

## Client Service Agreements - Client-Based Health and Workers' Compensation Programs

### Introduction

Although the underlying business and legal basis for a PEO – that of co-employment – remains the same, the realities of the marketplace are changing PEO operations. No longer can it be expected that PEOs operate using one basic business model. It used to be that one could expect a PEO to have the following characteristics: (1) Process payroll and file payroll taxes under one FEIN; (2) Provide workers compensation insurance by way of a master policy; (3) Sponsor a group health plan for all employees; (4) Sponsor a 401(k) plan through either a single employer or multiple employer plan; and (5) provide human resource consulting and advice. The operations of many PEOs are not so uniform anymore. The inability to access traditional, master workers compensation policies, increased regulatory pressure<sup>1</sup>, and changes in overall market conditions, have caused PEOs to re-think and re-engineer their business models. “Arbitrage” is no longer the central profit motive or component. A central part of this re-engineering is a client option or requirement to sponsor its own group health and/or to secure workers compensation insurance through an individual policy<sup>2</sup>.

One need not look further than the NAPEO Model Registration Act (the “Model Act”) to see the changing face of a PEO. The Model Act provides that either the PEO Client or the PEO may secure workers compensation insurance coverage.<sup>3</sup> The Model Act is also provides that both the a PEO and the client shall be deemed to be an employer for purposes of sponsoring retirement and benefit plans, and is silent on whether the PEO or the Client must be the plan sponsor.<sup>4</sup> The proposed federal PEO legislation<sup>5</sup> contains provisions for both PEO-maintained and client-maintained benefit

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<sup>1</sup> See: The NAIC/IAIABC *Report on Employee Leasing and Professional Employer Organizations*, 2002.; NC Stat., 96-1, et. seq. (see revised section 96-9(c)(4) added in 2003).

<sup>2</sup>There are generally two methods for a PEO client to secure workers compensation insurance by way of its own policy: (i) through a Multiple Coordinated Policy (MCP) arrangement [if permitted by the state], whereby the PEO is responsible for the payment of the aggregate premiums of its clients, there are common anniversary dates, and premium discounts based on the aggregate premium, but the carrier issues individual policies to the PEO clients, or (ii) through independent policies secured with the assistance of the PEO. In such an arrangement, the client is primarily liable to pay premiums, including any up front payments of premiums.

<sup>3</sup> See the NAPEO website for a copy of the Model Act. The workers compensation section of the Model Act can be found in Section 9.

<sup>4</sup> Id. at Section 8

<sup>5</sup> See The Professional Employer Organization Act, most recently introduced in the House of Representatives and the United States Senate as H.R. 2187 and S. 1269, respectively.

programs. Hence, it appears clear to this author that there is now an acceptance in the PEO industry that a PEO client can sponsor or maintain its own group health insurance and/or workers compensation insurance program, and that such a delegation or division of employer responsibility is not necessarily inconsistent with a co-employment relationship.<sup>5</sup>

Whether by choice or necessity, many PEOs have also added to their business models an administrative services division that provides administrative services to clients on an a la carte, agency basis under which it does not purport to be an employer of its clients' employees (a service commonly referred to as "ASO"). This method of providing administrative employer services, while an important component of many PEO company business models, is not the subject of this paper<sup>6</sup>. This paper will discuss the issues raised when, in a PEO, co-employment arrangement, the PEO client retains its own health plan or workers compensation policy, and the issues raised in doing so.<sup>7</sup> In particular, this paper will focus on the PEO Client Service Agreement, and the affect such arrangements have on the contractual relationship of the parties, and the changes to the Client Service Agreement that the PEO must consider.

## **Workers' Compensation Insurance**

Central to any PEO's business is workers' compensation insurance and workplace safety. Because the PEO is an employer of the worksite employees, the PEO generally has a duty to provide statutory workers' compensations insurance for the work

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<sup>6</sup> In an ASO model, there is no issue of employer status or liability. The ASO expressly rejects employer status and does not attempt to be an employer in any way. Thus, the questions of whether a "client" may sponsor a plan or be a policyholder are not relevant. In an ASO arrangement, only the client is an employer, and only the client may be a plan sponsor or policyholder.

<sup>7</sup> Many in the industry, particularly veterans who worked tirelessly for the right of a PEO to sponsor such plans, express concern that delegating the responsibility to provide such insurance to a PEO client will erode the PEOs ability to claim employer status. Although this may be a legitimate concern, it appears that the opposite may be true. More states than ever before recognize that either the PEO or the PEO client may secure workers compensation insurance (i.e., Arkansas, Colorado, Florida, Georgia, Idaho, Illinois, Louisiana, Maine, New York, Oklahoma, Oregon, South Carolina, and Tennessee); Kentucky and Utah actually require the client to maintain workers' compensation coverage; Florida has resolved the issue by rule (61G7-10.004, Florida Administrative Code), while other states are silent on the right of the PEO client to maintain statutory coverage. This author is unaware of any state that statutorily prohibits a client of a PEO from securing workers' compensation insurance. We have been made aware, however, that the state of Wisconsin has recently informed a PEO that its clients may not maintain their own policies. This "instruction" was without statutory support. Similarly, there is no federal statute that requires the PEO to sponsor a group health plan. Moreover, in some states (i.e., Maryland), the PEO client is required to sponsor its own health plan. In each state where the PEO client is permitted or required to maintain a workers compensation policy or group plan, the PEO maintains its status as employer under state law for other purposes (tax withholding, payment of wages, unemployment filing). As indicated previously, the NAPEO Model Registration Act also provides that either the PEO client or the PEO may maintain a group health insurance plan or a workers compensation policy.

