REPORT ON EMPLOYEE LEASING AND PROFESSIONAL EMPLOYER ORGANIZATIONS

By the
NAIC/IAIABC Joint Working Group

June 2002

NAIC/IAIABC Joint Working Group Members

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By the
NAIC/IAIABC Joint Working Group

EXECUTIVE SUMMARY

The National Association of Insurance Commissioners (NAIC) and the International Association of Industrial Accident Boards and Commissions (IAIABC) established a joint working group to enhance communications on issues of mutual interest, particularly those involving the interaction of workers’ compensation and labor laws with insurance laws.

This report addresses a topic of ongoing concern, which was also a principal focus of an earlier joint committee established in 1989. That joint committee’s work culminated in the NAIC’s adoption in 1991 of an Employee Leasing Model Regulation and Model Act. Because of the evolution of this market over the intervening years, it has become necessary to revisit the work of the joint committee and to broaden the horizons of the inquiry beyond employee leasing now that traditional leasing companies have become a less significant presence in most markets.

Therefore, the subject of this report will be employment services outsourcing, a term the working group has chosen to encompass a variety of alternative employment arrangements that can provide long-term employee services to a business, the most common of which at present is the Professional Employer Organization (PEO). The PEO contract expressly acknowledges a shared employment relationship between the employer (client) and PEO, in contrast to the traditional employee leasing contract, which states that most or all of the client’s workforce is employed by the leasing company and is merely “leased” to the client. The PEOs co-employment relationship better reflects economic reality and attempts to conform to the requirements of state law. In most states, the law continues to treat the employee leasing client as either the exclusive employer or as a co-employer.

More specifically, this report deals primarily with the ramifications of the “master policy” framework for workers’ compensation insurance coverage. A master policy arrangement is typically characterized by an insurer issuing a single policy covering the employees of all of the clients, including the internal employees of the master policyholder. Where possible, employment services outsourcing companies have generally sought to obtain coverage through this single policy arrangement. In most states, the voluntary market allows for master policies to be written at the insurer’s discretion. However, in the residual market each client is required to be insured under a separate insurance policy, referred to as a multiple coordinated policy (MCP). An MCP arrangement is characterized by having a single insurer issue a central policy for the employee leasing company with separate policies for each client company. The MCP approach raises fewer regulatory problems but more administrative burdens for insurers and employment services outsourcing companies.

Although employment services outsourcing and the use of master policies give rise to a number of concerns, these concerns should not be taken as disapproval of the entire concept of outsourcing. To the contrary, it is the recognition that this outsourcing will remain an important part of the marketplace that makes it so essential to develop a careful regulatory response.
There are many reasons for entering into employment services outsourcing agreements. Many businesses become employment services outsourcing clients because they find it to be an efficient way to obtain high quality administrative services, and many of these outsourcing companies have worked hard to develop professional standards for the industry. However, other employment services outsourcing arrangements have been motivated by factors ranging from exploitation of loopholes in rating rules to outright fraud. Regulators must be aware of all these motives, because focusing only on the abuses will result in laws that are inappropriately punitive and place unnecessary restraints on the market, while laws written with only the responsible sector of the industry in mind will be ridden with loopholes for the unscrupulous to exploit. Careful attention to terminology is particularly important, since many of the opportunities for manipulating the system involve the exploitation of confusing, imprecise, or overly narrow language.

Historically, the employee leasing industry began in the late 1970s. By the mid-1980s insurance companies and advisory organizations were concerned about abuses that were being discovered in some of these arrangements, sometimes nicknamed “rent-a-mod.” On Sept. 10, 1990, Maine Insurance Superintendent Joseph Edwards, then chair of the NAIC/IAIABC Joint Committee, summarized the issues involving employee leasing in this way:

One of the most significant issues is employers’ avoidance of their experience modification factor through employee leasing. The objective is not to outlaw employee leasing but rather to address the abuses while allowing legitimate services to continue. The primary issue that has to be resolved is whether each employer should be required to have a workers’ compensation policy covering the employees they lease as opposed to allowing the employee leasing company to hold the policy.

Another concern was that inadequate reporting requirements made it easier for leasing companies to evade proper premiums by misrepresenting their payrolls and classifications. Also, multi-state employee leasing arrangements could be used as a vehicle for misrepresenting the state where a business was located, in order to take advantage of lower insurance rates. While insurance regulators focused on premium fraud issues, workers’ compensation administrators were concerned with how to determine which insurance company was obligated to provide benefits to which employees.

The NAIC models adopted reflect a compromise between insurers and employee leasing companies. The National Council on Compensation Insurance (NCCI) had originally favored requiring separate policies in all cases, while employee leasing companies favored the master policy approach. Under the model act and regulation, MCPs are required in the residual market, but the employment services outsourcing company and client may negotiate either an MCP or a master policy approach in the voluntary market. The client must verify under oath that all of the client’s non-leased employees are also covered for workers’ compensation benefits. The leasing company must provide to its insurance company sufficient information to permit the calculation of an experience modification factor for each of its clients. If the client leaves the leasing arrangement, its experience travels with it to the extent possible. If the necessary data is unavailable, the leasing company’s experience modification factor applies to the client for up to three years.

According to the latest information provided by NCCI, slightly less than half the states have adopted laws similar in most key respects to the NAIC models. Six states do not regulate employment services outsourcing at all, and the remaining states have adopted a variety of approaches.

Some of the concerns identified a decade ago have since been effectively addressed in most states. However, a survey conducted by the working group demonstrates that other concerns persist, and new ones have arisen as the market has evolved. A summary of the survey responses is included as an appendix to this
report. Even the core legal terminology has become obsolete, since the applicable state and model laws are still phrased in terms of “employee leasing” and related concepts not properly applicable to PEOs that may be misleading when used in that context. Other key issues include:

- **Benefit and Coverage Issues**—Employment services outsourcing relationships can make it difficult to identify who is responsible for an injured worker’s claim. Delaying payment of benefits, even for uncontested claims, is a problem that can be exacerbated when large deductible policies are involved. By the same token, questions are also raised as to who has the benefit of the exclusive remedy. The confusion becomes more serious when there is “risk splitting” as a result of the client outsourcing only part of its workforce or participating in multiple employment services outsourcing arrangements. Even clients who believe they are outsourcing all of their employees may have uninsured exposures for workers the client erroneously believes to be independent contractors. An additional concern relating to coverage is that if notices of cancellation or non-renewal of master policies are sent only to the employment services outsourcing company and not to the client, there may be uninsured exposures and gaps in coverage. Placing notice obligations on the employment services outsourcing company is not sufficient because the client may be left without a meaningful remedy if that company fails to comply.

- **Notice and Reporting Requirements**—Although employment services outsourcing can simplify the collection and dissemination of information by centralizing it in a single point and delegating it to specialists, at the same time it complicates matters, because this outsourcing relationship adds a whole new level of relevant information. Crucial information that may be missing or inaccurate when employees are outsourced includes proof-of-coverage, unit statistical data, and loss data for rating purposes. One of the central public policy questions to face in developing a regulatory framework for employment services outsourcing is how much of this information must be collected and reported, by whom and to whom, balancing the need for accurate information against the need to eliminate unnecessary administrative burdens. Although these burdens are in many cases very real, they should not be overstated, especially since many of the software and process improvements that would be necessary in order to comply with enhanced requirements would be a sound business practice in any event.

- **Experience Rating**—A perennial area of concern to the working group has been employment services outsourcing experience rating. Although the most flagrant abuses of the rating system have been largely mitigated through regulations and insurance company rating methodologies, many problems persist. One way to address these problems is to require either an MCP arrangement in which each client is separately covered and rated, or an “MCP-like” approach in which coverage is issued at the master policy level but each client is treated as an autonomous rating unit purchasing the functional equivalent of a coordinated policy. However, there remains strong demand for master policy rating, both because of actual or perceived difficulties in implementing an MCP or MCP-like approach, and because an employment services outsourcing company provides a much larger risk pool, which theoretically, under the right conditions, could be capable of generating significantly more credible rating data. This report includes an extensive analysis of the possible methodologies for rating master policies globally. The conclusion is that although some methods can theoretically produce superior results in some cases, the drawbacks outweigh the advantages. When the opportunities for manipulating the system are taken into account, any theoretical advantages to experience rating at the master policy level turn out to be illusory. Rating at the client level is clearly the best methodology from an actuarial perspective and should be required unless the added administrative costs are intolerable. As a practical matter, this amounts to requiring separate policies, as insurers have indicated that there would be no market demand for master policies if they had to be administered in an MCP-like framework.
Financial Issues—By its nature, an employment services outsourcing arrangement establishes the outsourcing company as an intermediary between the insurer and the clients. As a result, employment services companies may take on some degree of underwriting responsibility. If there is a high-deductible or retrospectively rated master policy, or any sort of re-pricing of coverage in which the cost of insurance is not passed dollar-for-dollar to each individual client, the employment services outsourcing company also takes on insurance risk. These roles raise significant solvency and accountability concerns, with the potential for significant harm to clients if an employment services outsourcing company becomes insolvent. Significant harm may also occur to insurers if a large employment services outsourcing company either is unable or unwilling to meet its obligations and leaves the insurer on the hook, or manages to obtain coverage at unsound rates. Furthermore, if these outsourcing arrangements develop into a significant share of the market share, or if a troubled employment services outsourcing arrangement affects the solvency of the insurer, there are ripple effects that spread beyond the participating insurer and employers to affect the broader market.

The report concludes by identifying a number of central public policy questions arising from these issues that the states must resolve. Although greater harmonization of state rating practices and reporting requirements is desirable, particularly where multistate risks are involved, each state is different in its regulatory goals and priorities and in the details of its workers’ compensation and insurance laws. Therefore, “one size fits all” model legislation is unlikely to be feasible, especially in the area of substantive workers’ compensation laws where there are significant differences from state to state in both the legal framework and the benefit systems. Nevertheless, this report concludes that legislative or regulatory clarification is clearly desirable in many areas. In particular, states should seriously consider whether to move toward requiring separate coverage for individual clients of employment services outsourcing companies. The NAIC should evaluate whether its current model laws, which are geared primarily toward residual market issues and the regulation of master policies, should be repealed or substantially revised. It must also be kept in mind that improved legal requirements and rating plans are not sufficient in themselves; they must be backed up by meaningful enforcement.

INTRODUCTION

The National Association of Insurance Commissioners (NAIC) and the International Association of Industrial Accident Boards and Commissions (IAIABC) formed the NAIC/IAIABC Joint Committee during the NAIC 1989 Fall National Meeting in Wilmington, Delaware. After a period of inactivity, the NAIC and IAIABC reformed this body during the NAIC 1999 Summer National Meeting in Kansas City, Missouri under the new name of the NAIC/IAIABC Joint Working Group. The reason for this association between the NAIC and the IAIABC is to enhance communications on issues of mutual interest, which frequently involve the interaction of workers’ compensation and labor laws with insurance laws. By sharing information, both organizations have found they can be alerted to problems earlier and design better and more harmonized regulatory responses.

This report represents the work product of the two organizations on a topic important to both, which was also a principal focus of the earlier joint committee: employment services outsourcing. “Employment services outsourcing” is the term this report will use for a subject traditionally referred to as “employee leasing,” a label that is no longer an accurate description of the subject matter because employee leasing has in many areas been largely supplanted by other types of alternative employment arrangements, most notably professional employer organizations (PEOs).

Because of the evolution of this market, it has become necessary to revisit the work of the joint committee, which culminated in the NAIC Employee Leasing Model Regulation (Appendix B) and the NAIC Employee...
Leasing Registration Model Act (Appendix C), adopted at a special NAIC Plenary session in September 1991. The NAIC/IAIABC Joint Working Group has built upon this effort by reviewing the NAIC employee leasing model laws and by increasing its knowledge of today’s employment services outsourcing environment.

The working group’s purpose in writing this report is to inform the NAIC Workers’ Compensation (C) Task Force and the IAIABC Executive Committee of the changes that have occurred with employment services outsourcing since the NAIC/IAIABC Joint Committee reviewed these matters several years ago. The report begins with a description of the most common types of outsourcing arrangements and a discussion of the historical background and current regulatory framework. There follows a detailed discussion of the working group’s concerns about today’s environment.

A discussion of the available alternatives and the working group’s conclusions and recommendations are presented at the end of the main body of the report. In addition, the appendixes provide a glossary of the technical vocabulary (Appendix A), copies of the current NAIC model laws (Appendixes B and C), a report of the most recent survey findings (Appendix D), and additional pertinent information.

OVERVIEW OF EMPLOYMENT SERVICES OUTSOURCING

There are a variety of possible arrangements that provide long-term employee services to a business. Traditionally, the most common was “employee leasing.” An employee leasing company would enter into contracts with businesses (known as “clients” and/or “lessees”) under which all or most of each client’s workforce would be employed by the leasing company and leased to the client. Typically, a client would begin an employee leasing arrangement by laying off its employees, most or all of whom would immediately be hired by the leasing company, often on the same or very similar terms, and leased back to the client to perform the same work they were performing when they were the client’s employees. In most states, despite the language of the employee leasing contract designating the leasing company as the sole employer and the client company as a purchaser of services, the state would continue to treat the client company as the leased workers’ employer—either as the sole employer or as a co-employer in a joint employment arrangement with the leasing company.

In recent years, however, traditional employee leasing companies have become a less significant presence in most markets. Increasingly, the prevailing type of employment services outsourcing company is the professional employer organization (PEO), which acknowledges that its clients continue to function as employers and establishes the terms of the co-employer relationship by contract, to the extent that the contractual allocation of employer responsibilities is permitted by state law. The NCCI has indicated that PEOs first began operations in significant numbers in 1994 and 1995.

Where possible, employment services outsourcing companies have generally sought to obtain coverage on a “master policy” basis. This means that a single policy is issued to the outsourcing company, covering the outsourced workers for all the company’s clients and also the employment services outsourcing company’s own internal employees who administer the company’s outsourcing arrangements. In most states, this is permitted at the insurer’s discretion in the voluntary market, while separate policies for each client are now required in the residual market.

The master policy arrangement has many ramifications, which will be the principal focus of this paper. The alternative approach, multiple coordinated policies, accommodates the employment services outsourcing arrangement by insuring all clients through the same carrier with common anniversary dates and a common
billing address. This avoids most of the problems associated with master policies, but also nullifies many of the advantages.

As the structure of these long-term employment services for businesses has changed, so has the language used to describe these services. Although terms tend to settle and become commonplace over time, with meanings that are clearly understood, the employment services outsourcing market (the catchall term chosen for this report) has not yet evolved to that point, and differences in vocabulary sometimes lead to considerable confusion. The chart below compares the principal employment services outsourcing terms commonly used today by regulators, leasing companies, and PEOs.

Table of Terms and Common Meanings

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<th>SOURCE</th>
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<th>COMMON MEANING</th>
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<tr>
<td>NAIC EMPLOYEE LEASING MODEL REGULATION</td>
<td>Lessor</td>
<td>Employee leasing company</td>
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<tr>
<td></td>
<td>Lessee</td>
<td>Employer</td>
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<tr>
<td></td>
<td>Leased employee</td>
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The following comparison between PEOs and employee leasing companies may be useful in understanding the similarities and differences between these two categories and many of the principal features of the broader employment services outsourcing marketplace. It should be noted, however, that these comparisons are not all-inclusive, and particular PEOs or leasing companies will not necessarily fit these descriptions in every detail.

Similarities Between PEOs and Employee Leasing Companies

- Both provide long-term staffing services to the client.
- Both may offer services such as risk management, personnel management, human resources compliance, payroll and employment tax compliance services to the client.
- The client generally manages product development and production, marketing, sales and service of its business operations regardless of the extent to which its employees are under contract with the PEO or employee leasing company.
• The PEO or employee leasing company exclusively handles the workers’ compensation claims reporting and workers’ compensation data reporting to the insurance company for its client employees.

Differences Between PEOs and Employee Leasing Companies

• The contract between the PEO and the client typically specifies that a co-employer relationship exists between them. The employee is therefore considered to have an employment relationship with both the PEO and his or her client.

• The contract between the employee leasing company and the client specifies that an employee leasing arrangement exists between them. The leasing company, once acquiring the client employee through the leasing arrangement, leases back this same employee to the client—the employee’s immediate past employer.

• A PEO that is able to secure coverage in the voluntary market typically provides master policy coverage for its clients, although some states require a PEO to provide multiple coordinated policies in both the voluntary and residual market.

Statistics

• In 1984, only about 200 PEOs (or their functional equivalents) existed, while recently it has been estimated that more than 2,000 PEOs are today in operation.
• PEO and similar arrangements exist in nearly every state and have an estimated growth rate of 20 percent to 30 percent per year.
• PEOs nationwide employ between two million and three million workers.
• The states with the most PEOs in the year 2000 were Florida (243 PEOs) and Oregon (154 PEOs).
• The average number of employees per client in a PEO is between 14 and 16.
• The annual estimate of the number of PEO clients moving between these service organizations is 17 percent.
• PEOs are required in 21 states to obtain a license.

[Comparable statistics on traditional employee leasing company arrangements are lacking, since no comparable employee leasing company association has been identified—as of the date of this publication—and NCCI does not currently support data to break out differences between PEOs and employee leasing companies.]

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1 These statistics were provided by the National Association of Professional Employer Organizations during the 1999 and 2000 NAIC/IAIABC Joint Working Group meetings and have not been independently verified by the NAIC/IAIABC Joint Working Group.
HISTORICAL BACKGROUND

Prior to the 1991 NAIC Employee Leasing Models

The employee leasing industry began in the late 1970s to provide long-term outsourcing services to employers. Historically, small employers were interested in this service as it could relieve them of time-consuming administrative functions associated with government compliance requirements and with payroll administration. These services were often performed within a long-term and economically beneficial agreement between the employee leasing company and the employer.

