Some Pluses and Minuses of Employee Leasing:

A Review with Recommendations

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Employee leasing is a rapidly growing practice in American business and industry. It offers significant advantages for both employers and employees. However, it can also present problems unless it is managed carefully. A key issue in employee leasing is that of who is the employer of record. The answer to this question fixes responsibility for legal compliance. Unfortunately, the answer varies by state, law and situation. Careful attention to details when writing the employment agreement can mitigate many of the problems of employee leasing.

Joint employment arrangements such as employee leasing are an old and familiar practice (Covington and Decker, 1995). In rural areas, nineteenth-century American farmers, their hired hands and family frequently helped their neighbors during busy times. Such arrangements continue today, but on a commercial basis, especially in small businesses. Joint employment arrangements offer a number of advantages for both employers and employees; however, they also present potential problems and require careful design and administration (Munchus, 1988; Volk, 1992; Greble, 1997).

Employee leasing is the most common joint employment arrangement in U.S. business and will become even more prevalent in the future (Volk, 1992; Tyson, 1999). Under employee leasing arrangements, a company transfers some or all of its employees to the payroll of a Professional Employer Organization (PEO) in an explicit joint employment relationship (Greble, 1997). The PEO then leases the workers back to the client company and administers the payroll, provides and administrates benefits, maintains personnel records and performs most of the functions normally performed by a human resource (HR) department. Thus, a company "contracts out" the task of keeping up with federal and state regulations, and the annual chore of rebidding the company's medical and workers' compensation insurance, and gains professional assistance with a wide range of traditional human resource services (Tyson, 1999).

Employee leasing, although practiced for many years, became popular after the passage of the Tax Equity and Fiscal Responsibility Act of 1982, which formally recognized such leasing arrangements (Munchus, 1988). By 1998 there were 2.5 million employees under contract in PEOs, and the number was growing rapidly (Leming, 1998). Analysts estimate that PEOs are a $200-billion/year industry in the U.S., yet leasing arrangements have tapped only about two percent of the potential market (Medina, 1997; Applegate, 1999). It is expected that revenues and earnings of PEOs will increase by 30 percent per year for the next 10 years (Medina, 1997). Some of the growth can be attributed to the improved image of PEOs resulting from self-regulation, accreditation and the passage of state and federal laws requiring licensing or registration (Franczyk, 1993; Moline, 1999; Applegate, 1999).

Advantages and Disadvantages of Employee Leasing

Employee leasing offers employers, especially small businesses without HR expertise, several significant advantages. Unfortunately there are some disadvantages that require vigilance (Moline, 1999; Applegate, 1999; Munchus, 1988). These advantages and disadvantages are listed in Table 1 on page 17.

Legal Issues in Employee Leasing

A key concern in employee leasing is the "employer of record" issue. In a typical employee leasing arrangement, a business in need of workers hires an employee leasing firm or professional employee organization (PEO) and the PEO hires individual workers. Who then is the employer of record? The answer is likely to depend on why the question is asked, and which law governs in the state where the company is located (Covington and Decker, 1995; Moline, 1999). The differing ways in which states define a leased employee for various purposes leads to confusion in matters of liability. Neverthe-

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TABLE 1
Advantages and Disadvantages of Employee Leasing