site employees<sup>8</sup>. Under both state and federal law, employers also have a duty to provide a safe workplace.<sup>9</sup> In the past, it was assumed that the PEO would secure such coverage. In fact, providing workers compensation insurance was a central part of most PEO's business models. Times have changed. Now, most PEOs have at least some clients that maintain workers compensation insurance by way of policies in the name of the client.<sup>10</sup>

The reasons for the change in the way that PEOs provide workers compensation insurance are many, and include: lack of availability of master programs; high collateral requirements; high deductible requirements and the lack of aggregate coverage; clients that have favorable experience modifiers and retro programs; investor reluctance to take insurance risk or to rely on insurance as a source of revenue. Like most other areas of a PEO's business, it is important to examine the potential legal and/or regulatory effects of changing or altering a fundamental part of the PEO business model. The two most important issues to consider, and which will be discussed below are: (1) client service agreement requirements; and (2) exclusive remedy<sup>11</sup>.

### The Client Service Agreement

At the heart of a co-employment relationship is the Client Service Agreement ("CSA"). It is this agreement, coupled with state law that defines the relationship of the parties, and their respective obligations and liabilities. The obligation to secure and

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<sup>6</sup> The most notable exception is Texas. See, Tex. Gov't Code Sec. 406.002 (Vernon 1995), which permits an employer to elect to opt out of the workers' compensation act (interestingly, an employee also has an independent right to opt out).

<sup>7</sup> The federal Occupational Safety and Health Act (OSHA). 29 U.S.C. 654 and various state laws (e.g. CAL OSHA – California Code of Regulations, Title 8). While federal OSHA provisions are focused primarily on the client (as the employer controlling the worksite and instrumentalities of work), PEOs must be aware that under the OSHA multi-employer rules, liability reaches to four categories of employers (creating, correcting, exposing, or controlling employers). See, for example, OSHA Directive CPL 2-0.124, 12-10-99 Multi-Employer Citation Policy. A PEO, therefore, cannot absolve itself or all OSHA liability.

<sup>10</sup> This author is aware of more than one PEO that has decided to secure workers compensation for all of its worksite employees in this manner.

<sup>11</sup> It is very important for the PEO to recognize that case law, statutes, or commentary regarding the availability of exclusive remedy to both the PEO and the PEO client generally assume that the PEO is securing the policy of insurance. As a result, the analysis is whether the PEO client is extended the benefit of exclusive remedy. For purposes of this paper, the question is the opposite: Is the PEO protected by exclusive remedy if the client maintains the insurance? Therefore, any time that a conclusion is reached that both the PEO and its clients benefit from exclusive remedy, one must be sure to understand the assumptions made. A conclusion that exclusive remedy is available to both parties when the PEO secures the policy is not necessarily valid if the client secures the policy. Another issue that has been raised is whether a PEO client has the legal right to secure workers compensation insurance at all in a state where the PEO licensing statute provides affirmatively that the PEO is the employer for purposes of workers compensation and has a duty to provide such coverage. E.g., Tex. Gov't Code Sec. 91.006 (Vernon 1995). It is difficult to understand, however, how a PEO client, which absent a PEO contract, has a legal duty to provide workers compensation coverage (or in Texas, to opt out of such coverage), can suddenly not have the legal ability to maintain such coverage, particularly when there is no real dispute that the PEO client is the common law employer and therefore entitled to secure workers compensation coverage.

maintain workers compensation insurance must be clear in the agreement<sup>12</sup>, and must reflect the actual duties and responsibilities assumed by each party.

A PEO must recognize that the contractual relationship with its client is different if the PEO client maintains workers compensations insurance, and for this reason, the PEO should be careful to use an appropriate form of CSA to describe the relationship and protect the PEO's interests. When the client maintains workers compensation insurance, the relative responsibilities and powers of the parties change along with their potential legal liability. In most cases, the PEO's "standard" CSA will not be adequate to describe properly the duties and obligations of the parties, and will not contain sufficient protection for the PEO. Therefore, if a PEO decides to require its client(s) to secure workers compensation insurance through a policy or policies in the name of a client, the PEO should review carefully its client service agreement, and should use specifically prepared forms of agreement for "client workers compensation" relationships.

In order to place the relationship and contract requirements for this relationship in proper perspective, it is helpful to review the traditional PEO business model where the PEO maintains workers' compensation coverage, as well as the standard contract provisions PEOs use in such agreements. If the PEO is the policyholder, the CSA typically describe clearly the PEO's obligation to secure workers' compensation insurance. In many PEO licensing states, the statute also requires the CSA to provide that the PEO "[r]etains a right of direction and control over management of safety, risk, and hazard control at the worksite or sites affecting its leased employees . . ." <sup>13</sup> As a licensing mandate, this specific language must appear in the contract. Many form PEO contracts contain the required statutory language word-for-word. The following contractual provisions, while not statutorily required, are essential nonetheless to protect the interests of the PEO and its insurance carrier, and appear in most standard forms of PEO agreements<sup>14</sup>:

- The Client must assign accurate Classification Codes and warrant that the Classification Codes disclosed to the PEO are true and accurate;

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<sup>12</sup> More recent comprehensive PEO statutes have routinely required that the CSA specifically allocate this responsibility (see e.g. footnote 18 below.)