By the mid-1980s, insurance companies and advisory organizations were concerned about abuses that were being discovered in some of these arrangements and that led to litigation by the insurance industry. In 1987, the NCCI summarized the principle abuses as follows:2

- Experience Modifier Avoidance: The most significant problem associated with the emergence of the employee leasing industry is the undermining of the experience rating system. This problem has occurred because certain employee leasing companies have marketed their services by misrepresenting that businesses may legitimately escape their experience modification factors through the device of employee leasing. Critics have maintained that employee leasing companies were essentially engaging in “rent-a-mod” operations.

  Example: ABC business enters into a contract with XYZ Employee Leasing Company. ABC has a 2.0 experience modification based on its historical loss experience, but can legally enter into the employee leasing contract with XYZ, which has only a 1.0 experience modification because it is a new employee leasing company. If allowed to use that mod, the ABC business has effectively cut its workers’ compensation costs in half. ABC has done so at the expense of other employers within the same business classification—and can continue to do so despite its poor safety record, as long as it can find a new leasing company that is willing to claim ABC’s workers. If ABC ultimately cannot find another leasing company, it will be forced to re-apply for coverage under its own name. If several years have passed, however, the loss experience earned under its own name before the leasing arrangement will have aged its way out of the experience rating system. As a result, ABC may again have obtained a 1.0 experience modification. Further, the premium shortfall is distributed to the entire risk classification resulting in increased premium rates for all employers with that specific classification.

- Underestimation of Payrolls and Misclassification of Workers: There are instances where leasing companies have evaded proper premiums by misrepresenting their payrolls and classifications. While such fraudulent practices are not new, the leasing arrangement makes this more difficult to detect and confront.

- Underpayment of Premium Due to Rate Shopping: Certain jurisdictions have lower rates than other jurisdictions for the same classification(s). A number of employers, however, have attempted to use employee leasing arrangements to “rate shop”—to get coverage in a state with a lower rate for a specific risk classification.

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2 “Employee Leasing Issues as Observed by NCCI,” by Lynn Szymoniak, NCCI senior counsel.
Example: A Georgia trucking company with a high debit experience modification terminates its drivers. A Tennessee leasing company with a 1.0 experience modification then hires these same drivers. Not only did the trucking company avoid its debit experience modification, but it also obtained coverage for its Georgia employees at the significantly lower Tennessee rates even though the Tennessee leasing company consisted of only a trailer and a few clerical employees.

In the 1980s, when the employee leasing concept was new, nearly all the employers seeking contracts with employee leasing companies had come from the residual market. Insurers were reluctant to insure employee leasing companies, as they feared the abuses outlined above. As a result, nearly all the early employee leasing companies were insured in the residual market.

Development of the NAIC Employee Leasing Models

NAIC and IAIABC in 1989 formed the NAIC/IAIABC Joint Committee to look into matters of common concern, the primary issue being the alleged abuses brought about by some employee leasing companies. Maine Insurance Superintendent Joseph A. Edwards served as the first NAIC/IAIABC Joint Committee chair. On Sept. 10, 1990, Superintendent Edwards summarized the issues involving employee leasing in this way:

One of the most significant issues is employers’ avoidance of their experience modification factor through employee leasing. The objective is not to outlaw employee leasing but rather to address the abuses while allowing legitimate services to continue. The primary issue that has to be resolved is whether each employer should be required to have a workers’ compensation policy covering the employees they lease as opposed to allowing the employee leasing company to hold the policy.

Insurance regulators at the time focused on premium fraud issues, while workers’ compensation administrators were more concerned with how to determine which insurance company was obligated to provide benefits to which employees.

In December 1990, the NAIC/IAIABC Joint Committee presented its findings to the NAIC Workers’ Compensation (C) Task Force, proposing a draft employee leasing model that would incorporate the following provisions:

- Policy Issuance: If workers’ compensation coverage is to be placed in the residual market, each client must have a separate policy issued. If the coverage is to be issued in the voluntary market, the employee leasing company may be the policyholder on a single policy, although separate records should be kept of the experience and each client should receive a certificate of coverage. The purpose for keeping separate records, even though the policy may be issued in a voluntary market, is to provide the basis to calculate experience modifiers should the client terminate its relationship with the employee leasing company.

- Blended Experience Modifiers: Separate payroll and loss experience must be maintained to track the experience modifier of the individual client should the relationship terminate.

- Split Coverage: The regulation should provide that the employee leasing company maintains data on all of the clients’ employees even if only a portion of these employees is leased from the leasing company. The purpose of this provision is to ensure that data will exist for all employees of a given client should the employee leasing agreement be terminated.
In June 1991, the Workers’ Compensation (C) Task Force was asked by the NAIC/IAIABC Joint Committee to adopt the draft employee leasing model laws. After making some amendments, the task force adopted the model law and corresponding model regulation. The NAIC Plenary adopted the models in September of that year.

NCCI had originally favored requiring separate policies in all cases, while employee leasing companies favored the master policy approach. A compromise was proposed that included a coordinated set of policies with common billing dates and other coordinated provisions.

In 1991, regulatory concerns over fraudulent reporting that could occur under the master policy approach led the Workers’ Compensation (C) Task Force to choose the MCP approach for the residual market. However, the model regulation allows master policies to be written in the voluntary market when certain requirements are met.

**NCCI Employee Leasing Arrangement State Filings**

In late 1990, before the joint committee issued its report, NCCI filed to establish Basic Manual rules and provide policy forms for the issuance of workers’ compensation coverage to employers involved in employee leasing arrangements. The rules were developed and filed with the expectation that they would be an effective response to both intentional and inadvertent abuses that allowed some employee leasing companies and their clients to avoid payment of correct workers’ compensation insurance premiums for policies covering leased workers.

With a proposed effective date of April 1, 1991, the two filings, Item B-1265—Employee Leasing Arrangements (voluntary market) and Item B-8010—Employee Leasing Arrangements—Assigned Risk, were filed in all NCCI jurisdictions except Alaska and Oregon. Independent bureaus also received the filings for consideration.

Item B-1265 proposed generic rules for the voluntary market that provided insurance companies with the flexibility to write the policy under the name of the client or the “labor contractor” (i.e., the employee leasing company). Item B-8010 proposed structural rules for the residual market. It took the position that the employee leasing company was not the employer; therefore, residual market policies were to be written under the name of the client entity.

Meanwhile, as discussed above, the NAIC/IAIABC Joint Committee was undertaking the development of a model employee leasing rule for workers’ compensation insurance. Recognizing that the NAIC approach might differ in some important respects from the filed rules, in mid-1991, NCCI decided to seek a suspension of the two filed rules.

In addition to avoiding potential conflicts, the suspension would also allow time for consideration of the NAIC recommendations and thus aid in achieving consistent regulation of employee leasing coverage in the majority of states. Although the filing was suspended in all states, Connecticut and the District of Columbia approved Item B-8010 for use in the residual market.

Following the NAIC adoption of the Employee Leasing Model Regulation in 1991, NCCI developed countrywide item filing B-1276—Employee Leasing Arrangements. Item B-1276 was filed in the majority of jurisdictions where NCCI administered the Workers Compensation Insurance Plan (WCIP). It was also submitted to the independent bureaus for consideration.
Item B-1276 provided experience rating rules and policy forms for the voluntary and residual markets. For the voluntary market, it clarified that, with the insurer’s knowledge and consent, an employee leasing company could elect to secure coverage on leased employees through a standard workers’ compensation policy issued to the employee leasing company.

For the residual market, Item B-1276 required that the employee leasing company apply for coverage of leased employees on a multiple coordinated policies (MCP) basis. An MCP arrangement is characterized by having a single insurer that issues a central policy for the employee leasing company with separate policies for each client company.

Item B-1276 contained the following four new endorsements:

- Labor Contractor Endorsement;
- Labor Contractor Exclusion Endorsement;
- Employee Leasing Client Exclusion Endorsement; and
- Multiple Coordinated Policy Endorsement.

In addition, the filing included experience rating rules that provided for the experience rating of a client entity upon its termination of an employee leasing arrangement with an employee leasing company. The associated form to be used by insurance companies for the reporting of client experience was also incorporated in the filing.

As of June 2002, Item B-1276 has been approved in the following states: Alabama, Arkansas, Iowa, Indiana, Kansas, Kentucky, Louisiana, Maryland, Mississippi, New Hampshire, New Mexico, North Carolina, Rhode Island, South Carolina, South Dakota, Tennessee, and Vermont. In addition, many of the independent bureau states have adopted similar rules.

Description of the NAIC Model Laws

The following is a capsulated look at the two NAIC model laws on employee leasing as adopted in September 1991. To review a complete copy of each model, refer to Appendix B for the NAIC Employee Leasing Model Regulation and Appendix C for the NAIC Employee Leasing Registration Model Act. As of June 2002, nearly half of the states have adopted some variation of these models.

Employee Leasing Model Regulation

The model regulation is designed to help ensure that an employer that leases some or all of its employees properly obtains workers’ compensation insurance coverage and that the premium is paid commensurate with exposure and anticipated claims experience.

The model regulation requires an MCP approach in the residual market, but allows discretion by the employment services outsourcing company and client to use either a MCP or a master policy approach in the voluntary market. If MCPs are issued, a sworn written statement signed by the client is required that would certify to the insurance commissioner that all of the client’s non-leased employees are also covered for workers’ compensation benefits.

The employment services outsourcing company is required to provide to its insurance company sufficient information to permit the calculation of an experience modification factor for each of its clients. In the event
that the business relationship between the client and the employee leasing arrangement is terminated, the following is to take place:

- If the client had its own policy under an MCP arrangement, the insurance company should assign any applicable experience modification factor that reflects the client’s experience incurred during this association.

- If the experience of the client has been mixed with that of other clients under a master policy, then the experience of the client is to be developed and reported by the insurance company to the extent possible for use in developing any applicable experience modification. Should the data necessary for promulgating the client’s experience modification factor not be reported, the employee leasing arrangement’s experience modification factor would apply to the client—for up to three years—or until the client qualifies to develop its own experience modification.

**Employee Leasing Registration Model Act**

The model act is designed to require an employee leasing arrangement to register with the insurance commissioner (or other appropriate regulatory agency or department) before operating or offering its services in the state. The employee leasing arrangement is required to furnish and maintain certain information regarding the owners of the business and its insurance history. The regulatory agency is required to maintain a list of registered leasing companies.

**Subsequent Regulatory Activities**

The working group has discussed employment services outsourcing type arrangements since its first regular meeting in September 1999. To review a detailed account of the activities involving employment services outsourcing at these meetings, refer to Appendix E. The working group has received written comments regarding the current NAIC model regulations from the American Academy of Actuaries, Sigma Consulting Group, and the National Association for Alternative Staffing. The comments focused primarily on inconsistency among state laws that cause confusion, noncompliance, and poor statistical reporting.

In addition, NCCI and the National Association of Professional Employer Organizations (NAPEO) have provided the working group with the following data on current state activities regulating employment services outsourcing. While the information from these organizations is not all-inclusive, it does provide the reader with an understanding of the state activities that today shape this outsourcing environment.

*On Sept. 14, 2000, NCCI provided the following data on state employment services outsourcing activities. This information has not been independently verified for this report. Refer to Appendix F for additional information.*

- Some variation of the NAIC employee leasing models has been adopted in the following 18 states: Alabama, Arkansas, Indiana, Iowa, Kansas, Louisiana, Maine, Maryland, Mississippi, Missouri, New Hampshire, New Mexico, North Carolina, Rhode Island, South Carolina, South Dakota, Tennessee, and Vermont. While not adopting the NAIC employee leasing models, Connecticut and the District of Columbia have very similar legislation applicable to the voluntary and residual markets.

- Arkansas, Maine, Missouri, New Mexico, South Carolina, and Vermont additionally mandate requirements such as registration or licensing of the leasing company, maintenance of separate client data or client lists, and application of individual client experience.
• Variations on experience rating allow for the application of the employment services outsourcing company experience modification on a master policy basis or require the application and continued production of individual client modifications.

• When experience rating former clients of employment services outsourcing arrangements, application of individual client experience is required when separate client data is available, or if not available, the outsourcing company experience is applied for up to three years.

• The following eight states require separate client policies for both the voluntary and residual markets: Arizona, Massachusetts, Montana, Nevada, New Jersey, New York, Oregon, and Utah. With the exception of New Jersey and New York, these states allow for a master policy as long as the individual client data is reported properly for the promulgation of separate client experience rating modifications.

• The following five states allow for master policies but require the maintenance and reporting of client data and client lists: Florida, Georgia, Illinois, Kentucky, and Michigan.

• Kentucky requires individual client experience rating on the master policy. Illinois requires that the client experience rating modification be applied when the client’s modification is 50% or greater than the employment services outsourcing company modification.

• In California, a master policy may be used for non-rated risks. California requires that individual policies be written on each client when the client qualifies to be experience rated or where the client leases 50% or more of its workers.

• In Texas, either individual policies or master policies may be written. A master policy client that qualifies in Texas for experience rating must have its experience modification apply for the first two years under the master policy arrangement, with the modification of the employment services outsourcing company applying thereafter.

• These six states do not have employment services outsourcing rules: Alaska, Colorado, Hawaii, Idaho, Nebraska, and Oklahoma.

On March 7, 2000, the NAPEO provided the following data on state PEO activities. This information has not been independently verified for this report. Refer to Appendix F for additional information.

• The PEO can secure workers’ compensation coverage for its co-employees in 46 states.

• PEO reporting of client data to the insurance company on an aggregate basis is allowed in 30 states, while 11 states require data to be reported to the insurance company on an individual client basis.

• When the client relationship with the PEO is terminated, 25 states apply only the PEO experience rating modification to the terminated qualifying client.

• Connecticut requires the client to maintain accurate proof-of-coverage information with the state where a co-employer relationship exists between the client and the PEO.
ISSUES IN TODAY’S EMPLOYMENT SERVICES OUTSOURCING MARKET

Although some of the concerns identified a decade ago have since been effectively addressed, others persist, and new ones have arisen as the market has evolved. Even the core legal terminology has become obsolete, since the applicable state and model laws are still phrased in terms of “employee leasing” and related concepts that are not properly applicable to PEOs and may be misleading when used in that context.

It must be kept in mind that there are many reasons for entering into employment services outsourcing agreements. On the one hand, many businesses become clients because they find it an efficient way to obtain high quality administrative services, and many employment services outsourcing companies have worked hard to develop professional standards for the industry. However, other such outsourcing arrangements have been motivated by factors ranging from regulatory arbitrage to outright fraud. Regulators must be aware of all these motives, because focusing only on the abuses will result in laws that are inappropriately punitive and place unnecessary restraints on the market, while laws written with only the responsible sector of the industry in mind will be ridden with loopholes for the unscrupulous to exploit. Careful attention to terminology is particularly important, since many of the opportunities for regulatory avoidance involve the exploitation of confusing, imprecise, or overly narrow language.

The major substantive concerns identified by the NAIC/IAIABC Joint Working Group are discussed below. The first subsection will address benefit and coverage issues such as claims handling, exclusive remedy, and policy termination. The second subsection will address notice and reporting requirements such as proof-of-coverage and statistical reporting. The third subsection will address experience rating, and the final subsection will address financial issues.

For the most part, these concerns do not really arise out of employment services outsourcing as such, but rather out of the issuance of master policies to these outsourcing companies. If the client is treated as the employer for all workers’ compensation purposes and is issued its own policy at its own address at the normal rates, then the employment services outsourcing arrangement is essentially irrelevant from the perspective of this paper. However, the problem this poses is that master policies are not a peripheral feature of these outsourcing arrangements that can readily be abandoned, and the aspects which pose the most challenges for regulators and insurers are also closely related to some of the claimed efficiencies that help make employment services outsourcing an attractive way for clients to obtain workers’ compensation coverage.

**Benefit and Coverage Issues**

In every state except Texas, workers’ compensation coverage is mandatory for almost all employers and workers’ compensation benefits are the exclusive remedy available to injured workers against those employers. Thus, one of the fundamental questions that arises in the context of employment services outsourcing is: Who is the “employer”? One of the distinctive features of employment services outsourcing arrangements is the separation of the control of the work site and the conditions of the work from the payment of wages. However, workers’ compensation law tends to be based on the traditional definition of employment, which assumes the two are conjoined.

The common law dealt with related issues through the “lent servant” or “borrowed servant” doctrine, which developed to resolve issues concerning the availability of a tort remedy for on-the-job injury when there was

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3 New Jersey also has an opt-out law, but employers do not make significant use of this.
a temporary transfer of a worker from the “general employer” to the “special employer.” The case law required that the lent worker give informed consent to the new relationship, since he was giving up the right to sue the special employer in tort for any injury that took place in the course and scope of the special employment. If such informed consent is given or implied by the parties’ conduct, then both the general and special employers are entitled to the protections of the exclusive remedy doctrine upon assumption of workers’ compensation liability.

If both employers are liable to the worker, then the question of how they allocate the responsibility to pay must be decided. Not surprisingly, the majority view is that the employer whose business purposes are being furthered and who actually controls the performance of the work at the time of injury is primarily responsible, and the other employer is responsible only if the first fails to pay.

This analytical model has been applied to the employment services outsourcing industry as well as the temporary staffing services industry. In states that follow this analysis, assuming that the worker agrees to the arrangement and that the client controls the details of the work on a day-to-day basis, the employment services outsourcing company and client will both be considered “dual or co-employers.” The client would have primary liability for workers’ compensation and the employment services outsourcing company would have responsibility if the client failed to pay. Assuming that both are properly insured for workers’ compensation, both enjoy protection from tort liability that comes with their state’s version of the exclusive remedy doctrine.