Advantages for Employers	LOGIC
Provide more generous benefits	By grouping small firms into a larger pool, discounts can be negotiated.
Tap human resource expertise	Professional employer organizations can afford experts in functional areas.
Gain tax breaks	Tax Law (Tax Equity and Fiscal exclude leased employees from pension plans if the leasee firm has its own plan (Munchus, 1988).
Maintain union-free status	Since the Professional Employer organization is the primary employer, it would be the target of any unionization effort.
Improved moral and reduced turnover	Improved benefits at reduced cost may be the cause (Murray, 1984; Moline, 1999).
Reduced administrative cost	Large Professional Employer Organizations can gain the advantages of economies of scale and expertise.
Enhanced public image	Regulation, established guidelines and accreditation standards enhance professional status and public image.
Advantages for Employees	
More generous benefits	Professional Employer Organizations have greater bargaining strength because of larger size (pooling) (Moline, 1999).
Higher morale and reduced turnover	Better benefits at reduced cost may be the logic (Moline, 1999; Organ and Ryan, 1995).
Greater job flexibility	Leased employees have the options of accepting jobs that fit their time schedules and personal interests (Moline, 1999).
Greater job security	Professional Employer Organizations transfer employees to other jobs that match their qualifications (Volk, 1992).
Job opportunities for older workers	Professional Employer Organizations can establish benefit plans under which older workers receive the same benefits as other employees, thus reducing resistance to employing older workers (Moline, 1999).
Disadvantages for Employers	
Changes in tax laws	The tax benefits under the Tax Equity and Fiscal Responsibility Act could be taken away by Congress if employee leasing was used as a method of skirting pension responsibilities (Munchus, 1988).
Joint employer and common law rules	Laws governing employer/employee relations can prevent problems since both parties can be held accountable if either engages in an unlawful practice (Greble, 1997).
Increasing use of contigent workers	Use of contingent workers offers firms a competitive advantage, since such workers normally receive fewer benefits. Firms not employing contingent workers may be higher labor cost producers (Dreazen, 2000).
Questions of legitimacy	Concerns over whether employee leasing is right for the business, whether the leasing firm is legitimate and able to perform supervisory duties required by the IRS must be addressed (Brotherton, 1999).
Cost	Leasing fees may involve a fixed fee of 2-5% of payroll plus a markup of 9-20% of gross wages.
Regulation and loss of control	Employers give up some autonomy when they comply with legal regulations (Applegate, 1999).
Image and human relations issues	Unethical and illegal practices in the past have tarnished employee leasing. Employee leasing reduces personal contact between employees and their employer.
Disadvantages to Employees	
Ambiguous authority structures	Leased employees are hired, assigned to a firm and compensated by one firm while supervised by another. Co-employment can result in confusion and role ambiguity (Goeldner, 1999).
Divided loyalty	Reduced personal relationships and opportunities to switch to other firms may reduce loyalty and job commitment (Tyson, 1999).
Reduced motivation	Lack of a close tie between pay and performance and the temporary nature of employment may reduce performance motivation (Goeldner, 1999, Tyson, 1999).

less, some generalizations based on court rulings are possible. A review of generalizations for the most relevant laws follows.

Fair Labor Standard Act (FLSA) — This act defines an employer as "any person acting directly or indirectly in the interest of the employer." This expansive language has led courts to find simultaneous liability (both the PEO and the firm using the PEO's services) in many situations. Thus, responsibility for paying the minimum wage will often apply to both the PEO and the firm using the PEO's services (Covington and Decker, 1993).

National Labor Relations Act (NLRA) **—**In many cases employee leasing is viewed as a means of avoiding union activity or the duty to recognize and bargain with an existing union (Jansonius, 1985; Parker, 1994). The key determinant in deciding whether a firm must deal with the organizational activities of its workers is the nature of the employment relationship between the PEO and the user firm. If both the PEO and the client-company exert control over the same employees, they are considered "joint employers." If the PEO is willing to divorce itself from regular control over work, it may avoid employer status under the National Labor Relations Act (Jansonius, 1985), but not necessarily under other federal and state laws (discussed under discrimination laws).

In summary, past National Labor Relations Board (NLRB) and federal court rulings indicate that joint employment arrangements which do not involve direct supervision are a viable approach for either party to avoiding employer status under the National Labor Relations Act. It must be noted, however, that to preclude joint employer status, a firm must be willing to give up control over the employment agreement.

Civil Rights Laws—The issue of "joint employer" is of critical concern in discrimination cases. To the courts and regulatory agencies, the issue boils down to: Who looks more like the employer? The Equal Employment Opportunity Commission (EEOC) recently issued new guidelines stipulating joint liability (Covington and Decker, 1995). Therefore, a contract stating that the PEO is the sole employer for such purposes will not prevent a court from ruling that both the PEO and the company must share liability in the event of a civil action. EEOC guidelines indicate that you can't contract out of your obligations.

Occupational Safety and Health Act **(OSHA) —**Leased workers are covered by the Occupational Safety and Health Act of 1970. OSHA requires that the employer comply with all safety and health standards dictated by the Department of Labor (compliance requirements) and furnish to each employee a place of employment free from recognized hazards that are causing or are likely to cause death or physical harm (General Duty clause) (Bennett-Alexander and Pincus, 1998). OSHA rulings in recent court cases suggest that if the PEO is aware of safety violations and does nothing to correct them, the PEO may be held jointly liable for damages. Thus, if workers assigned to a given company reported to the PEO that working conditions were unsafe, the PEO would be obligated to pursue corrective action. Failure to do so could make the PEO jointly responsible for injury damages. On the other hand, if the PEO makes a documented recommendation which the company does not follow and an accident occurs as a result, the company will be totally responsible for damages (Moline, 1999).