<sup>13</sup> See, e.g., Fla. Stat. §468.525(4)(e)(3).

<sup>14</sup> PEO licensing statutes typically require other mandatory language not related to workers' compensation. Be sure to have legal counsel check the statute for each state in which the PEO does business for mandatory contractual language. See, e.g., SC § 40-68-70, which requires the following term: 'PEO agrees that the jurisdiction of the Client is the jurisdiction of PEO and its workers' compensation insurance carrier. PEO and its workers' compensation insurance carrier are bound by and subject to the awards, judgments, or decrees rendered against them under all applicable local, state and/or federal laws, ordinances, and regulations, including, but not limited to, those related to occupational health and safety.'

- The Client may work within approved Classification Codes;
- The Client must provide prior, written notice to the PEO of any new lines of business, new locations, and new class codes, and the PEO reserves the right to approve any such new business of class codes;
- The PEO (and its workers' compensation insurance carrier) reserves the right to inspect the workplace and change class codes;<sup>15</sup>
- The PEO (and its workers' compensation insurance carrier) shall have the right to audit client's payroll, class codes, and operations<sup>16</sup>;
- The PEO and the workers' compensation insurance carrier shall have the right to inspect the premises at any reasonable time;
- The PEO reserves the right to terminate the CSA for a breach of any of the client's workers' compensation obligations stated in the CSA, including, but not limited to, client's failure to follow safety or other risk management advice. In addition, the PEO should provide that it may terminate the CSA if the client's experience becomes too high or the carrier deems the experience to be unacceptable. The PEO must also be able to terminate if its carrier changes the workers' compensation program, raises rates or other material terms of coverage; and
- Client must report injuries within 24 hours, and the Client must agree to participate in a return-to-work program (light duty); and
- A worksite employee is not covered under the PEO's policy until the employee has completed all required paperwork

### When The Client Secures Workers' Compensation Insurance

The PEO should have a separate form of CSA for clients that retain their own workers' compensation policies. The rights and responsibilities of the parties are fundamentally different, and *must* be clearly stated in the document. This is an area where the PEO cannot afford either a misunderstanding or a mistake. For example, the PEO must understand that even though the Client is securing the workers compensation coverage, the PEO remains as the W-2 employer, and must have

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<sup>13</sup> Because the PEO in this situation is the insured, the PEO must have the authority to change class codes if the PEO disagrees with how a work site employee is classified.

<sup>16</sup> It is also a good idea to provide a process for the "challenging" of a class code so the client has an opportunity to explain the class code designation; however, the PEO must maintain the ultimate authority to change the class code.

assurances that the Client has in fact secured the coverage and is maintaining the coverage. These assurances are not typically contained in a “standard” PEO CSA. Because simply adding an addendum to a standard CSA can be confusing and lead to misunderstandings and/or mistakes, a separate form of CSA is the preferred course of action.

The PEO should also consider adopting a firm and clear internal policy regarding the type of insurance and insurance carrier that will be acceptable; in what form and when the client must produce evidence of such insurance; and what endorsements, if any, will be required. The PEO should reduce the internal policy to writing, publish it, particularly to sales people, and scrupulously adhere to the policy. Examples of questions that the internal policy should answer include:

- (i) Will the PEO accept only fully insured arrangements?
- (ii) Must the client’s insurance policy be from a rated carrier?
- (iii) What endorsements are required?<sup>17</sup>
- (iv) What proof of coverage is required prior to accepting the client’s payroll?

The obvious distinction in this type of arrangement is that the client, and not the PEO, is securing workers’ compensation insurance. Thus, it is equally obvious that the first topic that the CSA must address is the client’s obligation to maintain such coverage. The CSA must be very clear on this point.<sup>18</sup>

Written proof of workers’ compensation insurance, in a form and with a carrier acceptable to the PEO,<sup>19</sup> should be a condition precedent to the PEO beginning performance (i.e., accepting employees on its payroll). Such proof generally can be in

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<sup>15</sup> Please note that the Alternative Employer Endorsement (NCCI form WC 00 03 01 A) is not the applicable endorsement where the client secures the insurance policy. The Alternative Employer Endorsement applies to employees, “while in the course of special or temporary employment by the alternate employer ...” The purpose of this endorsement is to provide employer status protection to the PEO client. Where the client secures the insurance, it is the PEO that needs employer status protection by endorsement (See Appendix B for the text of the Alternate Employer Endorsement). The PEO should seek protection in the form of a Labor Contractor Endorsement (NCCI form WC 00 03 20 A). The NCCI adopted this form in 1992 specifically to address the situation where a client of a PEO secures workers’ compensation insurance. The Insurance Risk Management Institute (“IRMI”) also recommends this endorsement if the PEO client is the policyholder. The endorsement limits the risk to the client contract and provides Part II (employer liability) protection to the PEO. Unfortunately, many carriers are unfamiliar with this endorsement (because PEOs have traditionally secured the workers’ compensation insurance), thereby making it difficult at times to obtain, particularly if PEO is also unfamiliar with the endorsement, its history, and purpose. See Appendix A for a copy of this endorsement.

<sup>18</sup> In some states, such language is required by statute. For example, the Oklahoma statute provides the following: ‘The responsibility to obtain workers’ compensation coverage for covered employees, from a carrier licensed to do business in this state and otherwise in compliance with all applicable requirements, shall be specifically allocated to either the client or the PEO.’ Therefore, the CSA should clearly allocate this responsibility. 40 Okla. St. Ann. § 600.7C(4).