However, the appearance of settled law can be deceptive in the application of these principles to particular fact patterns, unless the situation is expressly addressed by statute in the state where the claim occurs. Confusion can exist as to which co-employer is primarily liable. Complex questions dependent on specific facts can arise concerning the existence and proper placement of tort liability. Where such confusion exists, the worker’s claim may be delayed and the intention of the workers’ compensation system to provide medical and indemnity benefits without delay and return the worker to gainful employment at the earliest opportunity may be hindered. For similar reasons, workers may be forced to engage counsel and litigate claims that would otherwise be informally resolved, again delaying provision of benefits and driving up systemic costs unnecessarily.

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5 Larson’s, Chapter 67.01, V. 3, p. 67-2-4.
7 Larson’s, 67.01[4], V. 3, p. 67-3.
8 Johnson v. Aztec Well Servicing, 875 P.2d 1128, (NM App., 1994).
12 The NAIC Employee Leasing Model Regulation and substantially similar state laws provide that a complying MCP arrangement or master policy satisfies the coverage obligations for both the employee leasing company and its clients.
13 In a recent case, a foreign employee leasing arrangement leased a worker to a client in an adjoining state. The leasing company was required to have workers’ compensation insurance for its out-of-state obligations but apparently only had insurance in its home state. Nonetheless, the third party administrator for the employee leasing arrangement’s insurance company was paying benefits, albeit at the employee leasing arrangement’s home state indemnity rates. The client never informed its insurance company of the claim. The worker was uninformed about the legal obligations of the parties and was confused as to the identity of the entity he was actually working for. The worker mistakenly sought tort damages against the properly insured client, rather than the technically uninsured employee leasing arrangement. Needless to say, the district court where the tort claim was pending was somewhat confused concerning the law and proper parties.
Where the client is in a contract with substantially all of its workers provided through the employment services outsourcing arrangement, there is a temptation for the outsourcing company to name the client as an additional named insured on its own policy. While this strategy may provide the client with exclusive remedy protection, it may lead to the elimination (whether intentional or not) of a discernible loss history for the client, impacting the client’s experience modifier if the client should re-establish operations as a direct employer. Some states have established regulatory provisions to regulate the purchase of policies and the reporting of losses in the employment services outsourcing context.

These problems are exacerbated when only part of a client’s workforce is outsourced or the client participates in multiple employment services outsourcing arrangements. This “risk splitting” can create confusion concerning the correct identity of the employer, leading to delays in claims processing and denials of benefits when the wrong party is named in the proceeding to resolve a dispute.

A significant concern is that even clients who believe they are employment services outsourcing all of their employees may have uninsured exposures for statutory employees, such as uninsured subcontractors, or for individuals they believe to be acting as independent contractors who may ultimately be found to be employees. Because of restrictive endorsements attached to the master policy, these exposures may not be covered unless the client purchases a second policy in its own name. These potential gaps in coverage may not be apparent to the client or to the state regulatory authorities charged with maintaining proof of insurance coverage, and they may represent a substantial errors and omissions exposure for the client’s insurance agent.

Another important concern when a PEO covers all client entities under a single policy is “piggybacking,” where a PEOs policy covers other PEOs. In some cases, this is done through what may be a misuse of the alternate employer endorsement. This would further magnify concerns regarding proof-of-coverage, uninsured exposures, maintenance of proper data by client, and experience rating. Arizona, South Carolina, and Virginia are states where regulators have recently voiced their strong concern over the PEO piggybacking issue.

An additional coverage concern is that notices of cancellation or non-renewal of master policies may be sent only to the employment services outsourcing company and not to each client, which could result in uninsured exposures or gaps in coverage for clients. Many states attempt to address this problem by assigning cancellation and non-renewal notice responsibilities to the outsourcing company, as in the NAIC Model. The problem with this approach is that when an insurance company sends proper and timely notice to the employment services outsourcing company, which then fails to comply with its obligations to send notice to its clients, the client may be left without a meaningful remedy. The usual remedy for improper cancellation, an extension of the term of coverage, is unavailable because the outsourcing company has no coverage to issue. Furthermore, this problem is not limited to master policies, since the NAIC Employee Leasing Model Regulation only requires such notices to be sent to the employment services outsourcing company even in the case of MCPs issued in the clients’ names.

14 According to NCCI, this would violate rating rules in most states, which do not allow an entity to be included as an additional named insured without common majority ownership.
15 For instance, see “Workers’ Compensation Classification and Rating For Employers and Leasing Contractors,” 13.17.5 New Mexico Administrative Code.
Notice and Reporting Requirements

One of the major benefits of employment services outsourcing is that it can simplify the collection and dissemination of information by centralizing it in a single point and delegating it to specialists. Ironically, however, the outsourcing at the same time complicates matters, because the employment services outsourcing relationship adds a whole new level of relevant information. One of the central public policy questions to face in developing a regulatory framework for employment services outsourcing is how much of this information must be collected and reported, by whom and to whom, balancing the need for accurate information against the need to eliminate unnecessary administrative burdens.

Although these burdens are in many cases very real, they should not be overstated. The information needed by regulators and insurers is the same information a well-run PEO needs for its own business purposes. Even the smallest clients are now likely to maintain electronic records and be able to transmit them electronically. Although the information is collected and maintained in a variety of different formats, software to assist in organizing and validating the data is routinely available, as is the computing power to run that software and the disk space to run the data. Obsolete “legacy” information systems and inadequately trained staff may, in some cases, still pose a significant obstacle to change, but it would be a sound business practice in any event to upgrade them to the level necessary to comply with enhanced data collection, maintenance, and reporting requirements.

Moreover, even where added costs exist, incurring them may still be necessary. As we have just seen in the preceding subsection, notice and reporting requirements cannot be disparaged as mere paperwork. One of the essential features of any insurance system—all the more important when the insurance is mandatory and is maintained for the benefit of third parties who have no say in the process—is a fair and efficient system that guarantees accurate and timely notice to the insured as to when coverage begins and ends, and also for lesser policy changes such as rate adjustments of various types.

Note that the “insured,” in this context, means not only the employment services outsourcing company but also each client. This is why one fundamental principle is that the outsourcing company’s insurers must know—on an ongoing basis—who the employment services outsourcing company’s clients are. In soft market conditions, some insurers may consider this optional, finding the collection of accurate underwriting information more trouble than it is worth and an impediment to generating business. Nevertheless, this cannot be left to the discretion of the insurer and the employment services outsourcing company because the interests of the clients and their workers are also at stake. In addition, the insurer or insurers may be responsible for involuntary coverage, if the first insurer subsequently has second thoughts.

Moreover, regulators need this information too. To enforce compulsory coverage requirements, the states have adopted, usually by statute, requirements that proof of insurance coverage be presented to the state regulatory authorities. Proof of insurance coverage may be transmitted electronically (EDI\(^{16}\)) or by other means. The information is intended for comparison against other data to facilitate the identification of non-complying employers for enforcement purposes, which may include administrative penalties and injunctive action. The database is consulted on a nearly continuous basis as various detection methodologies are utilized to expose employers illegally operating without coverage. The creation of an accurate database requires that the issuance of new policies be reported in a timely manner to the regulatory agency and all cancellations of policies be similarly reported.\(^{17}\)

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\(^{16}\) Electronic Data Interchange. IAIABC has a major initiative underway to facilitate the use of EDI for such data, as well as for first reports of accident and other important forms.

\(^{17}\) See, for example, Ohio §§ 4123.29.
In this context, the employment services outsourcing company requires special treatment. Although the client might argue that the outsourcing company is the employer for its co-employed or leased workers and that coverage should therefore be the employment services outsourcing company’s sole responsibility, case law or statute in most states establishes that the client has the primary workers’ compensation liability for these workers and the corresponding duty to maintain valid coverage. The regulator must be able to verify coverage, whether it is provided directly by an insurance company or through an employment services outsourcing company. When the client has no direct relationship with the insurer, it is necessary to verify both that the client participates in an employment services outsourcing arrangement and that the outsourcing company has a valid master policy that includes the client’s operations. However, many state mandatory insurance laws have not been updated to reflect this new mode of business by extending the reporting requirement to employment services outsourcing companies. As a result, in the absence of voluntary agreements or statutory provisions for reporting the coverage or cancellation of coverage of workers for a particular identified client, regulatory agencies find that their proof-of-coverage efforts at the client level are seriously hampered.

As a corollary, worker inquiries to the dispute adjudication agency will also be frustrated. Workers involved in an employee leasing arrangement or PEO will usually think of themselves as “working for” the client, and may not even know the identity of the outsourcing company. If there is a benefit dispute and the worker needs to know the identity of the insurer, absence of proof-of-coverage information identifying the client makes it difficult for the agency to respond to the worker’s request, and may slow or complicate the adjudication of disputes based on the worker’s inability to correctly name the parties to the action. One possible solution may be to make employment services outsourcing companies subject to the same coverage reporting requirements as commercial insurers.

Additional problems arise, as noted in the preceding subsection, from the fluidity of these outsourcing arrangements. Because the proof-of-coverage systems in use by state industrial boards or commissions are designed to associate a separate policy with each employer, these systems lose their effectiveness when multiple employers are insured under a single policy—and when a single employer is insured under multiple policies. In addition, since clients may enter and exit employment services outsourcing arrangements at any time, coverage for a specific employer under a master policy may end even though the policy remains in effect and there is not a cancellation or non-renewal notice generated by the insurer. The fact that employers exiting these outsourcing arrangements frequently enter other such arrangements makes tracking coverage all the more difficult, and is further aggravated when a outsourcing company piggybacks on another employment services outsourcing company’s policy.

In addition to tracking proof-of-coverage, states and advisory organizations also collect extensive statistical data for various purposes, including ratemaking, the administration of the experience rating system, and evaluation of workplace safety and the effectiveness of the workers’ compensation system. How much detail must be collected and reported has historically been one of the central points of controversy. The next subsection will discuss the effects of the availability of accurate employer-by-employer statistical data on the experience rating system.

The lack of accurate data creates a vicious cycle, since it makes it more difficult to identify what the problems really are, whether they are severe enough to call for arguably costly solutions, and whether those proposed solutions are really as costly as their critics say they would be.

The working group conducted a survey in summer 2001 to gain additional data to further define the current employment services outsourcing environment. The survey was submitted to state workers’ compensation regulators, through their membership in both the NAIC and IAIABC, representing each of the workers’
compensation jurisdictions in the United States. (A report of the survey findings may be found in Appendix D.) The findings statistically verify many of the underlying assumptions and lend support to some of the more pressing concerns identified in this report. Resources of the working group did not allow, however, the detailed statistical analysis the working group would have liked to have conducted and believes is important to fully explain the dynamics occurring.

Furthermore, it is essential to keep in mind that even the most carefully designed reporting requirements are meaningless without adequate enforcement. Regulators, insurers, and advisory organizations must all commit the resources necessary to ensure compliance. One must also be mindful of unintended consequences. For example, rules providing fallback procedures when credible data are lacking can provide new opportunities for manipulation if the employment services outsourcing company decides the data are sufficiently credible to report only when they produce a favorable result.

**Experience Rating**

There is concern that the current experience rating system is not adequately performing its intended tasks as it relates to employment services outsourcing companies. From a regulatory perspective, experience rating provides financial incentives for employers to maintain safe workplaces, which is why states require workers’ compensation carriers to adhere to a uniform experience rating system. This safety incentive does not function properly unless the cost of workers’ compensation coverage correlates with the relevant workplace safety record. In particular, since the client generally retains operational control over the worksite, experience rating will only operate as a safety incentive if the client’s loss history affects the price paid for workers’ compensation insurance by the client.

Meanwhile, from a market perspective, the purpose of experience rating is to facilitate the accurate pricing of insurance based on the expectation of future losses. Although the safety incentive operates primarily at the client level, the insurer’s concern when pricing a master policy is the aggregate risk presented by the employment services outsourcing company, which from the perspective of workers’ compensation exposure is simply a group of employers. The premiums for such groups are often substantial, which would appear to make such groups attractive to insurance companies, yet workers’ compensation markets for PEOs and other employment services outsourcing companies appear to be tighter than for most other classes of business.18

Underwriting causes for this reluctance may include expense considerations or the fact that many PEOs are relatively new, but the most common concerns appear to be related to rate adequacy. Specifically, there is a fear that experience ratings (which NCCI procedures will peg at unity—1.00—for a new PEO) tend to result in underestimation of future losses due to the progressive effects of adverse selection on PEO books of business. With the master policy approach, employers with high experience ratings have an additional incentive to go with an employment services outsourcing company, while employers with low experience ratings have a disincentive to do so.19 The fact that a PEO does not market itself as a haven for those with high experience ratings will not remove the existence of these incentives and disincentives. It makes no

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18 This is not always the case. In soft market cycles, master policies may be readily available for large employment services outsourcing companies. This can create its own difficulties, however, as discussed in the following subsection on financial issues.

19 The ability of an employer to use an employment services outsourcing company to dodge a high experience rating is only one source of anti-selection working against an outsourcing company, but it is obvious and can be substantial. Employment services outsourcing companies can also be expected to get applications from employers that are unable to find coverage in the voluntary market or that are being quoted an especially high price. But in a state with a healthy voluntary market, the strength of these other forces should be relatively small and generally not enough to push many employers into an outsourcing arrangement that does not otherwise make good sense for their business.
sense from a public policy standpoint for employers to be attracted to or discouraged from the usage of a PEO based on their workers’ compensation experience ratings.

An additional outsourcing-related problem with current data reporting practices is that employers that become employment services outsourcing company clients under a master policy lose relevant data necessary for determining their subsequent individual experience ratings. Changing this situation may be difficult, since there has been consensus among insurance data management professionals studying these issues that it would be costly to change data systems so that they would be able to capture individual client data when clients are written on an employment services outsourcing company’s master policy. However, reliance on historical experience will overstate the magnitude of the problem, since many of the most difficult changes, if they have not already been implemented, have become necessary for other business reasons.

Furthermore, despite the title of this section, employment services outsourcing on a master policy basis raises rating concerns that go beyond experience rating. The master policy concept can also create problems with the assignment of appropriate classification codes to payroll, since the operations of clients conducted at many different locations can make verification of worker classifications extremely difficult. Although payroll records may be maintained at a single location for all of the clients of the outsourcing company, effective inspections for classification purposes or safety engineering would require visits to the work sites of each client. Because of cost considerations and client turnover, such inspections are rarely performed. These same conditions may allow intentional misclassification and under-reporting of payroll to go undetected. Even PEOs with the best of intentions do not have the same level of expertise as workers’ compensation insurers in applying the rating rules governing classifications and payroll reporting.

It is not that the alternative—a multiple coordinated policy (MCP) approach—is devoid of shortcomings. The most common criticism of the MCP approach is that it is more expensive to administer than a master policy approach. This presumes that the master policy approach allows the insurer to use the aggregated experience of all clients without needing to worry about the payrolls and losses attributable to individual clients. This conclusion would not be valid for a hypothetical master policy approach where everything is kept separately for individual clients and reported separately to the statistical agent.

Another criticism of an MCP approach is that if there is any experience tendency for an employment services outsourcing company beyond the fact that its clients may tend to have debit or credit experience ratings, then the experience rating system won’t respond to that tendency as fully as would a master policy approach. Hypothetically, an employment services outsourcing company could have nothing but employers who are too small to be experience rated, yet it could have a total premium of hundreds of thousands of dollars. An insurance company that is pricing such an outsourcing company is likely to want to know the group’s total experience and, if additional adjustments are indicated, to be able to account for this experience in the pricing for the group.

There are two reasons why this problem should be viewed as hypothetical or expected to be of minimal consequence. The first is that it would only fully manifest itself with a large PEO having a stable client base of essentially the same small employers for the past four years. Practically speaking, it appears doubtful that any PEOs match this profile. The other reason why this problem can be viewed as of minimal consequence is that insurance companies usually have many other tools—schedule rating, multiple rate levels, dividend plans, etc.—that allow them to adjust pricing for large books of business. They are accustomed to accomplishing such pricing adjustments using tools other than experience rating. This means that, even if the experience rating system under an MCP approach does not produce optimal results, its imperfections would likely occur in situations where insurers would otherwise be able to adjust for the differences.
Consider the role of experience rating in the ratemaking process. Overall statewide loss cost changes represent the first step of ratemaking. Next, classification ratemaking matches the industry’s losses and payrolls with employer classes at the statewide level. Experience rating represents the final step as it refines expected classification loss costs (i.e., industrywide, statewide) in recognition of an individual policyholder’s experience to the extent that it is credible. The traditional paradigm is broken, however, when being a single individual “policyholder” does not equate to being a single individual business entity.

The combination of many employers into an employment services outsourcing arrangement produces challenges in the data management arena. It also requires one to look closely at what is desirable for the experience rating system to compute. These are two very different sets of problems and questions. It is easy to get so mired in problems relating to data management that one forgets the central question: What is best to produce with the data, anyway?

Suppose for the moment that an underwriter or actuary could obtain perfectly clean data for a PEO. The data would separately identify the experience for each current and past client of the PEO, and it would also differentiate its clients’ experience with respect to when they were clients and when they were not. What would be the best thing to do with this information? Consider the following possibilities:

A. Premiums could be obtained by summing the premiums for individual clients, with each client’s experience rating calculated separately based on its total experience.20

B. An experience rating could be calculated for the PEO:

(1) Based on the total experience of all current clients (that is, including their experience prior to the time that they were clients);

(2) Based on its own total experience (that is, for both current and past clients, but only while they were clients); or

(3) Based on its own total experience, plus the experience of current clients before they were clients. (This is a hybrid of (1) and (2).)

C. Experience ratings could be used for individual clients (Approach A), and then an additional experience rating could be calculated that would recognize the tendencies of the entire “book of business” (as a PEO can be viewed as a book of business). For example, if the average individual experience rating modifier is 1.20 and the PEO’s total experience rating modifier using a B(1) approach is 1.26, then each of the individual modifiers will be multiplied by 1.05 (1.26 ÷ 1.20).