Workers' Compensation—Leased workers are normally covered by workers' compensation laws which provide no fault insurance for employees whose injury or illness arises "out of and in the course of" employment. However, not every employee is covered. Employees of small businesses, the major clientele of PEOs, may not be covered because the law may exclude them (Bennett-Alexander and Pincus, 1998). In most states the PEO is considered the employer of record for workers' compensation claims (Moline, 1999). An injured employee cannot sue the PEO. However, because the company is not considered the employer, an injured worker can sue the company for damages. Thus, the company may still be liable for costs associated with the injury (Bennett-Alexander and Pincus, 1998).

Unemployment Compensation—States' treatment of unemployment insurance involving leased employees applies to situations in which contributions have not been paid. Some states hold the company liable for contributions if the PEO does not pay its contributions, even if the company has paid its share, while other states may consider the company and the PEO jointly liable for unpaid premiums. Twenty-two states consider the PEO the employer of record for such purposes (Metzler, Barnicle and Kilbane, 1997).

Pension and Healthcare Benefits Protection—Legal debate continues over the treatment of leased employees for purposes of pension and certain health care benefits (Moline, 1999). Pension plan payments are a controversial issue in the leased employee industry. Employee leasing arrangements may affect the method of calculating retirement benefits. Under the Employee Retirement Income Security Act (ERISA), all employees working over 20 hours per week must be included in a benefits plan. However, retirement plans may require that the employee work for the firm for one year—1000 hours in the last 12 months to be included (Steingold, 1996). Normally the PEO is responsible for employee benefits and for supervision of Trustees to assure that pension fund management complies with law (Goeldner, 1999).

Tax laws—As previously discussed, the Tax Reform Act of 1986 and the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) apply to PEOs.

The Tax Reform Act was written to (among other purposes) reduce wrangling over treatment of leased employees for purposes of pension and certain health care benefits. Section 414(n) of the Act stipulates that leased employees must be included as part of the head count to determine coverage for pension plans. However, if the PEO provides comparable benefits to its employees, the client firm does not have to provide additional benefits (Moline, 1999).

TEFRA formally recognized employee leasing and provided a "safe harbor" clause that allows firms to exclude leased employees from their pension plans, if the PEO has a pension plan and contributes a minimum of 7.5 percent of its salary (Munchus, 1988). A firm can, under this clause, set up an "owner exclusive" pension plan that provides a tax shelter for owner profits. However, the Act prohibited extra benefits to key employees when the firm's benefits plan is "top-heavy" (provides more than 60 percent of accumulated benefits to key employees).

The Family Medical Leave Act (FMLA)—The Family and Medical Leave Act of 1991 covers employers who employ 50 or more workers during 20 or more weeks of the year (Steingold, 1994). The Act states that "an employer who jointly employs 15 workers from a leasing or temporary help agency and 40 permanent workers is covered" by the Act (Covington and Decker, 1995). It should be noted that FMLA coverage differs from state to state with regard to which employers or employees are covered by the requirements, the length of the required leave time, job reinstatement rights and the continuance of benefits during leave time (Bennett-Alexander

and Pincus, 1998). Relevant to employee leasing, the FMLA states that "only the primary employer is responsible for providing leave, maintenance of health benefits and job restoration. Thus, for employees of leasing agencies, the PEO would normally be the primary employer" (Covington and Decker, 1995).

Worker Adjustment and Retraining Notification Act (WARN) —This act requires business enterprises that employ 50 or more employees to provide affected employees, or each of their bargaining representatives and certain state and local government entities, 60 days advance written notice before "plant closings" or "mass layoffs" (Covington and Decker, 1995). The Act poses a situation similar to that of parent – subsidiary cases with regard to determining who the employer is and who should give notice.

In summary, the key legal issue involves who the employer of record is. The answer to this question varies by state, situation and specific law. Courts and agencies seek guidance from principles developed under the general title of "borrowed servant." The process of determining whether a worker is a borrowed servant is very complex. Federal Courts have developed the following questions as guidelines for determining the employer of record (Covington and Decker, 1995).