<sup>19</sup> The PEO must develop a policy regarding the type of insurance it considers acceptable (i.e., fully insured, self-insured, or, in Texas, an opting out of such insurance altogether). In this author’s opinion, it is not advisable to allow a client to opt out of workers’ compensation insurance in a state where it is permissible. It is also risky to allow a client to be self-insured.

the form of a valid certificate of insurance. The PEO should require that the PEO be named in the certificate of insurance so that the PEO receives notice of any non-renewal or cancellation of the policy. The CSA should state which party is responsible for making premium payments. Some PEOs have elected to take on this responsibility to be sure the policy remains in force. Others have decided that the potentially liability for a missed premium by the PEO is too great, and, as a result, the client has the responsibility to pay deliver premiums to the insurance carrier<sup>20</sup>. The CSA must also provide that the failure to maintain workers' compensation insurance is grounds for immediate termination<sup>21</sup>.

These contract terms are critical to protect the PEO because a client's failure to maintain workers' compensation insurance may result in liability for the PEO. To be sure, the contractual agreement requiring or allowing the client to secure workers' compensation insurance does not, and cannot, remove the obligation to provide such coverage to work site employees. State law imposes the duty to maintain workers' compensation coverage and the state will expect at least one employer to maintain statutory coverage, irrespective of the terms of the CSA and a contractual allocation of "legal" responsibilities between the PEO and its client. Therefore, if a PEO client fails to maintain workers compensation insurance as required under the CSA, and a work site employee is injured, the state will look to the PEO to respond. Moreover, you can bet that if a PEO's client defaults on its premium obligation, the client is likely in poor financial condition or bankrupt (or simply gone).<sup>22</sup> Therefore, the PEO must be extremely careful and vigilant in delegating to its client this important employer obligation.

Even though the likelihood of recovery may be low, the PEO should nonetheless require in its CSA a separate indemnity for the failure of the client to maintain workers' compensation insurance, or in the alternative, the general indemnity clause should specifically refer to damages, costs, and fees incurred by the PEO due to the client's failure to maintain workers' compensation insurance. The PEO may also wish to obtain guarantees of this indemnity from the principals of the client.

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<sup>20</sup> This is a business decision for the PEO to make after weighing the risks and benefits. Keep in mind, however, that even if the PEO client has the responsibility for making the premium payments, if the client fails to make a payment, and a policy lapses as a result, the PEO could have exposure for any injuries to work site employees that were employed (i.e., on the PEO's payroll) by the PEO at the time of the injury. See discussion, *infra*.

<sup>21</sup> Such a termination provision must provide, at a minimum, that the termination is effective immediately upon notice being sent to the person and place stated in the CSA to receive notices for the client. The PEO can also attempt to make the termination effective immediately upon the lapse of the client policy, without the need for notice; however, such a provision is risky in the event that a state refuses to recognize such a notice. An alternative provision would provide that termination is effective on the earlier of notice sent or the effective date of the policy termination, and then have a 'saving clause' that provides that in the event the automatic termination provision is held to be invalid, the notice provision will govern.

<sup>22</sup> Because of this risk, the PEO must monitor even more closely any signs of financial difficulties of the client.

There are also terms typically included as part of the standard CSA that do not make sense and do not apply when a PEO client secures workers compensation insurance. Most standard PEO contracts require the client to allow the PEO to inspect the premises and audit the classification codes of employees, and further reserves to the PEO the right to modify classification codes. Because the PEO is not a party to the client's insurance policy, it is unnecessary to include language reserving a right to review class codes and to modify them if necessary. In fact, it may be risky to have such language in an agreement when the PEO is not an insured. The PEO could be at risk of unwittingly assuming a duty to inspect or verify such class codes. The PEO should, however, reserve the right to inspect the premises in that the PEO is a co-employer and may have a general duty to maintain a safe workplace under state and federal law.<sup>23</sup> Keep in mind, however, that in many PEO licensing states, a PEO is required to include in its client service agreement certain terms reserving to the PEO's a "right of direction and control over the safety of the worksite employees and/or the workplace"<sup>24</sup>. This requirement creates a peculiar contract drafting challenge. Therefore, a PEO operating in such states must retain such direction and control language in its agreement even though the client is securing the workers' compensation insurance. In conclusion, the PEO should have a separate agreement for clients that retain their own workers' compensation insurance policy, and the PEO should have an internal, written policy on how, and under what conditions, the PEO will enter into a contract for services under such conditions. The separate agreement should, at a minimum, contain the following provisions:

- A clear and unambiguous statement that it is the client's sole and exclusive obligation to secure workers' compensation insurance coverage that is acceptable to the PEO;
- A requirement that the client must provide proof of acceptable coverage *prior to* the contract being effective;
- A requirement that the PEO be named in the certificate of insurance and that the PEO receive notice of cancellation or non-renewal;

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<sup>23</sup> See, e.g., the Occupational Safety and Health Act (OSHA).

<sup>24</sup> See e.g. New Jersey Permanent Statutes 34:8-68 (2) b "Every employee leasing agreement shall provide that the employee leasing company and the client company shall each retain a right of direction and control over management of safety, risk and hazard control at the work site or sites affecting each covered employee including: (1) Responsibility for performing safety inspections of client company equipment and premises; (2) Responsibility for the promulgation and administration of employment and safety policies; and (3) Responsibility for the management of workers' compensation claims, the filings thereof, and procedures related thereto." The PEO should consult legal counsel to be sure that all statutorily required terms are included.