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20 When PEOs with master policies are involved, the current experience rating system applied to individual employers doesn’t work this way. Rather, the current system only recognizes the experience of PEO clients for that period of time when they were not clients. Because it is considered a flaw of the current system that experience for individual employers is commonly lost if incurred while they are clients of a PEO, this aspect of the current system will not be considered as an alternative approach in subsequent discussions of a desirable or optimal experience rating system. It is only mentioned for completeness because it is currently in existence.
Placed into the context of current experience rating systems:

- The current NCCI experience rating system applied to master policies can be characterized as a B(2) system. It bases the experience rating for the PEO on the PEO’s total experience, including experience of both current and past clients, but only while they were clients.

- The current experience rating system applied to an MCP approach attempts to follow Approach A. The premium for a PEO is obtained by summing the premiums for individual employers after their experience ratings have been applied on an individual basis.

- Approach B(3) is used in Pennsylvania. That state bases its experience rating for a PEO on the PEO’s total experience (for current and past clients) plus the prior experience of clients under contract at the inception of each rating period. This is not the same as a B(1) approach, as Pennsylvania does not remove the experience of clients that leave a PEO.

- Approaches B(1) and C are not used anywhere within the current set of experience rating systems. (This fact does not mean that these methods might not be valuable, but rather than the data necessary to apply these approaches is usually not available.)

Which of these approaches is the best way to experience rate a PEO? What are the practical implications?

*Master Policy Approaches*

An insurance company for a PEO that is covering all of its clients on a master policy basis with a single experience rating will want to know the most appropriate experience rating for the group. But which of the previously described approaches is most relevant—B(1), B(2), or B(3)? Which approach would be optimal for the insurance company to use? The answer is that none of them will be optimal for all situations. In some situations, no procedure will give particularly good results. Four examples will help explain.

**Example 1**

Suppose that a PEO has had exactly the same group of clients for many years and has had a consistent experience rating for the group of 0.90. In this case, an experience rating calculated using all three methods would be the same. At this point, however, the PEO decides to aggressively promote itself in order to increase its client base. It succeeds and quickly doubles in size. The new group of employers that it adds would have received an experience rating of 1.20 if their experience rating had been calculated on a group basis in the past.

Although the calculations are not nearly as clean as it may first appear, one would suspect that most underwriters would feel more comfortable with a B(1) or B(3)-type calculation, which would indicate approximately a 1.05 experience rating, than with a B(2)-type calculation, which would continue to indicate somewhere around a 0.90 experience rating.

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21 Data in the form necessary to apply these approaches is generally available for employers that are not employment services outsourcing clients, as well as for clients when the outsourcing company is rated using an MCP-like approach. The problem is that the data is not widely available for employers that have become associated with outsourcing arrangements covered on a master policy basis. Thus, although such data is generally available for most employers, it is unavailable in the particular situation where there might be the most interest in it.
Example 2

Suppose that a large PEO with a past loss ratio of 90 percent divested itself of half of its clients. It went through its client base, employer by employer, and pulled out the worst 50 percent based on their experience for the years to be used for experience rating. The employers that were divested had produced a 160 percent loss ratio, while the employers that were retained had produced a 20 percent loss ratio. Would this action indicate—actuarially, not from the standpoint of “fairness”—that the PEO should have a very low experience rating modifier based upon the application of experience rating to a historical loss ratio of 20% for what is still a large book of business?

In this case, a B(1) answer—basing an experience rating upon the 20 percent loss ratio—would be statistically incorrect. This error wouldn’t have anything to do with “fairness” or underwriting considerations. Rather, the B(1) approach would overreact to the more favorable experience (which would result in an underestimation of the true answer) because it wouldn’t be using a statistically unbiased sample of the experience of the past policyholders. The reason that this is brought up is to illustrate how a B(1) approach could be manipulated. In this case, none of the approaches would give a correct answer, because the new PEO would probably be much different than the old PEO. While the reconfigured group of clients would tend to be better than the old PEO, this would not be true to the extent that it may appear at first glance, if the artificially constructed loss ratio were taken at face value.

The example just stated might appear hypothetical. However, if a B(1) approach was used to experience rate PEOs on a master policy basis, with the experience rating based on the experience of all current clients (so that experience would be dropped should a client leave), then this example would not only be very realistic, but it would likely become the basis for operation of many sizeable PEOs.

Example 3

An entity forms as a PEO on Jan. 1, 2000, purchases a workers’ compensation policy, and begins to add clients. Its experience rating is calculated using the NCCI’s B(2) approach. Even if it does not promote itself as a way to escape bad experience ratings, the fact remains that it will be subject to a substantial degree of anti-selection. The PEO grows over the course of the next few years and gets its first experience rating for its policy effective Jan. 1, 2002, two years after it has entered into business.

There is a greater than average chance that this PEO will be in the assigned risk plan before 2002, in part because insurance companies are reluctant to write accounts with limited historical data, but also because they are aware of the anti-selection that can occur with clients joining a PEO. Suppose that anti-selection occurs and the first experience rating is 1.28. How well will this PEO be able to market its services to new (or existing) accounts with significant workers’ compensation premiums, other than those that have even worse experience ratings? Does a high experience rating mean that the PEO is not doing a good job for its clients or that it is doing something devious or underhanded? Not necessarily—it may simply be a matter of anti-selection and luck. Wouldn’t it be better if the experience rating system allowed the PEO—that may be doing a very good job of what it does—to be able to market itself to midsize employers with good experience ratings?

This example provides a realistic illustration of the problems with the B(2) approach used by NCCI. The B(1) approach and Pennsylvania’s B(3) approach would both do better in this example, but even these approaches would only partially escape the progressive adverse selection that can often result in a PEO client base with poorer experience ratings each year.
Example 4

A PEO is so large that it is nearly self-rated under approach B(1) or B(3) for workers’ compensation. A small retail store contacts the PEO about becoming a client. The problem is that the retail store had experienced a workers’ compensation claim of $200,000. As a result, the PEO would almost certainly decline to take the small employer as a client, because its experience rating would suffer nearly the full brunt of the large claim. With the B(1) and B(3) approaches, this rejection would make economic sense for the PEO, even if the small employer is very safety conscious and the accident was a freak accident that had nothing to do with bad safety practices. Clearly, this would be an example of a problem with the B(1) and B(3) approaches, as there would be no underlying public policy reason for the PEO to want to refuse service to this potential client.

Discussion of the Master Policy Experience Rating Examples

Example 1 illustrates the most serious weakness of the B(2) approach used by NCCI. It fails to contemplate the arrival of new clients, some of which may be very different in nature than those that were present during the experience period used to calculate the PEO’s experience rating. This device has encouraged employers with high experience ratings to join a PEO to escape their high experience rating. This clearly points one in the direction of the B(1) or B(3) approach.

Example 2 illustrates a serious weakness with the B(1) approach, in that it could be manipulated by the selective deletion of clients with losses during the period of time that would be used to calculate the PEO’s experience rating. While it is rational for a PEO to constantly re-underwrite its book of business, the activity this would encourage would be mindless in that it would encourage the deletion of clients with losses, regardless of the underwriting characteristics of the client. At this point, one would be pushed toward favoring the B(3) approach (used by the Pennsylvania bureau). B(3) wouldn’t necessarily provide the optimal answer for this example, but neither would it provide the motivation for this type of activity in the first place.

Example 3 provides another illustration of the practical problems with the current B(2) approach used by NCCI. This would push one away from the B(2) approach and would do nothing to dissuade a leaning toward the B(3) approach.

Example 4 provides an illustration of another problem with the B(1) approach, except that this problem would also pertain to the B(3) approach. Admittedly, this example is one-sided. Its purpose is to illustrate that inclusion of the experience of new clients would cause a PEO to unreasonably reject some potential new clients. Yet experience with NCCI’s B(2) system indicates that if prior experience of new clients were recognized, usually more appropriate experience ratings would be produced using a master policy approach. After all, some potential clients with unfavorable underwriting characteristics will have unfavorable loss histories. An insurance company will want to be able to reflect this in the additional premium charged to cover that new client. The point of Example 4 is not that exclusion of the prior experience of new clients would be a part of the best master policy approach; it wouldn’t. However, the inclusion of prior experience will still result in unfair consequences for some potential clients, since their experience would be given the credibility—and dollar impact—associated with claims against large employers, and they would lose the experience rating system’s recognition that a single large claim against a small employer is not a meaningful indicator of high-risk status.
The shortcoming with any purely formulaic approach to experience rating, be it for a master policy or for an individual employer, is that it is blind to the nature and relevance of the underlying losses. An underwriter, after analyzing the causes of past losses and their relevance to the probability of future losses, may decline an employer with a 0.75 experience rating while writing another with a 1.50 experience rating.

The additional dimension that a master policy rating approach adds is that the PEO will be aware of the pricing consequences of its actions and it will be motivated to take different steps depending on the rating approach that is applied to it. It is reasonable to expect PEOs to “underwrite” their potential clients to determine whether they will be advantageous as new business for the PEO. If—and this is not a reasonable expectation—PEOs were to simply go about their business and be oblivious to workers’ compensation matters, then B(1) would probably give the most appropriate results more often than the other two approaches. But one suspects that, in practicality, a B(1) approach would be subject to substantial manipulation (see Example 2).

The B(2) approach avoids the problem illustrated in the somewhat one-sided Example 4, but alternative B(3), which includes the prior experience of new clients, would probably be better in practice than the NCCI’s B(2) approach.

However, while the B(3) approach would probably be the best of the three master policy choices, it must be stressed that it would not be without occasional unfair results in situations of the nature illustrated by (the somewhat one-sided) Example 4. In addition, it won’t recognize newly added clients until renewal. Thus, it wouldn’t discourage a shady entity from forming a PEO and sheltering clients from high experience rating modifiers on a short-term basis. It should also be noted that Pennsylvania’s B(3) approach is more costly for the bureau to administer than NCCI’s B(2) approach. Both approaches include the experience of departed clients, which may or may not be relevant for all prospective rating purposes.

An MCP Approach that Rates Each of the Clients Individually

The preceding examples illustrate one of the fundamental problems with trying to rate master policies appropriately—the availability of a PEO with a master policy will allow employers to move back and forth between being rated on a stand-alone basis and being rated as part of a large employer pool. For the PEO with a stable client base, the pooled experience would be genuine, but if PEO experience is always taken at face value, then any master policy experience rating approach will be dangerously open to manipulation.

The surest way to avoid experience rating manipulation with master policies is to experience rate clients individually. This would be consistent with an MCP approach, but there are other ways that this could be implemented, so this paper shall refer to such approaches as “MCP-like.” Such approaches could allow downward adjustments to expense loadings for large PEOs. In this discussion, however, only expected losses are being considered. As a practical matter, however, requiring MCP-like rating and reporting for master policies may be tantamount to requiring separate policies. There appears to be no interest in the marketplace for master policies under those conditions.

Approach A merely uses the “normal” experience rating system to determine the expected losses for individual clients. In the MCP approach, this is normally done through the device of issuing separate policies. It could also theoretically be done on a single policy if the industry’s data processing systems allowed for it. In general, however, they don’t.
A Dual Rating Approach that Applies a “Group Modifier” to Individual Experience Ratings

It may appear unrealistic to simply rely on individual experience rating modifiers, because insurance companies will probably want to examine the group’s overall experience. Approach C might be attractive because it would address this concern by following a “dual formula” approach—applying a “group modifier” to the premiums determined by summing the individually rated clients.

If the data with all of the necessary details is available to perform the calculations, dual rating could be used as a component of any of the B approaches. For instance, using a B(1) approach, an experience modifier could be calculated using the experience of all of the current clients added together. Then a “group modifier” could be calculated so that, after being multiplied by the “group modifier,” the weighted average of the individual client experience rating modifiers would be equal to the experience rating modifier determined for the entire group of clients on an aggregate basis. The method using a B(2) or a B(3) approach would be similar, with the difference being that the numerator in the calculation would be calculated using B(2) or B(3), while the denominator would again be the premium calculated using the individual client experience rating modifiers.

The advantages to any of these “dual formula” approaches would be that they would preserve the safety incentives of experience rating at the individual employer level and they would recognize changes in the client base occurring midterm during the annual experience rating period. The relative advantages to each “dual formula” approach would be similar to the advantages of the B(1), B(2), or B(3) methodology used to calculate the numerator in the calculation of the “group modifier.”

However, the use of a group modifier based solely on the group’s historical experience creates its own opportunities for manipulation. If the group modifier is less than unity—which is the only time the group modifier would be relevant, since otherwise the clients will buy individual policies instead—then the employment services outsourcing company becomes a magnet for employers seeking discounted workers’ compensation coverage, and its client base may change to the point where the experience used to calculate the group modifier has become meaningless.

The weaknesses of the various rating approaches discussed above would be serious only if all insurers mandated for use the chosen approach. If, however, this approach were merely an underwriting tool available to insurers, then the likelihood of misuse would be greatly reduced. Presumably, an underwriter could evaluate the client selection process and other relevant activities for the individual PEO and decide the relevance of the methodology. In this fashion, if a PEO acted in one of the fashions as described in Example 2 or Example 4, then the underwriter would be able to recognize that the “group modifier” would be likely to provide a distorted estimation of the PEO’s expected losses.
Summary

Except in the unlikely situation of an employment services outsourcing company with a large and completely stable client base, an MCP-like approach\(^{22}\) appears more likely to produce actuarially sound premiums for these accounts than does a master policy approach involving the calculation of a single experience rating for the entire outsourcing company. The major reason for this is not numerical and actuarial; rather, it is because MCP-like approaches can avoid the opportunities for manipulation\(^{23}\) that exist with master policy approaches. Advantages of the MCP-like approach over a master policy approach include:

1. An MCP-like approach will free these outsourcing companies of the major source of anti-selection, which is the motivation of employers with high experience ratings to avoid their high experience ratings by becoming an employment services outsourcing client. This will allow employment services outsourcing companies to more effectively market their services to employers with favorable experience ratings, without having to develop their own methodology for passing through the group’s experience rating to clients.

2. An MCP-like approach will eliminate the concern of regulators about the use of employment services outsourcing arrangements to dodge or manipulate the experience rating system.

3. The effects of the experience of individual clients will remain more apparent, which is more consistent with the desire for the experience rating system to promote employer safety.

4. MCP-like approaches can be effective no matter how quickly or when an employer or an employment services outsourcing company moves its business. It would not be practical for master policy approaches that recognize new clients to recalculate their experience ratings every time a client moves.

5. As the bureau will calculate an experience rating modifier for each individual client, the data will also be available for an underwriter to examine the experience of all clients in the aggregate and/or to request the bureau to calculate an experience modifier from this aggregated experience (for informational purposes). The underwriter would need to carefully analyze these calculations in light of changes in the company’s client base\(^{24}\) and the criteria used by the employment services outsourcing company to add and drop clients, but it appears that this could provide meaningful information on many such companies.

\(^{22}\) These comments would apply equally to other schemes that use and preserve the experience rating of individual client employers. At this writing, however, the only approach that appears to accomplish this reliably is the MCP approach.

\(^{23}\) While accurate, the term “manipulation” often carries certain negative connotations that may be misunderstood. To be sure, some disreputable operators have victimized the insurance industry. But honest PEOs and employers will take whatever set of rating rules that they are presented with and will look for whatever will produce the best outcome for them. This isn’t dishonest. Rather, their natural motivation is to minimize the premium paid to insurers by whatever legal means are available. They are not in the business of trying to make money for insurance companies. Because of this motivation, all master policy approaches will encounter problems, even though they would produce excellent results in the hypothetical situation where PEOs and employers are oblivious to their workers’ compensation premiums.

\(^{24}\) Example 2 gives a good illustration of how a B(1) basis of calculation could be manipulated by an outsourcing company. The underwriter would need to guard against this. In addition, Example 4 illustrates how an outsourcing company might arbitrarily decline to accept new clients based on their past experience. The underwriter and the outsourcing company would need to understand and attempt to avoid this problem as well. While these caveats might result in serious problems if Approach C were a mandatory bureau procedure, they do nothing to diminish its value to underwriters as long as the results of this approach are analyzed so as to avoid these problems.
Disadvantages of the MCP-like approach include:

1. It would be more expensive than a simpler master policy approach that does not track the experience of the individual clients.  

2. It reduces the recognition of the experience of the employment services outsourcing company as a whole.  

3. In some states, legislation may be required to implement an MCP-like approach. If an employment services outsourcing company is found to be the “employer” of the workers who are paid through the outsourcing arrangement, separate policies corresponding to each client’s workforce may be inconsistent with the state’s law requiring all employees to be covered by one policy.

The nature of the decision that must be made is this—whether to adopt a system that preserves more detail and provides more value, but at a higher cost, or to maintain a less expensive system that is subject to manipulation. When evaluating the relative costs and benefits, one must keep in mind that the years of experience accumulated since the NAIC/IAIABC Joint Committee’s work in 1990 have given us a better understanding of the costs of maintaining the status quo, while the costs of implementing changes have diminished significantly.

Financial Issues

The involvement of an employment services outsourcing company as an intermediary also complicates the financial picture considerably and raises significant solvency and accountability concerns. From the perspective of the workers’ compensation insurance marketplace, these outsourcing companies might be regarded as buying in bulk from insurance companies and reselling the product to client companies. In states that allow these arrangements to self-insure, they could also function as alternative insurance providers, raising a number of issues that are beyond the scope of this paper. This subsection will assume that the outsourcing company cannot or does not self-insure and has some sort of insurance in place.

Even if this insurance is provided through MCPs, the employment services outsourcing company’s role as intermediary still raises issues that are not present when the insurer deals directly with the operating employer. For example, is this outsourcing company acting as an insurance producer? Is payment of premium by the client to the employment services outsourcing company deemed to be payment to the insurance company? May the employment services outsourcing company offer discounts or charge markups? If so, must they be uniform for all clients?

