable, include the confusion about the roles of the outsourcer and customer in delivering services under a service level agreement. The PEO has no "SLA" other than to comply with certain laws and to deliver the agreed services. We have not yet seen PEO's offering SLA's that tie into any performance parameters other than compliance with laws and applicable pension plans and health insurance plans. The PEO's are not in a position to engage in any project management, change management, employee supervision or the implicit design and implementation of the customer enterprise's business plan. The PEO has no role in developing or implementing any "core business strategies" or "core business drivers" for the viability and prosperity of the customer enterprise. So the PEO does not share in its customers' prosperity.

Knowledge Capital. Additionally, if an external organization (a "super-PEO") were to have the right to supervise customers' worksite employees according to PEO-developed proprietary methodologies, the super-PEO would lose its proprietary methods over time. And the customer organization would be in conflict with the super-PEO over policy issues. This conflict stems from the fundamental precept of corporate governance, that the board of directors alone, not some super-PEO hired as an independent contractor, has the ultimate responsibility for management of the customer enterprise.

Amalgamation Opportunities. But consider also the possibility that an enterprise hires a PEO and wants some transitional assistance in knowledge management, process design and other services that will make the customer look more streamlined and effective. The PEO model could be amalgamated with other service delivery models. The customer enterprise could hire the PEO (or become its own internal PEO in a shared services business unit) to manage the administrative and payroll operations and hire a consultant to implement business process improvement for the shared services. This has been done. For this reason, we have probably not seen the end of the PEO model in outsourcing, and we can envisage its expansion.

As a matter of disclosure, from time to time, Bierce & Kenerson, P.C. represents the interests of PEO's and/or their customer organizations in relation to outsourcing of human resources through co-employment, shared services and other business structures.