- Separate indemnity language specifically addressing the client's obligation to provide workers' compensation coverage;
- A provision for immediate termination for non-renewal or cancellation of workers compensation insurance for any reason;
- Language reserving the right to direct and control safety of workplace in states where such contractual language is required;
- Language retaining the right of the PEO to inspect the premises;
- A provision stating which party is responsible for paying premiums and how such payments will be made; and
- No language giving the PEO a right to approve or modify classification codes.

Although it is impossible to know when a risk will result in damages, one can be sure that if the PEO receives a call from a regulator or injured worker it will be in a case where there has been serious injury and high medial costs and potential damages, and during a period of time that a client's policy was not in effect. Therefore, the PEO should proceed down this path very carefully and take the time and effort to construct sound contracts and policies to minimize its risks.

#### Exclusive Remedy

No discussion of workers compensation insurance would be complete without raising the question of exclusive remedy<sup>25</sup>. For purposes of this article, the question focuses on whether exclusive remedy is available to the PEO when its client is the policyholder.

For many years, the PEO industry worked diligently for the right of a PEO to provide workers compensation insurance, and for clarity that if the PEO maintained coverage the PEO client was protected under the exclusive remedy doctrine. PEOs have been largely successful in obtaining, mostly through statutory action, the right to provide workers compensation insurance. The vast majority of states have extended to a PEO client exclusive remedy protection if the PEO secures coverage.

When a PEO client maintains workers compensation insurance for its employees, the issue is turned on its head. If the PEO client secures workers

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<sup>25</sup> Exclusive remedy is the *quid pro quo* given by employees in exchange for the employer not contesting liability if an injury occurs to an employee on the job. It is the way that employers stay clear of courts and juries in the face of a personal injury to a worker. Without exclusive remedy, the employer could potentially face lawsuits for negligence. Therefore, the principle of exclusive remedy is very important to a PEO. There are limited exceptions under most state laws, including gross negligence, but for the most part, an employee's exclusive remedy for injury on the job will be pursuant to the state's workers compensation statute.

compensation insurance, is the PEO protected by exclusive remedy? The clarity of the answer to that question depends on the state.

Unfortunately, some state laws do not address the question at all, including states that have PEO licensing statutes<sup>26</sup>. Some state statutes are silent on the question of exclusive remedy, but permit, or do not prohibit, the PEO client from securing workers compensation coverage<sup>27</sup>. Other states are very clear, and these states tend to be the ones that have adopted recent PEO licensing or registration statutes. These statutes explicitly state that either the PEO or its client may secure workers compensation insurance, and irrespective of which party secures the insurance, both parties are protected by exclusive remedy<sup>28</sup>. The NAPEO Model Registration Act also provides that either party can secure workers compensation insurance, and that both parties are protected by exclusive remedy<sup>29</sup>.

Because the answer to the question of exclusive remedy varies from state to state, a PEO should research the state laws in which it does business prior to securing workers compensation insurance through client policies<sup>30</sup>. In the end, the PEO must balance what it believes, after adequate research, is the risk of being sued in tort against the advantages of allowing clients to maintain coverage.

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<sup>26</sup> E.g., Staff Leasing Services Act, Texas Labor Code Ch. 91.

<sup>27</sup> E.g., F.A.C. 61G7-10.0014 (Florida).

<sup>28</sup> See, e.g., Ark.; Okla.; Ga.; CO; NY; La.; Me.; N.M.. Two examples of favorable statutory language can be found in Arkansas and New York: Ark. Stat. § 23-92-315 (4) provides: '[A] licensed employee leasing firm shall be deemed an employer of its leased employees and shall ... be entitled and entitle the client, together as joint employers, to the exclusivity of the remedy in 11-9-105 under both the workers' compensation and employer's liability provisions of a workers' compensation policy or plan that either party has secured within the meaning of 11-9-105; 4. New York Professional Employer Act, Art. 31, § 922.4 provides: 'Both the client and the professional employer organization shall be considered the employer for the purpose of coverage under the workers' compensation law and both the professional employer organization and its client shall be entitled to protection of the exclusive remedy provision of the workers' compensation law irrespective of which entity secures and provides such workers' compensation coverage'.

<sup>29</sup> See, Section 7(A)(2)(d) of the Model Act, where it provides: 'The responsibility to obtain workers' compensation coverage for Covered Employees, from a carrier licensed to do business in this State and otherwise in compliance with all applicable requirements, shall be specifically allocated to either the client or the PEO in the Professional Employer Agreement'.