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25 Some jurisdictions require experience for individual clients incurred on an outsourcing company’s master policy to be tracked by the insurance company or the outsourcing company, even though it is not reported to the bureau. The idea is that this experience can be provided when an employer leaves the outsourcing arrangement. It appears questionable how well this works in practice, however.

26 It is quite possible that this “problem” is really not a problem at all. First off, one might suspect that the incidence of PEOs with a large and stable (for four years) clientele would be so infrequent that the “problem” may not occur. Even in such instances—should they exist—the real and continuing extent to which a PEO’s services actually change its clients’ loss potential is unknown, so giving additional weight to the total experience of the PEO may not be appropriate. In addition, should this situation occur, insurance companies have many other pricing tools (in most states) to recognize the experience of a PEO’s entire book of business.
Further complexities also arise when the employment services outsourcing company obtains a master policy. What rates can the outsourcing company pass through to the client? Do insurance charges have to be separately itemized, or can the employment services outsourcing company charge the client a comprehensive fee? If the outsourcing company is rated based in whole or part on its aggregate experience, do all clients get the benefit or burden of that modifier? If so, what effect does that have on the integrity of the experience rating system or the underwriting characteristics of its client base? If not, what other methodology is the employment services outsourcing company allowed to use, and what effect does that have on the integrity of the experience rating system or the underwriting characteristics of its client base?

Whichever choices are made in answering these questions, employers could have access to significantly different rating plans by obtaining coverage through employment services outsourcing arrangements. What ripple effects would that have on the conventional one-employer-per-policy market?

Even deeper questions arise if the employment services outsourcing company obtains a high deductible or retrospectively rated policy. At this point the outsourcing company is probably absorbing most or all of the layer of risk it retains and is building that cost in some way into the prices it charges clients—thus effectively acting as an insurance company.

The situation is complicated enough when the outsourcing company is successfully operating, but what happens when something goes wrong and somebody cannot—or does not—fulfill its obligations? When risk is transferred to an employment services outsourcing company, which party bears the risk of loss—the clients or the insurance company—if the employment services outsourcing company cannot or will not pay? High deductible policies can be disturbingly similar to fronting arrangements with unauthorized reinsurance companies, with unpleasant consequences for the insurance company if the losses are significant.

Furthermore, the risks involved in insuring employment services outsourcing companies are not limited to the risk of outsourcing company insolvency. Issuing coverage to an employment services outsourcing company, even on an MCP basis, amounts to delegating the underwriting function to the outsourcing company; in other words, the company functions much like a managing general agent. If there is a master policy, the employment services outsourcing company also takes on a role in the rating process, increasing the potential impact on the insurance company. Although rate flexibility in the voluntary market gives insurance companies a way to use their judgment to avoid some of the pitfalls inherent in the pricing of master policies, this can become a double-edged sword, since it also increases the insurance company’s vulnerability if that judgment is not borne out by events.

Nor are the possible adverse effects limited to the insurer providing the coverage. The broader market can be affected, both through the potential for guaranty fund exposure and through the distorting effects of inaccurate statistical reporting on the entire rating system. It is essential, therefore, to maintain a regulatory framework that can respond effectively to these questions.

**REGULATORY OPTIONS**

Outsourcing of employment services is a continuing trend throughout the United States. These arrangements can impede, or at least change, the regulation of workers’ compensation laws. First, regulatory surveillance of coverage mandates is complicated and in some cases weakened. Second, crediting (decreasing)/debiting (increasing) an employer’s policy premium for their own loss experience is thought to motivate and strengthen safety performance. Typically, these credits/debits are done through “experience rating.” Experience rating is jeopardized by some employment services outsourcing relationships. Third, access to responsible parties for claims handling is sometimes confused and complicated. Finally, statistical data vital
to ratemaking and system performance measurements can be lost or distorted by some employment services outsourcing arrangements.

It is not employment services outsourcing per se that creates these concerns. Rather, they stem from the way the workers’ compensation coverage, employment, and loss experience are reported to statistical agents, insurers, and state agencies. Presented below are two broad alternatives for regulation along with their advantages and disadvantages.

**Authorizing Master Policies**

In review, a master policy is a single contract of insurance that includes worker-exposures for a number of independent job sites. Payroll and loss experience is typically aggregated, rather than broken out by client. The entry and exit of individual companies under the master policy can be dynamic and recordkeeping a major business task.

**Pros**

This is the most efficient system for the employee leasing company or professional employer organization. The division of premiums and losses becomes an internal allocation for the employment services outsourcing company, and not a matter of reporting to regulators. Administration is simplified. Many employer organizations probably maintain client-level records for charging back expenses and providing loss reports to individual clients. To the extent these client-level records are used for internal business purposes, the regulatory burden of sharing this company-level detail with state agencies is mitigated.

**Cons**

The recording of sound payroll and loss data may be lost. This weakens the statistical credibility of ratemaking data, especially at the class level. Loss experience suitable for the experience rating of individual clients often may not be reported at all or is inaccurately reported to the regulatory authority. Thus, the ability of the experience rating system to provide equitable rate differentials between employers with favorable and unfavorable loss experience is lost. If there is no premium debit for poor safety experience or premium credit for good safety experience, then a major incentive for safe workplaces is lost. Verification of compliance for insurance coverage may be impeded if timely reporting of additions and removals of entities from the master contract is not accurately reported on a timely basis to state regulators. Moreover, if the master policy itself is cancelled, the client may not receive adequate notice.

**Requiring Multiple Coordinated Policies**

In review, this system requires the employment services outsourcing company to name and record information on each subcontracting employer, as gathered from separate client policies. The explicit reporting places new demands on the outsourcing company (refer to the NAIC Employee Leasing Model Regulation—Appendix B).
Pros

Maintains existing state systems for coverage monitoring and enforcement. Allows for individual employer experience rating. Enhances the accuracy of statistical data, especially classification data. Eases state efforts for monitoring compliance, especially for checking that workers covered by workers’ compensation law are clearly included in insuring agreements. This avoids benefit gaps and interruption to injured workers and reduces the potential for litigation over which the insurer is responsible for coverage.

Cons

Adds extra expense for employment services outsourcing companies. These companies would be responsible for more quality control and compliance; hence, they may be exposed to more fines and enforcement actions by state agencies.

These two models can, in some states, “blend” into hybrids. Nominally, a master policyholder might be required to keep individual experience on its clients in a policy, but not report it until the contractual relationship terminates. While this may circumvent some of the cons of a master policy, it does not remove the key issue—that of obtaining accurate and reliable experience rating modifications.

Terminology

Confusing or inconsistent terminology often gets in the way of smooth enforcement and assignment of responsibilities. Key employment and reporting issues are defined and described differently from state to state. It would be helpful for regulators and employers, especially those with interstate operations, if key terms were defined according to common definitions.

Further problems arise in the employment services outsourcing context because state laws generally refer to “employee leasing.” This may open the door to challenges by PEOs that, since they are not employee leasing companies, the law does not apply to them. Some observers may view even a successful determination that a PEO is considered a type of employee leasing company for regulatory purposes as antagonizing efforts to clarify the distinctions between PEOs and employee leasing companies.

On the other hand, if states change their laws in piecemeal fashion, it opens new areas where there is a risk not only of inconsistent terminology, but also of inconsistent conceptual frameworks. It is essential that both the terminology of the laws and the substantive conceptual framework be developed by regulators, with regulatory needs in mind, because allowing the regulated community to define the terms of discourse, or tailoring the regulatory framework too closely to current conditions, provides fertile ground for creative efforts to circumvent the law.

CONCLUSION

Although greater harmonization of state rating practices and reporting requirements is desirable, particularly where multistate risks are involved, each state is different in the details of its workers’ compensation and insurance laws. Therefore, it is important that each state’s insurance and workers’ compensation administrators tailor their response to the issues discussed in this paper to the laws and administrative procedures in their state. For this reason, “one size fits all” model legislation is unlikely to be feasible, especially in the area of substantive workers’ compensation laws where there are significant differences from state to state in both the legal framework and the benefit systems. States also differ in regulatory goals, resource priorities, and monitoring and enforcement. For example, emphasis on the surveillance of coverage
and compliance differs markedly from state to state, as does the importance the state attaches to adherence to a uniform experience rating system.

Nevertheless, there are a number of areas in which legislative or regulatory clarification is clearly desirable, and it is worth exploring the extent to which a public policy consensus may be developed. In particular, states should seriously consider whether to move toward requiring separate coverage for individual clients of employment services outsourcing companies, and the NAIC should evaluate whether its current model laws, which are geared primarily toward residual market issues and only secondarily towards the regulation of master policies, should be repealed or substantially revised. It must also be kept in mind that improved legal requirements and rating plans are not sufficient; they must be backed up by meaningful enforcement.

Coverage on a client-by-client basis could be implemented, in principle, in the following two basic ways:

- By prohibiting the use of master policies and requiring separate policies for each client.
- By allowing master policies but with client-specific notice requirements and payroll, loss and other data reporting requirements that would give the client a status similar to that of an individual insured under a group policy.27

If the latter approach is taken, careful attention must be paid to the need to guarantee that coverage cannot be terminated or materially altered by the insurer or by the employment services outsourcing company without reasonable advance notice to the client. It is also important to maintain and report accurate and up-to-date information in sufficient detail to permit the calculation of meaningful client-specific experience ratings and verification of proof-of-coverage on the client level. In practice, this may be a moot point, since insurers and employment services outsourcing companies may not consider the master policy a worthwhile option if client-by-client recordkeeping and reporting are unavoidable.

While the issuance of a separate policy or certificate for each client is more expensive for employment services outsourcing companies and insurers than the framework under which master policies are typically issued today, this paper has identified significant deficiencies in the status quo, ranging from proof-of-coverage and notice of cancellation to inaccurate rating and financial concerns. These problems are serious and solving them will be worth the additional costs.

States that choose to allow master policies for employment services outsourcing companies are urged to give careful consideration to the problems identified in this research. The authorization of simplified procedures for master policies should only be in areas where those problems are felt to be of less importance and the costs of solving the problems are demonstrated to be substantial.

27 Persons drafting or reviewing endorsements for workers’ compensation policies should be particularly sensitive to complications that may exist if the state allows insurers covering clients of employment services outsourcing companies to issue policies that cover only those employees for which the outsourcing company is handling payroll. However, states considering resolving this issue by requiring all of an employer’s employees in the state to be covered on the same policy should be aware of other situations, such as wrap up rating plans, where coverage may be split between policies.

28 Such description may raise more questions than it answers, since the legal status of certificate holders under group policies varies somewhat from state to state and even within a state may not always be entirely certain. Similar difficulties will arise and must be addressed if group-like coverage is to be available to clients under master policies.

29 Some past approaches have focused only on the availability of information for experience rating when a client leaves an employment services outsourcing company. This limited approach has a number of problems. The data is often unavailable if the outsourcing company goes out of business; the data (when provided) is often of questionable quality and is difficult to update; and insurers wishing to offer pricing to a current client of an outsourcing company will probably not be able to obtain experience ratings. These problems will be avoided with a separate-policy approach.
Other important public policy questions include:

- Does the law give effect to a contractual provision that deems an employment services outsourcing company and its client to be co-employers? If so, in what circumstances and subject to what terms? If not, which party is deemed to be the sole employer?
- Does the law give effect to a contractual provision that deems an employee leasing company or other employment services outsourcing company to be the sole employer? If not, is there dual employment by operation of law or is the client the sole employer?
- In a dual employment relationship, which rights and responsibilities can be contractually allocated between co-employers, and which ones are fixed by operation of law?
- In particular, who must secure compensation and file proof-of-coverage for which employees? Who must respond to claims? Who has the benefit of the exclusive remedy? If one co-employer is out of compliance, what are the consequences for the other co-employer?
- Can an employment services outsourcing company obtain a master policy? If so, under what conditions and subject to what reporting requirements? What can it charge its clients for coverage? How and when can a client’s coverage be terminated? What defenses and remedies does an insurer have?
- What notice rights does a client have before being terminated by an employment services outsourcing company? Should there be any restrictions on how or when a client can be terminated without cause? Should there be a right to convert to a separate policy if terminated by the employment services outsourcing company?
- What recordkeeping and reporting requirements should apply to employment services outsourcing companies and their current and former clients?
- What special provisions are necessary for employment services outsourcing companies with clients in multiple states or clients with interstate operations?
- Can an employment services outsourcing company self-insure? If so, under what conditions?
- Do any special regulatory requirements apply if there are separate policies for each client? Can the employment services outsourcing company collect and remit premium, and if so, must it be licensed as a producer?
- How is the scope of the law defined? Will it also apply to group insurance arrangements that are not based on employment services outsourcing contracts?
- What effect would the insolvency of the outsourcing company have upon the responsibilities of its clients, and what effect would the insolvency of a client have upon the responsibilities of an employment services outsourcing company?
- To the extent that the law allows insurers several different ways of providing coverage for employment services outsourcing companies and their clients, should all of these options be available when such coverage is written in the state’s assigned risk plan?

It is essential that states work to provide definitive answers to these questions, although the answers themselves in some cases will vary from state to state. It is hoped that this paper has demonstrated the importance of these issues and has provided information that will be useful in crafting solutions.
GLOSSARY

Terminology

Client

Client means an employer that has entered into an employment services outsourcing contract (typically a co-employment arrangement with a PEO or a leasing arrangement with an employee leasing company). This term has largely replaced the term “lessee,” which is used in the 1991 NAIC Employee Leasing Model Regulation and the 1991 NAIC Employee Leasing Registration Model Act.

Co-employer Relationship

A co-employer relationship is a dual employment arrangement existing between a PEO or other employment services outsourcing company and its client involving an allocation and sharing of responsibilities, contractually or by operation of law. Each party will be solely responsible for certain obligations of employment, while both parties will share responsibility for other obligations. Typically, both the PEO and the client establish common law employment relationships with work site employees.

Employee Leasing Company

Employee leasing companies offer an arrangement whereby a client may lease all or part of its workforce from the employee leasing company. The leased employees are generally the client’s own former employees. Employee leasing companies offer services to the client that may include, but are not limited to, full-service employee leasing arrangements, long-term temporary arrangements, and other arrangements that involve the allocation of employment responsibilities among two or more entities.

Employment Services Outsourcing Company

Employment services outsourcing company is a term used by this paper to refer collectively to PEOs, employee leasing companies, and other entities entering into alternative employment contracts in which they agree to serve as the employers or co-employers of all or part of their clients’ workforces.

Master Policy

A master policy is a workers’ compensation policy issued in the name of an employment services outsourcing company. Master policies typically cover the employees of all of the clients and also the internal employees of the master policyholder. The policy is usually endorsed to exclude coverage for any of the clients’ workers who are not part of the employment services outsourcing arrangement. A single experience modification factor, based on the experience of the employment services outsourcing company, generally applies. Master policies are typically written in the voluntary market and are usually not available through assigned risk plans or other residual market mechanisms.
Multiple Coordinated Policy (MCP)

Under a multiple coordinated policy, each client has its own policy covering its leased, or co-employed, employees under an employment services outsourcing arrangement. With the MCP approach, all policies for clients of the same employment services outsourcing company are assigned to one insurance company that arranges for all policies to have the same renewal dates. If a client’s workforce is divided between two or more employment services outsourcing arrangements, the client obtains separate workers’ compensation policies for each such arrangement. The insurance company may also issue a coordinated policy covering the internal employees of the employment services outsourcing company. Appropriate endorsements are used to restrict the coverage to specific employees and to coordinate coverage between the client and the employment services outsourcing company. Premium notices and notices of cancellation or non-renewal are often sent only to the employment services outsourcing company. MCPs have historically been written almost exclusively in the workers’ compensation residual markets, but may also be found in voluntary markets, depending on the state of jurisdiction.

Professional Employer Organization (PEO)

PEOs are the most common type of employment services outsourcing arrangement today. PEOs acknowledge a co-employer relationship with their clients, meaning that both the PEO and the client have an employment relationship with the worker. The PEO and client contractually allocate some, and share other, employer responsibilities and liabilities. The PEO typically assumes the responsibilities and liabilities associated with risk management, personnel management, human resource compliance, payroll and employee tax compliance. The client generally manages product development and production, marketing, sales, and service. While not all states recognize this co-employer relationship, the contractual sharing and allocation of employment responsibilities (co-employer relationship) is widely regarded as the primary difference between this type of long-term employee services arrangement and traditional employee leasing arrangements. The traditional employee leasing arrangement is typically one in which the leasing company holds itself out as the sole employer of the employees it leases back to the client that originally employed them directly. The term PEO has largely replaced the term “employee leasing,” due to the proliferation in the past decade of the PEO co-employment relationship.

Temporary Staffing Arrangement

Temporary staffing arrangements have long been distinguished from PEOs and traditional employee leasing companies. Temporary staffing arrangements are identified by their use in supporting or supplementing a client’s workforce for limited periods of time in work situations such as employee absences, temporary skill shortages, seasonal workloads, and special assignments and projects. Because of their short-term and temporary nature, temporary staffing arrangements are not considered employment services outsourcing arrangements within the scope of this paper, and it is generally considered appropriate for temporary staffing companies to be covered and rated separately from their clients.

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30 National Association of Professional Employer Organizations and the National Association for Alternative Staffing.
Organizations

Employer Services Assurance Corporation (ESAC)

ESAC, formed in 1995, serves as an accreditation source to help ensure the integrity and professionalism of PEO arrangements (Appendix F).

International Association of Industrial Accident Boards and Commissions (IAIABC)

The IAIABC was formed in 1914 and is composed of workers’ compensation administrators from 42 states, the District of Columbia, three U.S. territories, the U.S. Department of Labor and many foreign regulatory authorities. The workers’ compensation administrators oversee workers’ compensation benefits in their jurisdictions under agencies generally referred to as workers’ compensation commissions or industrial accident boards. Like the NAIC, the IAIABC has many committees that review insurance issues, except that all of the IAIABC issues are related to workers’ compensation. The IAIABC is an international organization and represents a diverse set of government, business, labor, and insurance constituencies. The IAIABC maintains a complete database of workers’ compensation laws and practices.