1. Who has control over the employee and the work he/she is performing, beyond mere suggestion of details or cooperation?
2. Whose work is being performed?
3. Was there an agreement, understanding or meeting of the minds between the original and the borrowing employer?
4. Did the employee agree to the terms and conditions of employment?
5. Did the original employer terminate his/her relationship with the employee?
6. Who furnished tools and place for performance?
7. Was the new employment over a considerable length of time?
8. Who had the right to discharge the employee?
9. Who had the obligation to pay the employee?

Recommendations

The maze of federal and state laws and the case by case approach of the courts and regulatory agencies make recommending guidelines quite difficult. However, some generalizations are possible (Franczyk, 1993; Moline, 1999; Metzler, Barnicle and Kilbane, 1997; Leming, 1998; Greble, 1997).

1. *Become familiar with joint employment laws*. As employee leasing becomes more prevalent, the increasing number of court rulings will result in a body of common law that should clarify joint employment situations.

2. *Lobby for changes in joint employment laws*. Uniform laws would clarify and simplify joint employment situations and permit the parties to formulate better agreement contracts. Workers' compensation laws may serve as a model.

3. *Lobby for legislation regulating the operation and licensing of PEOs*. Such laws should regulate PEO licensing, set fees and minimum standards for applicants, create terms for license renewal and accreditation and establish disciplinary action through a labor commissioner. Such legislation would supplement self-regulation, protect users and enhance the reputation of PEOs.

4. *Spell out the contractual arrangement*. Formalize the employment relationship by signing a contract that spells out the details of the agreement. Such agreements can reduce the occasions of liability confusion (Leming, 1998). Greble (1997) offers the following general guidelines for leasing agreements:

- Beware of preprinted or standard forms. When negotiating an important contract, be sure to understand and agree with every clause. Anything not understood should not be in the agreement.
- Clarity is essential – keep the contract simple and straightforward. Clearly define the respective rights and obligations of both sides. Resist the temptation to leave ambiguous provisions for later interpretation.
- Consider including a provision for alternative dispute resolution.
- Make sure the agreement includes a simple opt-out procedure if the company is dissatisfied for any reason – be wary of fixed term agreements.
- Negotiate clear and precise provisions for what happens when the relationship ends or the contract expires – these are the most likely times for disputes to mushroom into unnecessary litigation.
- Check for accreditations. The National Association of Professional Employer Organizations can offer a list of PEOs. Another source: The Institute for Accreditation of Professional Employer Organizations, which has established measurable standards for PEOs. (Opt out clauses, performance ratios, fees, responsibilities, licensing, history).
- Investigate a company's administrative competence. The purpose of employee leasing is to shift the administrative burden. Avoid working with a PEO that is a poor administrator. Contact several current and former clients and get their opinions of the service.
- Consider the size of the PEO as well as its rate of growth. The larger the leasing firm, the better it can negotiate rates for benefit packages. Also, make sure the agency provides an audited financial statement and has worked with the specific situation before.
- Prevent possible joint-management problems. Make sure the contract clearly divides responsibility and power between your company and the PEO. Insist on the right to cancel the contract on short notice. Insure a 30-day escape clause.
- Find out if the PEO is battling unionization. If so, your employees could wind up being unionized.
- Beware PEOs that offer to camouflage a poor safety record. Make sure the leasing firm uses your company's workers' compensation modification factor to determine workers' compensation premiums. Reason: Insurance officials are cracking down on PEOs that substitute their modification factor to reduce premium costs for clients.

Summary

Employee leasing is a rapidly growing practice in American business and industry. It encompasses most industries and types of labor. Employee leasing, a form of joint employment, offers several significant advantages for both employers and employees. However, there are also disadvantages for both that suggest careful analysis, design and administration. The employee leasing business has suffered image problems in the past but legislation, self-regulation, accreditation and licensing have, at least partially, overcome such problems.

The key issue in laws regulating joint employment arrangements, such as employee leasing, is who is the employer of record. The answer to this question varies by state, by law and by situation. Courts and agencies do not offer a clear picture, but interpretation should become clearer as a body of common law emerges from court rulings.

Although it is difficult to recommend courses of action, joint employer agreements probably should be negotiated in a manner similar to labor contracts. Both require formalization, careful attention to details and good will if they are to protect the rights of both parties. Some generalizations are possible. In time, and with experience in application, leasing agreements should become less confusing.

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