<sup>30</sup> The following are examples of states that provide clearly that the PEO is protected by exclusive remedy if the client purchases workers compensation coverage: Arizona (§23-901.08); Arkansas (§ 23-92-315(4)); Louisiana (§ 1210.56(C)); Maine (32 § 14044(B)); Montana (§39-8-207(8)(b)); New Mexico (§60-13A-5); New York (Art. 31, § 922.4); North Dakota (§ 65-01-08(2)); Oklahoma (§ 600.7(E)); Tennessee (§ 62-43-113(e)(1)); Utah (§ 34A-2-105(2)). The following states have statutes that provide a strong argument for exclusive remedy for the PEO because the statute permits either party to purchase coverage, considers both parties employers or co-employers for purposes of workers compensation insurance, and/or there is no prohibition against the PEO delegating or allocating the responsibility to secure workers compensation to the PEO client: California (§ 3602(3)(d)); Colorado (§80-70-114); Florida (§§ 440.11(2) and F.A.C. 61G7-10.0014); Idaho (§§ 72-103(3) and 72-103(1)(b)); Illinois (§113, 45); Indiana (§ 22-3-6-1(a)); Minnesota (§176.071); New Hampshire (§ 27-B-10); New Jersey (§34-8-72); Oregon (§§ 656.850(3) and 656.018(4)); South Carolina (§ 40-68-70(a)(7)); Georgia (§§ 34-9-11(c) and 34-7-6(d)); and Vermont (§65.2-803.1(G)). Other states are silent on the question of whether the client can purchase workers compensation insurance and/or do not address the issue of exclusive remedy for other than the "employer": Alaska; Connecticut; Delaware; Hawaii; Iowa; Kansas; Kentucky; Maryland; Massachusetts; Michigan; Mississippi; Missouri; Nebraska; Nevada; North Carolina; Ohio; Pennsylvania; Rhode Island; South Dakota; Texas; Virginia; Washington; West Virginia; Wisconsin, and Wyoming.

In addition, the PEO should use all means available to cover or minimize its risk<sup>31</sup>. One important part of minimizing risk for the PEO is obtaining an appropriate endorsement. The endorsement used when the PEO is the insured is the “Alternate Employer Endorsement”<sup>32</sup> Its purpose is to provide employer coverage to the PEO client. If the PEO client is the insured, this endorsement is unnecessary.<sup>33</sup> What is necessary is a “Labor Contractor Endorsement”<sup>34</sup> This endorsement, while little used, was created by NCCI in 1992 to address specifically a PEO relationship whereby the PEO client secures the workers compensation coverage. The purpose of the endorsement is to provide to the PEO coverage as an employer and to identify clearly the risk covered by the policy.<sup>35</sup> The International Risk Management Institute (IRMI) recommends use of this endorsement also when the PEO client is the insured<sup>36</sup>. Although the Labor Contractor Endorsement is the favored endorsement because it identifies the risk being insured, many underwriters are unfamiliar with the endorsement and need to be educated.

There is one final consideration for the PEO if it decides to require or allow clients to secure workers compensation insurance. Will the PEO provide any assistance to the client in obtaining the coverage. Although the PEO is the W-2 employer even when the client has its own policies, and has workers’ compensation responsibilities, states generally require an insurance license to provide insurance products advice or assistance in securing insurance. State insurance departments rigorously enforce laws related to the sale of insurance. Therefore, if the PEO is conducting, or intends to conduct, any insurance-related activities on behalf of the client, it will need to make

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<sup>31</sup>Please be aware that a General Liability Policy will likely exclude a claim for personal injury at the work place

<sup>32</sup> NCCI form WC 00 03 01 A

<sup>33</sup> The Alternate Employer Endorsement provides that the endorsement ‘applies only with respect to bodily injury to your employees while in the course of special or temporary employment by the alternate employer ....’

<sup>34</sup> NCCI Form WC 00 03 20 A

<sup>35</sup> Paragraph one of the endorsement provides: ‘This endorsement applies only with respect to bodily injury to your leased employees in the state named in Item 2 of the Schedule when provided by a labor contractor named in Item 1 of the Schedule. This endorsement does not apply with respect to bodily injury to workers provided to you on a temporary basis’. The term Labor Contractor means the PEO for purposes of the endorsement. The Schedule attached to the endorsement specifically identifies the Labor Contractor (PEO), the PEO’s address, and the PEO agreement to which the client and work site employees are subject. (see Appendix “A” for the text of the Schedule in the endorsement).

<sup>36</sup> The IRMI publication *Contractual Risk Transfer – Strategies For Contract Indemnity and Insurance Provisions*, provides the following recommendation for an insurer writing a PEO client policy: ‘[W]hen, under the terms of the contract, the client is responsible for purchasing coverage, the labor contractor endorsement (WC 00 03 20 A) should be attached to the client’s policy. This endorsement is a form of additional insured endorsement drafted specifically for employee leasing arrangements to extend coverage to the PEO for any liability it may have arising out of injuries to employees it leases to clients. Vol. II, at XI.G.9. IRMI further recommends that the PEO attach to any policy in its name the employee leasing client endorsement (WC 00 02 19) or the labor contractor exclusion endorsement attached to its policy to exclude coverage for leased employees and reinforce the intent of the parties that the client will be responsible for providing this coverage. *Id.*

certain that it complies with all necessary insurance licensing requirements.Client Sponsored Group Health Plans

Based on informal polls, it appears that client sponsored group medical plans are considerably more common than client based workers' compensation insurance policies. This variation in the PEO business model has existed for quite some time. It also appears, however, that PEOs are generally not aware of the need for different forms of client service agreements to accommodate this manner of providing health insurance to worksite employees.

Although some of the legal issues differ from the client policy workers' compensation analysis, the basic requirements of addressing the nature of the relationship formed, and the obligations of the parties is the same. For these same reasons, the PEO should create a written, internal policy that governs how the PEO will allow a client to maintain its own group health plan, then publish the policy and adhere to it. The PEO should also use a separate and distinct form of agreement when the client sponsors its own group medical plan.