National Association for Alternative Staffing (NAAS)

NAAS was formed in 1991 as a trade association for its member employment outsourcing service companies. The association provides educational, training, and government relations services to its members.

National Association of Insurance Commissioners (NAIC)

The NAIC is the organization of state insurance regulators from the 50 states, the District of Columbia, and four U.S. territories. The state insurance departments primarily provide financial and market regulation to the insurance industry in their respective jurisdictions. The NAIC assists the states in a multiplicity of ways regarding all lines of insurance. The NAIC, formed in 1871, is the oldest association of state officials and maintains the world’s largest insurance database.

Among the more than 100 committees composed of insurance department regulators (insurance commissioners and/or selected insurance department staff) is the NAIC Workers’ Compensation (C) Task Force, which serves as the NAIC parent committee of the NAIC/IAIABC Joint Working Group. The Workers’ Compensation (C) Task Force has formed various working groups when special needs have arisen. The Workers’ Compensation (C) Task Force reviews the myriad of workers’ compensation issues that face state insurance regulators to help them better understand these issues and find appropriate solutions.

National Association of Professional Employer Organizations (NAPEO)

NAPEO was formed in 1984 as a trade association for its member professional employer organizations. The association provides educational, training, and government relations services to its members.
APPENDIX B

NAIC EMPLOYEE LEASING MODEL REGULATION

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Section 1. Purpose
Section 2. Authority
Section 3. Definitions
Section 4. Eligibility for Policy Issuance and Continuance
Section 5. Policy Cancellation or Nonrenewal
Section 6. Lessee’s Obligation
Section 7. Insurer or Service Carrier Audit
Section 8. Penalties
Section 9. Effective Date

Section 1. Purpose

The purpose of this rule is to ensure that an employer who leases some or all of its workers properly obtains workers’ compensation insurance coverage for all of its employees, including those leased from another entity, and that premium is paid commensurate with exposure and anticipated claim experience.

Section 2. Authority

This rule is promulgated pursuant to Section [insert cite to appropriate section of law].

Drafting Note: States should consider the appropriate agency or department of the state having authority to regulate workers’ compensation policy issuance and premium rates.

Section 3. Definitions

A. “Employee leasing arrangement” means an arrangement, under contract or otherwise, whereby one business or other entity leases all or a significant number of its workers from another business. Employee leasing arrangements include, but are not limited to, full service employee leasing arrangements, long-term temporary arrangements, and any other arrangement that involves the allocation of employment responsibilities among two (2) or more entities. For purposes of this rule employee leasing arrangement does not include arrangements to provide temporary help service. Temporary help service means a service whereby an organization hires its own employees and assigns them to clients for a finite time period to support or supplement the client’s work force in special work situations such as employee absences, temporary skill shortages and seasonal workloads.

B. “Leased employee” means a person performing services for a lessee under an employee leasing arrangement.

C. “Lessee” means an entity that obtains all or part of its workforce from another entity through an employee leasing arrangement or that employs the services of an entity through an employee leasing arrangement.
D. “Lessor” means an entity that grants a written lease to a lessee through an employee leasing arrangement. In this rule, the lessor may also be referred to as an employee leasing company.

E. “Multiple coordinated policies basis” means:

(1) (a) Each lessee shall have its own policy covering its leased employees required to be covered pursuant to the laws of this state;

(b) If non-leased employees of a lessee are not provided coverage pursuant to a separate policy or [insert applicable self-insurance statute], they shall be included on the policy required by Subparagraph (a) above; and

(2) All assigned risk policies for lessees of the same employee leasing company shall be assigned to one servicing carrier in the state and in other states to the extent possible; and

(3) The servicing carrier shall arrange to have the same renewal dates for all such policies; and

(4) The servicing carrier shall arrange to have all notices sent to the employee leasing company and to have a single master invoice sent to the employee leasing company for all policies covering the lessees of that leasing company.

(5) If a lessee leases employees from more than one lessor, there shall be a separate policy for the leased employees of each lessor.

(6) The servicing carrier also shall issue a policy covering the internal employees of the employee leasing company unless they are otherwise covered.

(7) Appropriate endorsements need to be used to restrict the coverage to specific employees and to coordinate coverage between lessees and lessor.

Drafting Note: These provisions may violate some state’s statutes or regulations which require all of an insured’s operations in a single state and/or single location be covered by a single policy.

F. “Premium Subject to Dispute”

Premium shall be considered subject to dispute only if the insured has provided a written notice of dispute to the insurer or service carrier, has initiated any applicable proceeding for resolving such disputes as prescribed by law or rating organization rule, or has initiated litigation regarding the premium dispute. The insured must have detailed the specific areas of dispute and provided an estimate of the premium the insured believes to be correct. The insured must have paid any undisputed portion of the bill.
Section 4. Eligibility for Policy Issuance and Continuance

A. Basic Rule

Except as provided in Subsection B, a lessee shall fulfill its statutory responsibility to secure benefits under the Workers’ Compensation Act by purchasing and maintaining a standard workers’ compensation policy approved by the Commissioner of Insurance. The exposure and experience of the lessee shall be used in determining the premium for policy.

B. Exceptions

A lessor that obtains coverage in the voluntary workers’ compensation market and is registered with the Commissioner of Insurance may, with the voluntary market insurer’s knowledge and consent, elect to secure the coverage on leased employees through a standard workers’ compensation policy issued to the lessor. The insurer of the lessor may take all reasonable steps to ascertain exposure under the policy and collect the appropriate premium through the following procedures:

(1) Complete description of lessor’s operations;

(2) Periodic reporting of covered lessee’s payroll, classifications, experience rating modification factors, and jurisdictions with exposure. This reporting may be supplemented by a requirement to submit to the carrier Internal Revenue Service Form 941 or its equivalent on a quarterly basis;

(3) Audit of lessor’s operations; and

(4) Any other reasonable measures to determine the appropriate premium.

C. Residual Market Coverage

A lessor that obtains coverage through the residual market, established pursuant to Section [insert appropriate statutory reference] for leased employees, shall secure coverage on a multiple coordinated policies basis. To qualify for coverage on a multiple coordinated policies basis, the lessor shall meet each of the following requirements at application and annual renewal:

(1) Its officers or directors, or any person with a five percent (5%) or greater interest does not owe any premium to the current or prior insurers, except premium subject to dispute; and

(2) Provide the information that is otherwise required by this regulation; and

(3) Be registered as an employee leasing arrangement with the Department of Insurance.
D. Application Data Required for Residual Market

A lessor that applies for coverage through the residual market shall furnish the following information with the application for coverage:

(1) A list by jurisdiction of each and every name that the employee leasing company has operated under in the preceding five (5) years (including any alternative names and names of predecessors, and successor business entities) along with the policy number and carrier for each workers’ compensation insurance policy issued to the employee leasing company under each and every such name in the preceding five (5) years and a copy of the most recent Form 941 or its equivalent filed with the United States Internal Revenue Service by the employee leasing company;

(2) A list of each and every person or entity that owns a five percent (5%) or greater interest in the employee leasing business at the time of application and a list of each and every person or entity that formerly owned a five percent (5%) or greater interest in the employee leasing company or its predecessors, successors, or alter egos in the preceding five (5) years;

(3) For each person or entity identified in the preceding subsection, a list of all other employee leasing companies in which each such person or entity owns or owned a five percent (5%) or greater interest and a list of all other businesses in which each such person or entity or combination of two or more such persons or entities owns or owned a fifty percent (50%) or greater interest at the time application is made and in the preceding twelve (12) months;

(4) A list by jurisdiction for each lessee, along with any other names the lessee has operated under in the preceding five (5) years and the Internal Revenue Service Form 941 or its equivalent most recently filed with the service with respect to each lessee and a copy of the most recent Form 941 or its equivalent filed with the United States Internal Revenue Service by each lessee;

(5) A sworn written statement signed by the owner, partner or officer authorized to bind the lessee legally, that states the policy number and carrier for each workers’ compensation insurance policy issued to the lessee under each and every name in the preceding five (5) years;

(6) The employee leasing company shall also furnish for each lessee at the time of application or renewal, a listing of all leased employees along with their social security numbers, classification codes and wages; and

(7) A sworn written statement signed by the owner, partner or officer authorized to bind the lessee legally that states that all of the lessee’s non-leased employees are covered by a workers’ compensation insurance policy. In addition, the sworn written statement must provide the policy number, carrier, a listing of the number of non-leased employees, and the aggregate payroll applicable to each classification code.
E. Other Data Required

A lessor that applies for coverage or is covered through either the voluntary market or the residual market mechanism shall also maintain and furnish to the insurer or to the principal rating organization through the residual market servicing carrier, sufficient information to permit the calculation of an experience modification factor for each lessee. The information shall include:

1. The lessee’s corporate name;
2. The lessee’s taxpayer or employer identification number;
3. The lessee’s risk identification number;
4. A listing of all leased employees associated with each lessee, the applicable classification code and payroll; and
5. Claims information grouped by lessee, and any other information necessary to permit the calculation of an experience modification factor for each lessee.

Section 5. Policy Cancellation or Nonrenewal

A. Grounds for Cancellation and Nonrenewal

In addition to any statutory grounds that may exist, a violation of this rule is grounds for cancellation or nonrenewal provided that the employee leasing company has been provided a reasonable opportunity to cure the violation.

B. Notice to Lessees

If an employee leasing company has received notice that its workers’ compensation insurance policy will be canceled or nonrenewed, the leasing company shall notify by certified mail, within fifteen (15) days of the receipt of the notice, all of the lessees for which there is an employee leasing arrangement covered under the to-be-canceled policy.

C. Experience Modification Factor Following Termination

1. Lessee covered by multiple coordinated policies basis:

In the event that the employee leasing arrangement with a lessee is terminated, the lessee shall be assigned an experience modification factor that reflects its experience during the experience period specified by the approved experience rating plan, including, if applicable, experience incurred for leased employees under the employee leasing arrangements.
Lessee covered by master policy:

In the event that the employee leasing arrangement with the lessee is terminated and the experience of the lessee is commingled with that of other clients on the lessors master policy, then the experience of the lessee shall be developed and reported by the insurer, to the extent possible, for use in development of an experience modification for the lessee. If suitable payroll and loss experience is not reported, then the lessors experience modification factor will apply to the lessee for up to three (3) years or until such time as the lessee qualifies for development of its own experience modification.

The employee leasing company shall notify the insurer or the service carrier thirty (30) days prior to the effective date of termination or immediately upon notification of cancellation by the lessee of an employee leasing arrangement with a lessee in order to allow sufficient time to calculate an experience modification factor for the lessee.

Section 6. Lessee’s Obligation

A. Nothing in this rule shall have an effect on the statutory obligation, if any, of a lessee to secure workers’ compensation coverage for employees not provided, supplied or maintained by a lessor pursuant to an employee leasing arrangement.

B. (1) A lessee shall not be eligible for coverage pursuant to a workers’ compensation insurance policy issued to a lessor in the voluntary market if the lessee owes its current or a prior insurer any premium for workers’ compensation insurance, except premium subject to dispute.

(2) A lessee shall not be eligible for coverage pursuant to a workers’ compensation policy under a multiple coordinated policy basis in the residual market if the lessee owes its current or a prior insurer any premium for workers’ compensation insurance, except premium subject to dispute.

Section 7. Insurer or Service Carrier Audit

Insurers shall audit policies issued pursuant to Section 4 of this rule within ninety (90) days of the policy effective date and may conduct quarterly audits thereafter. The purpose of the audit will be to determine whether all classifications, experience modification factors and estimated payroll utilized with respect to the development of the premium charged to the lessor are appropriate.

Section 8. Penalties

In addition to any adjustment in premiums, the commissioner may impose penalties upon a lessor or lessee as provided under Section [insert appropriate statutory reference] in any case where a violation of this regulation or applicable statute has occurred.
Section 9. Effective Date

The effective date of this rule is [insert date].

Legislative History (all references are to the Proceedings of the NAIC).

APPENDIX C

NAIC EMPLOYEE LEASING REGISTRATION MODEL ACT

Table of Contents

Section 1. Workers’ Compensation Insurance; Lessors of Employees
Section 2. Advertising Prohibition
Section 3. Criminal Penalties

Section 1. Workers’ Compensation Insurance; Lessors of Employees

A. Registration required. A corporation, partnership, sole proprietorship, or other business entity that provides staff, personnel or employees to be employed in this state to other businesses pursuant to a lease arrangement or agreement shall, before becoming eligible to be issued a policy of workers’ compensation insurance or becoming eligible to secure coverage on a multiple coordinated policies basis, register with the commissioner. The registration shall:

Drafting Note: States should consider the appropriate agency or department of the state to receive the registration.

(1) Identify the name of the lessor;

(2) Identify the address of the principal place of business of the lessor and the address of each office it maintains within this state;

(3) Include the lessor’s taxpayer or employer identification number;

(4) Include a list by jurisdiction of each and every name that the lessor has operated under in the preceding five (5) years including any alternative names and names of predecessors and, if known, successor business entities;

(5) Include a list of each and every person or entity that owns a five percent (5%) or greater interest in the employee leasing business at the time of application and a list of each and every person that formerly owned a five percent (5%) or greater interest in the employee leasing company or its predecessors, successors or alter egos in the preceding five (5) years; and

(6) Include a list of each and every cancellation or nonrenewal or workers’ compensation insurance that has been issued to the lessor or any predecessor in the preceding five (5) years. The list shall include the policy or certificate number, name of insurer or other provider of coverage, date of cancellation and reason for cancellation. If coverage has not been cancelled or nonrenewed, the registration shall include a sworn affidavit signed by the chief executive officer of the lessor attesting to that fact.

B. Ineligibility to register. Any lessor of employees whose workers’ compensation insurance has been terminated within the past five (5) years in any jurisdiction due to a determination that an employee leasing arrangement was being utilized to avoid premium otherwise payable by
lessees shall be ineligible to register with the commissioner or to remain registered, if previously registered.

C. Notice of change. Persons filing registration statements pursuant to this section shall notify the commissioner as to any changes in information provided pursuant to this section.

D. List maintained. The commissioner shall maintain a list of those lessors of employees who are satisfactorily registered with the commissioner.

E. Forms of registration. The commissioner may prescribe forms necessary to promote the efficient administration of this section.

F. Application of section. Any lessor of employees that was doing business in this state prior to enactment of this section shall register with the commissioner within thirty (30) days of the effective date of this section.

Section 2. Advertising Prohibition

No organization registered under this Act shall directly or indirectly reference its registration in any advertisements, marketing material or publications.

Section 3. Criminal Penalties

Any corporation, partnership, sole proprietorship or other form of business entity and any officer, director, general partner, agent, representative or employee of any of the foregoing that knowingly utilizes or participates in an employee leasing agreement, arrangement or mechanism for the purpose of depriving one or more insurers of premium otherwise properly payable shall upon conviction thereof be subject to a fine of not to exceed $1,000 in the case of a natural person and $5,000 in the case of an organization or imprisonment for not over six (6) months, or to both.

Legislative History (all references are to the Proceedings of the NAIC).

APPENDIX D

SYNTHESIS OF SURVEY FINDINGS

In order to gauge the concerns of regulators, the NAIC and IAIABC sent an identical survey instrument to each of their constituent regulators. The survey was sent in August 2001 to all state insurance and workers’ compensation regulatory departments. In all, 27 insurance departments responded, as did 11 workers’ compensation agencies. A copy of the survey and the survey responses follow in this appendix.

The survey responses show a high degree of similarity. Both groups of regulators share similar concerns. Nearly half of all the insurance department respondents considered professional employer organizations (PEOs) and employee leasing as a “very important” employment practice. A slightly smaller proportion of the workers’ compensation agency regulators saw PEOs and employee leasing companies as a strong trend in their state.

The range of activity for PEOs seems to be very different from state to state. While no state reported that PEOs or employee leasing companies were not important, roughly one-fifth said that the two practices were not common now but were catching on. Four-fifths of the respondents thought the two organizational types were either moderately or very important.

Three of the eleven workers’ compensation agency respondents reported large enforcement cases against PEOs or employee leasing companies. Most of the rest reported nothing unusual. By contrast, a slightly larger portion (10 of 24) of the insurance regulators reported large enforcement cases, with fewer reporting “nothing unusual.”

As expected, the workers’ compensation agency regulators were relatively less familiar with rating issues than insurance department respondents. Four out of eleven had no opinion on the impact of these organizations on experience rating. A much higher percentage of insurance regulators rated distortions to experience rating as a “very important” issue.

As expected, insurance regulators were relatively less concerned about finding parties legally responsible for claims payments and enforcement of coverage requirements, since that is the principle domain of workers’ compensation boards and commissions. To insurance regulators, these enforcement topics were either not important or the respondent had no opinion. Six out of the eleven workers’ compensation agency regulators responded that coverage enforcement was “very important.”

Insurance regulators had relatively fewer “no opinions” and a stronger conviction in the importance of safety incentives being compromised by distortions to experience rating. This presumably stems from their greater knowledge of the experience rating mechanism. Workers’ compensations agency respondents reported a higher portion of “no opinion” (6 of 11) on this question.