The internal policy for client sponsored group medical plans should provide clarity on the following:

- (i) Whether the PEO will use a separate form of CSA?
- (ii) Whether the client may have a self-insured plan?<sup>37</sup>
- (iii) Whether the insurance carrier has been approved and admitted to write insurance in the states where the client has employees/participants?
- (iv) Will the PEO or the client pay the premiums of the plan participants?<sup>38</sup>;
- (v) Will the work site employees be permitted to participate in the PEO Section 125 plan?<sup>39</sup>.

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<sup>37</sup> Although an employer, including a PEO, is not required to provide health insurance, and self-insured plans are permitted, the PEO should consider the possible adverse effects of a client having a self-insured health plan. Unfortunately, many companies have been fooled by unscrupulous companies that offer what appears to be a legal self-insured plan, but turns out to be a bogus plan. In addition, the client could mismanage the plan and/or fail to pay benefits. If the plan fails to pay benefits, the PEO could get caught up in the dispute as an employer of the plan participants.

<sup>38</sup> Some PEOs pay the premiums directly to the client's insurance carrier from payroll, while other PEOs require the client to make such payments. In the latter circumstances, the client receives a credit in the amount of the premiums.

<sup>39</sup> Even if there is a "credit" provided to the client, the full amount of the payroll is processed nonetheless through the PEO. Therefore, there is an issue as to whether a worksite employee can participate in the PEO's Section 125 plan if the employee if the client is the sponsor of the group health plan. Although there is no case law directly on point or official guidance on the subject, it does appear clear that the preferred method to allow such an employee to participate in the PEO's Section 125 plan is for the PEO plan to be a "multiple employer type plan" (that is one that is tested at the client level). Assuming that the PEO has such a plan, there is support for allowing an employee who is a participant in one type of plan to participate in another employer's Section 125 Plan. Two Revenue Rulings provide that any accident or health coverage, including medical, long term disability (LTD) or AD&D coverage, that satisfies Code Section 106 may qualify under the cafeteria plan rules, even if provided under individual as opposed to group policies. Rev. Rul. 61-146, 1961-2 C.B. 25 and Rev. Rul. 75-241, 1975-1 C.B. 316( describing certain arrangements for employer payments or reimbursements of individual policy premiums that satisfy Code Section 106). Both Revenue Rulings discussed individual

If the client is sponsoring one or more plans, the Client Service Agreement must identify clearly the plans sponsored by the client and any plans sponsored by the PEO<sup>40</sup>. The PEO does not want to risk being deemed a sponsor of a plan that it does not actually sponsor.

The biggest risk to the PEO when a client sponsors its own group health plan is the risk of being a fiduciary of the client's plan<sup>41</sup>. The avoidance of this risk must be a central theme of the client service agreement and the relationship between the parties. Keep in mind that even if the agreement is written well to avoid this risk, if the PEO acts in a way that makes it a fiduciary the PEO could be deemed a fiduciary notwithstanding the terms of the agreement.

To minimize the risk of being a fiduciary of the client's plan(s), the client service agreement should provide the following in the form of an affirmative statement and an acknowledgement by the client:

- (1) The PEO has no discretionary authority of the assets of the plan or administration of the client's plan;
- (2) The PEO has no control over plan assets;
- (3) The PEO is relying on the information supplied by the client and the participants and will administer the plan according to such instructions<sup>42</sup>; and
- (4) The PEO is not a fiduciary with respect to any participant of the client's plan or any assets of the plan<sup>43</sup>

Some actions that may impose fiduciary responsibility on a PEO when a client sponsors a group plan include: (i) interpreting the meaning or application of a plan or its terms (a PEO should never provide advice on the meaning of a plan term); (ii) making eligibility decisions; and (iii) handling plan assets (i.e., paying health providers directly on behalf of a client).<sup>44</sup>

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policies rather than employer-provided group policies. Further, it appears that the primary inquiry of the IRS in looking at this general question is whether the plan is paying for benefits of someone who is not an employee. In the PEO/Client Plan example, the cafeteria plan benefits are for an employee of the PEO, which is the cafeteria plan sponsor. Therefore, although there is no clear guidance on the issue, there appears to be support for a cafeteria plan sponsored by one employer paying benefits provided by another employer.

<sup>40</sup> A preferable way to do this is to create an exhibit that names the PEO plans and one that names the client plans.

<sup>41</sup> Under the Employee Retirement and Income Security Act (ERISA), a fiduciary is defined as a party that: (i) exercises any discretionary authority over management of the plan, or over management or disposition of plan assets; (ii) renders investment advice ...; or (iii) has any discretionary authority or discretionary responsibility in the administration of the plan. ERISA Section 3(21). A fiduciary duty is a heightened duty and imposes on the fiduciary an obligation to act always in the best interest of the plan participants irrespective of the effect on the fiduciary own interests.)

<sup>42</sup> The agreement should also include an acknowledgement that all information provided by the Client is accurate and complies with the terms and conditions of the client's plan. In addition, the PEO should include as part of the enrollment process permission for the PEO to make deductions based on the information supplied by the Client.

<sup>43</sup> It is important to understand that an agreement between the parties that the PEO is not a fiduciary, while worthwhile to have in the agreement, will not overcome actual conduct of the PEO that would constitute fiduciary status.

<sup>44</sup> This activity, although presenting some risk of fiduciary status, does not appear to be as compelling an argument as points (i) and (ii).