In summary, the survey confirmed the importance of these employment practices, either at present or in their rate of growth. It also confirmed the existence of some perceptions of large enforcement problems in several states. It confirmed a strong concern about distortions in experience rating and subsequent safety patterns, particularly by insurance regulators. Finally, it showed the concern of workers’ compensation agency regulators for enforcement of coverage and responsibility for claims handling.
SURVEY ON THE EMPLOYEE LEASING ENVIRONMENT

CONDUCTED JOINTLY BY

• THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS (NAIC)

AND

• THE INTERNATIONAL ASSOCIATION OF INDUSTRIAL ACCIDENT BOARDS & COMMISSIONS (IAIABC)

PURPOSE OF THE SURVEY

This survey is being conducted under the auspices of the NAIC/IAIABC Joint Working Group as part of a two-year study on Professional Employer Organization and employee leasing arrangements. The goal of the NAIC/IAIABC Joint Working Group is to inform the insurance community about this rapidly growing institutional change affecting workers’ compensation and to determine if any regulatory requirements need to be updated to accommodate these new employment practices.

To this end the survey has been developed for distribution to the membership in both organizations—workers’ compensation administrators through the IAIABC and insurance commissioners through the NAIC. Survey results are to be presented in the Report on Employee Leasing, being drafted by the NAIC/IAIABC Joint Working Group.

PLEASE PROVIDE THE FOLLOWING INFORMATION TO IDENTIFY THE PERSON COMPLETING THE SURVEY. (If you or your agency are not the appropriate contact for completing this survey, please forward to the appropriate contact in your state, or if available provide the new contact information to us with their name, telephone number and e-mail address.)

NAME: __________________________________________________
TITLE: __________________________________________________
EMPLOYER: ______________________________________________

AFFILIATION: NAIC Other: ______________________

TELEPHONE NUMBER: ________________________________
FAX NUMBER: ________________________________
E-MAIL (if available): ________________________________
DEFINITIONS USEFUL IN COMPLETING THE SURVEY—

Professional Employer Organization (PEO): The term PEO has largely replaced the term “employee leasing,” due to the proliferation in the past decade of PEO dual employment arrangements. The PEO and client (the employer who has entered into an employee leasing arrangement with a PEO or with an employee leasing company) contractually allocate some and share other employer responsibilities and liabilities. While not all states recognize this dual employment relationship, the contractual allocation of employment responsibilities is widely regarded as the primary difference between this type of employee leasing arrangement and traditional employee leasing arrangements. (Not a temporary staffing arrangement, which is identified by its support of the client’s work force for a limited period of time in work situations such as employee absences, temporary skill shortages, seasonal workloads, and special assignments and projects.)

Employee Leasing Company: A traditional employee leasing arrangement in which the leasing company has held itself out as the sole employer of the employees it has leased back to the client that had once hired them. (Not a temporary staffing arrangement.)

PLEASE ADDRESS THE FOLLOWING QUALITATIVE QUESTIONS AS INDICATED BELOW—

Q1A. In your opinion or best judgment, which of the following statements best describes the influence and growth of PEOs and employee leasing companies (Leasing Co’s) in your state:

<table>
<thead>
<tr>
<th>Statement</th>
<th>PEO</th>
<th>Leasing Co’s</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not important at all</td>
<td>(   )</td>
<td>(   )</td>
</tr>
<tr>
<td>Not common now, but growing</td>
<td>(   )</td>
<td>(   )</td>
</tr>
<tr>
<td>Not common, but slowly catching on</td>
<td>(   )</td>
<td>(   )</td>
</tr>
<tr>
<td>Moderately important</td>
<td>(   )</td>
<td>(   )</td>
</tr>
<tr>
<td>Very important employment practice</td>
<td>(   )</td>
<td>(   )</td>
</tr>
<tr>
<td>No opinion/No information</td>
<td>(   )</td>
<td>(   )</td>
</tr>
</tbody>
</table>

Q2A. Has either organization type been involved in large or notable enforcement actions or fines by your agency in the last year?

( ) Yes, some large cases ( ) Nothing unusual ( ) No basis to tell

If Yes, please describe briefly:
PLEASE ADDRESS THE FOLLOWING QUANTITATIVE QUESTIONS AS INDICATED BELOW—

Please rate the following issues for their importance to regulation of workers’ compensation in your state. Please use a scale of 1 = not at all important to 5 = very important to regulation. If you cannot rate the issue, check the space for “no opinion.”

Q1B. Improper employer experience rating modifications being calculated for employers

Importance of this issue = (   ) OR No opinion on this issue (   )

Q2B. Safety incentive compromised by experience rating modification incentives misdirected to PEO or employee leasing company

Importance of this issue = (   ) OR No opinion on this issue (   )

Q3B. Insurance coverage enforcement hampered by difficulty of finding individual employer coverage

Importance of this issue = (   ) OR No opinion on this issue (   )

Q4B. Overall ratemaking distorted by inability to capture and classify loss and premium statistics

Importance of this issue = (   ) OR No opinion on this issue (   )

Q5B. Responsible parties for adjusting claims difficult to identify

Importance of this issue = (   ) OR No opinion on this issue (   )

We welcome below any additional comments you might wish to make about PEOs and/or employee leasing companies:

PLEASE PROVIDE THE DATE THE SURVEY WAS COMPLETED: _______. TABULATION OF THE SURVEY RESULTS WILL BEGIN ON JULY 27, 2001. WE THEREFORE ASK THAT YOU RETURN THE COMPLETED SURVEY PRIOR TO THAT DATE.

TO RETURN THE COMPLETED SURVEY—

E-mail, fax, or mail to the following person: (provided prior to sending to member)

Thank you for participating in this survey.
## Findings

### Questions Q1A and Q2A

**Q1A.** In your opinion or best judgment, which of the following statements best describes the influence and growth of PEOs and employee leasing companies (Leasing Co’s) in your state:

<table>
<thead>
<tr>
<th></th>
<th>PEO</th>
<th>Leasing Co’s</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not important at all</td>
<td>( )</td>
<td>( )</td>
</tr>
<tr>
<td>Not common now, but growing</td>
<td>( )</td>
<td>( )</td>
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<tr>
<td>Not common, but slowly catching on</td>
<td>( )</td>
<td>( )</td>
</tr>
<tr>
<td>Moderately important</td>
<td>( )</td>
<td>( )</td>
</tr>
<tr>
<td>Very important employment practice</td>
<td>( )</td>
<td>( )</td>
</tr>
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<td>( )</td>
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<tr>
<th>State</th>
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<th>Q1A: Employee Leasing Companies</th>
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</tr>
<tr>
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<td>Very important employment practice</td>
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<td>Very important employment practice</td>
<td>Very important employment practice</td>
</tr>
<tr>
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<td>Very important employment practice</td>
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</tr>
<tr>
<td>OK</td>
<td>Not common now, but growing</td>
<td>Not common now, but growing</td>
</tr>
<tr>
<td>OR</td>
<td>Moderately important</td>
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</tr>
<tr>
<td>TX</td>
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</tr>
<tr>
<td>VT</td>
<td>Moderately important</td>
<td>(Licensing law does not distinguish)</td>
</tr>
<tr>
<td>WI</td>
<td>Not common now, but growing</td>
<td>Very important employment practice</td>
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Questions Q2A

Q2A. Has either organization type been involved in large or notable enforcement actions or fines by your agency in the last year?

( ) Yes, some large cases  ( ) Nothing unusual  ( ) No basis to tell

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<td>MI</td>
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<tr>
<td>MN</td>
<td>Nothing unusual</td>
</tr>
<tr>
<td>OK</td>
<td>No basis to tell</td>
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<tr>
<td>OR</td>
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</tr>
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<td>TX</td>
<td>Nothing unusual</td>
</tr>
<tr>
<td>VT</td>
<td>Nothing unusual</td>
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<tr>
<td>WI</td>
<td>Nothing unusual</td>
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</table>

Questions Q1B through Q5B

Please rate the following issues for their importance to regulation of workers’ compensation in your state. Please use a scale of 1 = not at all important to 5 = very important to regulation. If you cannot rate the issue, check the space for “no opinion.”

Q1B. Improper employer experience rating modification being calculated for employers, as required by state law.
Importance of this issue = ( ) OR No opinion on this issue ( )

Q2B. Safety incentive compromised by experience rating modification incentives misdirected to PEO or employee leasing company.
Importance of this issue = ( ) OR No opinion on this issue ( )

Q3B. Insurance coverage enforcement hampered by difficulty of finding individual employer coverage
Importance of this issue = ( ) OR No opinion on this issue ( )

Q4B. Overall ratemaking distorted by inability to capture and classify loss and premium statistics
Importance of this issue = ( ) OR No opinion on this issue ( )
Q5B. Responsible parties for adjusting claims difficult to identify

Importance of this issue = (   ) OR   No opinion on this issue (   )

<table>
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<tr>
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<th>Q3B</th>
<th>Q4B</th>
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<tr>
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<tr>
<td>OR</td>
<td>5</td>
<td>5</td>
<td>5</td>
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<td>5</td>
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<tr>
<td>TX</td>
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<td>0</td>
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<td>5</td>
<td>5</td>
<td>3</td>
</tr>
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</table>

**Analysis of State Workers’ Compensation Agencies Responses**

Q1A: 4 of the 11 respondents checked “very important employment practice” for PEOs (36.4%), whereas only 2 responded that employee leasing companies were a “very important employment practice” (18.2%). 3 of the 11 respondents believe that both PEOs and employee leasing companies were “moderately important” (27.3%). Overall, 4 of 11 respondents believed PEOs were “moderately important” (36.4%) and 4 out of 11 believed employee leasing companies were “moderately important” (36.4%). One respondent checked PEOs and employee leasing companies were “not common, but growing” (9.0%). And one respondent reported that both were “not common now” (9.0%). Only one respondents checked that employee leasing companies were “not common, at all” (9.0%). 71% of the respondents believe that PEOs and employee leasing companies are moderately or very important employment practices, while 54.5% felt the same about employee leasing companies. Overall, 63.6% of the respondents believed either PEOs or employee leasing companies were important practices. From this response, it can be seen that both these practices are encountered frequently among state workers’ compensation divisions indicating an interest in the findings of the Report on Employee Leasing.

- 8 said PEOs were moderately important or very important employment practice
- 6 said employee leasing companies were moderately important or very important employment practice
- $8 + 6 = 14$ divided by 2 = $7$
- $7$ divided by 11 total respondents = .636 or 63.6%

Q2A: 3 respondents (27.3%) said that their jurisdiction has been involved in litigation involving PEOs and/or employee leasing companies. This percentage compares with 6 respondents who replied “nothing unusual” (63.6%), and 1 who responded they had “no basis to tell” (9.1%).

These figures would indicate that some of the jurisdictions are currently involved in PEOs and/or employee leasing company litigation. However, the majority reported nothing unusual.
Q1B: Importance of this issue—

- 4 of the respondents rated this issue as 5 (“very important to regulators”): 36.4%
- 4 of the respondents rated this issue as 0 (no opinion on this issue): 36.4%
- 2 of the respondents rated this issue as 4: 18.2%
- 1 of the respondents rated this issue as 3: 9.0%
- 0 of the respondents rated this issue as 2: 0%

The results would indicate the majority of state workers’ compensation divisions view the improper calculation of employer experience rating modifications as a serious matter.

Q2B: Importance of this issue—

- 2 of the respondents rated this issue as 5 (“very important to regulation”): 18.2%
- 5 of the respondents rated this issue as 0 (no opinion on this issue): 45.4%
- 1 of the respondents rated this issue as 4: 9.0%
- 1 of the respondents rated this issue as 3: 9.0%
- 0 of the respondents rated this issue as 2: 0%
- 1 of the respondents rated this issue as 1: 9.0%

The results indicate the majority of state workers’ compensation divisions have no opinion on compromising of safety incentives caused by the misdirection of experience rating modifications. Less than 1 of 5 of respondents believed this issue to be very important.

Q3B: Importance of this issue—

- 6 of the respondents rated this issue as 5 (“very important to regulation”): 54.6%
- 1 of the respondents rated this issue as 0 (no opinion on this issue): 9.0%
- 2 of the respondents rated this issue as 4: 18.2%
- 2 of the respondents rated this issue as 3: 18.2%
- 0 of the respondents rated this issue as 2: 0%
- 0 of the respondents rated this issue as 1: 0%

The results indicate there is large concern among the state workers’ compensation divisions regarding the enforcement of tracking insured coverage on workers’ compensation. This is largely a regulatory issue of the IAIABC, and thus it is of greater interest to these respondents than to respondents from individual insurance departments.

Q4B: Importance of this issue—

- 3 of the respondents rated this issue as 5 (“very important to regulation”): 27.3%
- 7 of the respondents rated this issue as 0 (“no opinion on this issue”): 63.6%
- 1 of the respondents rated this issue as 4: 9.1%
- 0 of the respondents rated this issue as 3: 0%
- 0 of the respondents rated this issue as 2: 0%
- 0 of the respondents rated this issue as 1: 0%
The results indicate a very few state workers’ compensation divisions believe the distortion of ratemaking by the inability to capture and classify loss and premium statistics is a serious issue. In fact, the majority of states had no opinion on this issue, indicating they have very little contact with this type of distortion.

**Q5B: Importance of this issue—**

- 5 of the respondents rated this issue as 5 (“very important to regulation”): 45.4%
- 2 of the respondents rated this issue as 0 (“not at all important): 18.2%
- 2 of the respondents rated this issue as 4: 18.2%
- 1 of the respondents rated this issue as 3: 9.1%
- 0 of the respondents rated this issue as 2: 0%
- 1 of the respondents rated this issue as 1: 9.1%

The results indicate that the state workers’ compensation divisions were greatly divided on the difficulty of identifying the responsible parties for adjusting claims. Since the IAIABC members are not usually responsible for dealing with this issue, it is understandable the respondents had such varied opinions on the matter.
Questions Q1A and Q2A

Q1A. In your opinion or best judgment, which of the following statements best describes the influence and growth of PEOs and employee leasing companies (Leasing Co’s) in your state:

<table>
<thead>
<tr>
<th></th>
<th>PEO</th>
<th>Leasing Co’s</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not important at all</td>
<td>( )</td>
<td>( )</td>
</tr>
<tr>
<td>Not common now, but growing</td>
<td>( )</td>
<td>( )</td>
</tr>
<tr>
<td>Not common, but slowly catching on</td>
<td>( )</td>
<td>( )</td>
</tr>
<tr>
<td>Moderately important</td>
<td>( )</td>
<td>( )</td>
</tr>
<tr>
<td>Very important employment practice</td>
<td>( )</td>
<td>( )</td>
</tr>
<tr>
<td>No opinion/No information</td>
<td>( )</td>
<td>( )</td>
</tr>
</tbody>
</table>

State Q1A: PEOs

- AL: Not common now, but growing
- AR: Moderately important
- AZ: Moderately important
- CO: Very important employment practice
- CT: Not common now, but growing
- DC: No opinion/No information
- DE: Not common, but slowly catching on
- FL: Very important employment practice
- HI: Not common, but slowly catching on
- IL: No opinion/No information
- IN: Very important employment practice
- KS: Moderately important
- KY: Very important employment practice
- LA: Very important employment practice
- MA: No opinion/No information
- ME: Moderately important
- MI: No opinion/No information
- MT: Very important employment practice
- NC: Very important employment practice
- NE: No opinion/No information
- NH: Very important employment practice

State Q1A: Employee Leasing Companies

- AL: Moderately important
- AR: Moderately important
- AZ: Moderately important
- CO: Very important employment practice
- CT: Moderately important
- DC: No opinion/No information
- DE: Not common, but slowly catching on
- FL: Very important employment practice
- HI: Not common, but slowly catching on
- IL: Moderately important
- IN: Very important employment practice
- KS: Moderately important
- KY: Very important employment practice
- LA: Very important employment practice
- MA: No opinion/No information
- ME: Moderately important
- MI: No opinion/No information
- MT: Very important employment practice
- NC: Very important employment practice
- NE: No opinion/No information
- NH: Very important employment practice
<table>
<thead>
<tr>
<th>State</th>
<th>Q1A: PEOs</th>
<th>Q1A: Employee Leasing Companies</th>
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<td>NJ</td>
<td>Moderately important</td>
<td>Moderately important</td>
</tr>
<tr>
<td>NV</td>
<td>Very important employment practice</td>
<td>Very important employment practice</td>
</tr>
<tr>
<td>OK</td>
<td>No opinion/No information</td>
<td>No opinion/No information</td>
</tr>
<tr>
<td>SC</td>
<td>Very important employment practice</td>
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<td>TX</td>
<td>Very important employment practice</td>
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</tr>
<tr>
<td>UT</td>
<td>Very important employment practice</td>
<td>Very important employment practice</td>
</tr>
</tbody>
</table>

Q2A. Has either organization type been involved in large or notable enforcement actions or fines by your agency in the last year?

( ) Yes, some large cases  ( ) Nothing unusual  ( ) No basis to tell

<table>
<thead>
<tr>
<th>State</th>
<th>Q2A</th>
</tr>
</thead>
<tbody>
<tr>
<td>AL</td>
<td>Nothing unusual</td>
</tr>
<tr>
<td>AR</td>
<td>Nothing unusual</td>
</tr>
<tr>
<td>AZ</td>
<td>No basis to tell</td>
</tr>
<tr>
<td>CO</td>
<td>Yes, some large cases</td>
</tr>
<tr>
<td>CT</td>
<td>Yes, some large cases</td>
</tr>
<tr>
<td>DC</td>
<td>No basis to tell</td>
</tr>
<tr>
<td>DE</td>
<td>Nothing unusual</td>
</tr>
<tr>
<td>FL</td>
<td>Yes, some large cases</td>
</tr>
<tr>
<td>HI</td>
<td>No basis to tell</td>
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<tr>
<td>IL</td>
<td>Yes, some large cases</td>
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<tr>
<td>IN</td>
<td>Nothing unusual</td>
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<tr>
<td>KS</td>
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<tr>
<td>KY</td>
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<td>LA</td>
<td>Yes, some large cases</td>
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<td>ME</td>
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<td>MT</td>
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<td>SC</td>
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<tr>
<td>TX</td>
<td>Nothing unusual</td>
</tr>
<tr>
<td>UT</td>
<td>No basis to tell</td>
</tr>
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</table>
Questions Q1B through Q5B

Please rate the following issues for their importance to regulation of workers’ compensation in your state. Please use a scale of 1 = not at all important to 5 = very important to regulation. If you cannot rate the issue, check the space for “no opinion.”