The CSA should clearly state that the PEO is not responsible for paying any COBRA benefits, although the PEO may assume responsibility for sending COBRA notices and other administrative duties. Because the PEO is not the plan sponsor, the PEO is not legally obligated to provide any COBRA benefits or notices<sup>45</sup>. The client must understand this distinction. The CSA should also require the client to provide to the PEO notice of a qualifying event under ERISA within forty-eight (48) hours of such an event. Failure to provide such notice to the PEO will relieve the PEO of contractual responsibility to provide the COBRA notice.

The PEO should add as an additional basis for termination, the client's failure to keep current its obligations under an existing group plan. Although a client should have the option not to renew a group plan, the client should be required to maintain a current plan. Otherwise, the PEO could get drawn into a dispute over benefits allegedly owed to one or more worksite employees. The PEO should also require the client to provide to the PEO notice of termination of a client plan (from either the plan sponsor or the insurance carrier).

The PEO must be aware that the relative responsibilities under the Health Insurance Portability and Accountability Act (HIPAA) are different when the client sponsors a plan. HIPAA applies to "Covered Entities" as defined under the Act<sup>46</sup>, and does not necessarily apply to an employer. Because the PEO is not a sponsor of the client's plan, it is not a Covered Entity, at least with respect to that plan.<sup>47</sup> In its role as plan sponsor, the client, on the other hand, will likely be a Covered Entity, and be required to comply with the HIPAA privacy rules.

Under the peculiar HIPAA privacy rules, even an entity that is not a Covered Entity can nonetheless be subject to its requirements. Pursuant to HIPAA, a Covered Entity may require another party that is not subject to the privacy rules to execute a "Business Associate" agreement with the Covered Entity. In short, the Business Entity agreement provides that the non-Covered Entity agrees to comply with the HIPAA privacy rules when dealing with the Covered Entity and any information provided by the Covered Entity. For this reason, the PEO will need to understand the nature of the

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<sup>43</sup> The PEO should also take all necessary steps to avoid be deemed a co-sponsor of the client's plan.

<sup>46</sup> A Covered Entity is defined under HIPAA to mean: (i) a group health plan sponsor; (ii) a health care clearinghouse; and (iii) a health care provider.

<sup>47</sup> Contrast this to the situation where the PEO is the sponsor of a group medical plan. Where it is a sponsor the PEO is a Covered Entity under the HIPAA privacy rules, and must comply with these rules in accordance with how it generates and transmits participant information.

information provided by the client, and the extent to which the PEO must establish procedures and policies to minimize the risk of a HIPAA privacy violation<sup>46</sup>.

Many PEOs that allow a client to sponsor one or more group plans administer the client's plan. It is essential for the PEO to state clearly the extent of the administrative services provided in order to set expectations and avoid confusion. The term "benefits administration" can mean many things. Matters that the PEO must consider in defining "benefits administration" include, at a minimum, whether the following are included, and to what extent: (i) payment of insurance premiums (premium accounting)<sup>49</sup>; (ii) COBRA administration; and (iii) benefit enrollment and post-enrollment assistance.

As employer of the affected employees, the PEO may have the authority to provide such administration; however, counsel for the PEO should investigate whether or not a particular state would require the PEO to have a TPA license. For example, a PEO that provides administrative services to non-PEO clients (i.e., ASO) would likely have to have such a license in most states.

Also, as noted in the workers' compensation section, if the PEO is engaged in assisting the client to obtain coverage, care must be taken that the PEO complies with any insurance licensing requirements.

To conclude, the Client Service Agreement defines the relationship between a PEO and its client. Without it, a PEO cannot provide its services. Therefore, it is essential that when the relationship between a PEO and its client changes such that a client is the policy holder for workers compensation insurance and/or the client is the sponsor of one of more benefit plans, the PEO should adjust and modify its contract accordingly.<sup>48</sup>

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<sup>46</sup> Although the PEO would not be directly subject to the HIPAA privacy rules as a "Business Associate", the PEO client could be held responsible for violations committed by the PEO, thereby jeopardizing the PEO-client relationship. A full discussion of the HIPAA privacy rules is beyond the scope of this article. For an excellent discussion of the HIPAA Medical Privacy Regulations, see Serena G. Simons, "Employer Responsibilities under the HIPAA Privacy Regulations" PEO Insider, page 24 (June/July 2002).

<sup>47</sup> The handling of premium by the PEO can create potential problems on a number of fronts. Although there is no case law that of which this author is aware, the payment directly of insurance premiums on behalf of participants of a plan the PEO does not sponsor could provide a basis to argue that the PEO is a fiduciary of the plan because this activity constitutes "plan administration" under ERISA and imposes a fiduciary duty on the PEO. Such activity also may qualify the PEO as a third party administrator (TPA) under state law, although there is an exception under most TPA statutes for the "employer". It is unclear whether the PEO would qualify as an "employer" under such statutes in that it could be argued that the intent of the statute was to provide an exception to the employer that was also acting as the plan sponsor. If the PEO was in fact a TPA, then it would have to obtain a TPA license in each state with such licensing requirements.

<sup>48</sup> Depending on the nature of the PEO's business, it could be necessary to have four distinct forms of client services agreements to cover the following possible relationships: (1) PEO secures workers compensation and health insurance; (2) PEO secures workers compensation, but client sponsors group health plan; (3) PEO sponsors group health plan, but client maintains workers compensation insurance; and (4) client maintains group health plan and workers compensation insurance.

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