Q1B. Improper employer experience rating modification being calculated for employers, as required by state law.
Importance of this issue = (   ) OR    No opinion on this issue (   )

Q2B. Safety incentive compromised by experience rating modification incentives misdirected to PEO or employee leasing company.
Importance of this issue = (   ) OR    No opinion on this issue (   )

Q3B. Insurance coverage enforcement hampered by difficulty of finding individual employer coverage
Importance of this issue = (   ) OR    No opinion on this issue (   )

Q4B. Overall ratemaking distorted by inability to capture and classify loss and premium statistics
Importance of this issue = (   ) OR    No opinion on this issue (   )

Q5B. Responsible parties for adjusting claims difficult to identify
Importance of this issue = (   ) OR    No opinion on this issue (   )

<table>
<thead>
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<th>State</th>
<th>Q1B</th>
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</table>
Analysis of Insurance Department Responses

Q1A: 12 respondents checked “very important employment practice” for both PEOs and for employee leasing companies (44.4%). While only five respondents checked PEOs as “moderately important” (18.5%), nine respondents checked employee leasing companies as “moderately important” (33.3%) Combining the totals for both the “moderately important” and the “very important employment practice” develops an impressive 70.4% of respondents who felt that PEOs and/or employee leasing companies were either moderately important or very important employment practice. The combined percentage would strongly indicate to the working group that the Report on Employee Leasing and Professional Employer Organizations should be of much interest to state insurance department regulators.

- 17 said PEOs were moderately important or very important employment practice
- 21 said employee leasing companies were moderately important or very important employment practice
- 17 + 21 = 38 divided by 2 = 19
- 19 divided by 27 total respondents = .704 or 70.4%

Q2A: 10 respondents (37%) said that their jurisdiction has been involved in litigation involving PEOs and/or employee leasing companies. This percentage compares with nine respondents who replied “nothing unusual” (33.3%) and eight who replied “no basis to tell” (29.6%).

These figures would indicate that perhaps a large number of jurisdictions are currently involved in PEOs and/or employee leasing company litigation.

Q1B: Importance of this issue—

- 13 of the respondents rated this issue as 5 (“very important to regulators”): 48.2%
- 6 of the respondents rated this issue as 0 (no opinion on this issue): 22.2%
- 4 of the respondents rated this issue as 4: 14.8%
- 2 of the respondents rated this issue as 3: 7.4%
- 2 of the respondents rated this issue as 2: 7.4%

The results would indicate that a majority of the insurance regulators view as a serious matter the improper calculation of employer experience rating modifications.
Q2B: Importance of this issue—

- 11 of the respondents rated this issue as 5 ("very important to regulation"): 40.7%
- 6 of the respondents rated this issue as 0 (no opinion on this issue): 22.2%
- 5 of the respondents rated this issue as 4: 18.5%
- 4 of the respondents rated this issue as 3: 14.8%
- 1 of the respondents rated this issue as 2: 3.7%

The results would indicate that a majority of the insurance regulators view as a serious matter the compromising of safety incentives caused by the misdirection of experience rating modifications.

Q3B: Importance of this issue—

- 10 of the respondents rated this issue as 0 (no opinion on this issue): 37%
- 8 of the respondents rated this issue as 5 ("very important to regulation"): 29.6%
- 4 of the respondents rated this issue as 3: 14.8%
- 3 of the respondents rated this issue as 2: 11.1%
- 1 of the respondents rated this issue as 4: 3.7%
- 1 of the respondents rated this issue as 1: 3.7%

The results indicate concern among the insurance regulators regarding the enforcement of tracking insured coverage on workers compensation. This is a particularly high level of concern since this is largely a regulatory issue of the IAIABC members.

Q4B: Importance of this issue—

- 8 of the respondents rated this issue as 5 ("very important to regulation"): 29.6%
- 7 of the respondents rated this issue as 4: 25.9%
- 4 of the respondents rated this issue as 0 ("not at all important"): 14.8%
- 3 of the respondents rated this issue as 3: 11.1%
- 3 of the respondents rated this issue as 2: 11.1%
- 2 of the respondents rated this issue as 1: 7.4%

The results indicate a substantial majority of the insurance regulators view the distortion of ratemaking by the inability to capture and classify loss and premium statistics as a very serious issue.

Q5B: Importance of this issue—

- 9 of the respondents rated this issue as 5 ("very important to regulation"): 33.3%
- 8 of the respondents rated this issue as 0 ("not at all important"): 29.6%
- 3 of the respondents rated this issue as 3: 11.1%
- 3 of the respondents rated this issue as 1: 11.1%
- 2 of the respondents rated this issue as 4: 7.4%
- 2 of the respondents rated this issue as 2: 7.4%

The results indicate concern among the insurance regulators regarding the identification of parties for the proper adjustment of claims. As with Question 3B, this is significant because this is largely a regulatory issue for the IAIABC members.
WORKING GROUP DISCUSSIONS

The following paragraphs capture employee leasing and professional employer organization (PEO) discussions from the NAIC/IAIABC Joint Working Group meetings. The reader should keep in mind that the term “employment services outsourcing” was not adopted as the catchall term to encompass a variety of alternative employment arrangements that can provide long-term employee services to businesses until the Feb. 23, 2002, working group meeting.

The last item in this appendix contains a listing of questions and answers directed to representatives of the National Association of Professional Employer Organizations (NAPEO) and the National Council on Compensation Insurance (NCCI) in March 2000 regarding employee leasing company and PEO arrangements.

By reviewing the comments made the reader will gain a better understanding of the employment services outsourcing environment and the issues the working group weighed.

Sept. 24, 1999, Meeting in Washington, D.C.

This was the first regular meeting of the working group. The main issue of discussion at the meeting was employee leasing. Pat Borowski (National Association of Professional Insurance Agents) addressed the working group commenting that employee leasing has evolved since the NAIC adopted the employee leasing models. PEOs originally developed from temporary help services and the outsourcing of accounting services, Ms. Borowski said. It was noted that many employers are going to PEOs as they are so overwhelmed with compliance issues. Ms. Borowski concluded that the NAIC employee leasing models might not fully apply today, with PEOs—the most prominent form of employee leasing arrangement today—proclaiming that workers are not leased, but co-employed.

Dec. 4, 1999, Meeting in San Francisco, California

Jim Nau (NCCI) and Cecilia Renn (NAPEO) made presentations on long-term employee service arrangements.

Mr. Nau said that the NCCI’s concerns about employee leasing—or as more commonly called today Professional Employer Organizations (PEOs)—have not been relieved by the NAIC adoption of the employee leasing models in 1991. Less than half the states have adopted the models, he pointed out. PEO and employee leasing arrangements are now a much bigger part of the economy than they were in 1991. He explained that historically employee leasing arrangements have been designed to cover the residual market risks. Mr. Nau noted that the primary advantage of a multiple coordinated policy approach is that it requires separate policies to be issued for each lessee. The disadvantage of the multiple coordinated policy approach is that it is cumbersome and expensive to apply. The advantages of the master policy approach, Mr. Nau said, was that it is simple to implement, but greatly complicates unit statistical reporting since multiple employers are in a real sense covered under a single policy. Mr. Nau believed that absent a multiple coordinated policy approach as outlined in the model regulation, PEO and employee leasing arrangements create tracking problems for insurers and statistical agents in keeping up with PEO and employee leasing clients. The primary problem, he said, is in tracking the data when a PEO client or a employee leasing client changes from one employee outsourcing arrangement to another. It hurts experience rating, he added.
Experience rating has been around over 70 years and encourages safety in the workplace by developing reduced premium for risks with above average experience.

Ms. Renn said that the PEO does not lease employees, but is a dual employer. The employee is therefore under a co-employment (i.e., dual employment) arrangement with the business for which they perform services and with the PEO who provides outsourcing services to that business. This does not mean “fire and hire,” she emphasized. Ms. Renn also made these comments:

- PEOs sell a bundled service.
- Small businesses are especially attracted to PEO arrangements.
- PEO arrangements can free up to 25% of the small businesses time previously spent on administrative and human resource duties.
- It is important for the PEOs to have a single master policy for these employees, to reduce costs.
- Ms. Renn believes the PEO industry has cleaned up significantly over the past decade.

Also during the meeting, Keith Bateman (Alliance of American Insurers) commented that some employers lease part of their employees and retain some of their employees. This greatly complicates providing adequate coverage and tracking these exposures where master policies are utilized, he said. This causes difficulties for workers’ compensation administrators who are charged with policing proof-of-coverage. It was also noted that this makes it more difficult to detect premium fraud and abuses of the experience rating system.

Alan Wickman (NAIC—NE) asked Mr. Nau if a single workers’ compensation policy, with multiple employers endorsed to it, could not be tracked by NCCI. He wondered if NCCI would design a data tracking system for that purpose. Mr. Nau responded that this could be done, but that it would be very expensive.

March 9, 2000, Meeting in Metairie, Louisiana

To gain greater insight into these long-term service arrangements, the working group developed some specific questions to present at this meeting to the NAPEO and NCCI. These questions and responses may be found as the last item in this appendix.

June 12, 2000, Meeting in Orlando, Florida

Christine Siekierski (Wisconsin Compensation Rating Bureau) discussed the current efforts of the Workers Compensation Insurance Organizations (WCIO) to investigate the employee leasing arrangements in the United States. She explained that the Electronic Data Interchange (EDI) Committee of the WCIO is developing a draft survey to be sent to insurance companies who write workers’ compensation coverage on PEOs. The central purpose of the survey is to gain a better understanding of what information is collected on clients that are covered under the PEO master policies. The EDI Committee is especially interested in obtaining this information as it relates to proof-of-coverage reporting and experience rating promulgation.

Ms. Siekierski said insurance companies are generally not able to obtain a breakdown of data on each client covered by a master policy issued to a PEO. On the whole, she said, PEOs do not seem to be reporting the data on each client needed by the insurance company to be able to provide necessary employee statistical information for insurance company reporting purposes. It will be expensive, she said, for insurance companies to track the needed information on each client. Some insurance companies have acknowledged to the WCIO that it would likely be less expensive to gear up for tracking each client on a PEO master policy than it would be to issue separate policies for each client (e.g., MCP basis).
Charlie Tenser (NCCI) remarked that the IAIABC appeared to be primarily interested in obtaining accurate proof-of-coverage information on the client, while the NAIC appeared to be primarily interested in obtaining accurate experience rating information on the client.

Sept. 19, 2000, Meeting in Seattle, Washington

Cordell Hull, executive director of the National Association of Alternative Staffing (NAAS), asked two representatives from the NAAS professional employer organization membership to address the working group: George Gersema (Employers Resource) and Jerry Ormand (HRC).

Mr. Gersema said that he did not have any problems with the present NAIC model laws on employee leasing that were adopted by the NAIC in 1991. He was, however, of the opinion that it would be desirable to have more uniformity among the states in their regulation of these long-term employee service arrangements. Mr. Gersema said that less than 20 states follow the NAIC model closely and other states have their own separate ways of handling PEO and employee leasing arrangements.

Some “mod washing” does go on caused by a few unscrupulous clients, Mr. Gersema admitted. Mod washing is where an employer joins a long-term employee service arrangement (e.g., PEO) to escape a high experience modification. These activities are to the disadvantage of the PEO, Mr. Gersema said, as the PEO would lose the client business before being able to fully benefit from the business relationship. He said he did not have an answer to mod washing. PEOs are almost like incubators, Mr. Gersema added. We can help the small business along to improve its benefit and safety program and then, as clients get stronger, we lose them as they return to full employment within their own business or leave for another PEO that has some additional appeal at the time, he said.

Mr. Gersema said that only 5%—10% of Employers Resource clients would have enough premium to qualify for experience rating to obtain an experience modification. He believed the PEO concept worked fine and was perfectly logical for the small employers they mostly served. “This concept makes sense with small businesses,” Mr. Gersema added. He could appreciate the problem regulators were often faced with, he said, but stressed the need for uniformity among states in the handling of employee leasing arrangements and added that Employers Resource and probably all PEOs prefer experience rating being aggregated under the PEO’s total operations.

Mr. Gersema reminded the working group that the world has been changing very fast the past few years. Within this change, the PEOs have developed as a hybrid that does not fit clearly within the regulatory structure today, he reflected.

Mr. Ormand began his presentation by supporting Mr. Gersema’s contention that, by far, the majority of PEO clients are not large enough to be experience rated. He said his PEO likes to obtain master policies to cover its clients in a state, but that, of course, depends on the jurisdiction(s) involved.

Mr. Wickman expressed concern that PEOs do not usually provide a listing of their clients to the insurance company. Mr. Wickman said that this was necessary for the insurance company to have any way of tracking the client experience while with the PEO. Mr. Ormand responded that PEOs do not like to reveal the names of their clients as this list could be used competitively against the PEO. He would like to see some kind of confidentiality agreement worked out where such a list could be provided to third parties without threat to the PEO.
Mr. Hull said that the NAAS was satisfied with the way the NAIC model laws were currently written. He did believe, however, that difficulties would persist for employee leasing arrangements, insurance regulators, and workers’ compensation administrators until the model laws were adopted by a large majority of states in a uniform manner.

Ms. Siekierski provided a WCIO survey, released on Aug. 2, 2000 for completion by insurance companies who write workers’ compensation coverage. The purpose of the survey was to gather information on PEO reporting requirements. The survey primarily dealt with master policy concerns and questions relating to how the insurance company would track the client and what costs it anticipated would be associated with this tracking. Ms. Siekierski said the response from the insurance companies has been disappointing, as only about 20 surveys had been returned completed.

“We are getting a mixed response,” Ms. Siekierski said. “Insurance companies say they cannot get the information they need on clients from the PEOs and the PEOs counter that they cannot get the help they need from the insurance companies to provide this information,” she said. Ms. Siekierski continued that it appears many insurance companies do not want to establish effective data reporting on PEO clients until mandated by law. As a result, she said, insurance companies do not always know who comes in and who goes out of their insured PEOs. Ms. Siekierski said that the goal is to have a method in place for the insurance company to report PEO client information so the states will know who has workers’ compensation coverage.

Terri Robinson (NCCI) provided materials that summarized recent NCCI findings on PEO and employee leasing arrangements (Appendix F). The NCCI data available at the meeting reported that the NAIC Employee Leasing Model Regulation had been adopted in 18 states, with similar laws being passed in three additional states. Six NCCI states presently do not have rules specifically for regulating PEOs and employee leasing companies.

NCCI contradicted statements that only a small percentage of PEO and employee leasing clients qualify for experience rating. Ms. Robinson said that the NCCI believes approximately 50% of PEO and employee leasing clients are of sufficient size to be eligible for experience rating. This figure holds true in the voluntary market as well as the assigned risk market, she said. Ms. Robinson added that about 20 percent of the clients leave their PEOs or employee leasing companies each year. She said that the NCCI is continuing to refine the data it has collected on the PEO and employee leasing environment. Ms. Robinson said that multiple coordinated policies have been obtaining the needed experience rating data, but master policies usually do not usually provide the needed data to follow the experience of clients.

Dec. 5, 2000, Meeting in Boston, Massachusetts

A draft Report on Employee Leasing was presented to the working group members by Bob Card (NAIC). Mr. Card explained that this was a very rough draft of several sections of the planned report, and that not all sections had been drafted yet. Eric Cioppa (NAIC co-chair—ME) reminded those present that the working group wants the report to reflect a balanced approach on the PEO and employee leasing issues identified.

Mr. Cioppa said that what was bothering him about the report at this time was the lack of comparable statistics on PEOs and employee leasing companies from the various organizations associated with it. He noted that NCCI statistics on this subject often did not match with those of the PEO associations.
June 11, 2001, Meeting in New Orleans, Louisiana

Dr. Gregory Krohm (IAIABC co-chair—WI) discussed the draft survey he had composed to send to both insurance departments and workers’ compensation administrators to gain a better understanding of their attitudes regarding PEOs and employee leasing companies. The survey includes a scale of 1 through 5 for ranking in importance various employee leasing environment issues.

Mr. Bill Wempe (NAIC—KS) suggested that the report should include a remark about a problem identified in Kansas with PEOs that involves the late notification—or lack of notification—to their clients whenever the PEO receives important policy information from the insurance company. This is especially a problem, Mr. Wempe said, when the PEO discontinues coverage with an insurance company.

Mr. Wempe also asked the working group if it wanted to make specific recommendations in the report or just provide information about the PEO and employee leasing company environment, thus leaving flexibility to the states. Mr. Bob Wake (NAIC—ME) replied that this is one of the primary unresolved issues to complete the report. Another primary issue, Mr. Wake added, is what to say regarding proposed revisions to the 1991 NAIC employee leasing models.

Oct. 9, 2001, Meeting in Portland, Maine

Dr. Krohm explained that the survey results from both the NAIC and IAIABC were incorporated in a newly written section of the draft report titled “Synthesis of Survey Findings” (Appendix D). The draft survey was identically designed for submission simultaneously to members of both the NAIC and IAIABC for comparison of responses. He added the survey results confirmed that there is a high degree of similarity in responses between the two organizations regarding PEOs and employee leasing companies. Dr. Krohm said that four-fifths of the respondents thought PEOs and employee leasing companies were either moderately or very important. This helps confirm, he said, that the report being completed by the working group is needed by those who are involved with workers’ compensation regulation.

Dr. Krohm pointed out that differences in responses between NAIC and IAIABC members were greatest when questions involved their particular expertise. For example, Dr. Krohm said that IAIABC members were relatively less familiar with rating issues than insurance department respondents and, likewise, the insurance department respondents were relatively less familiar with issues regarding identification of parties for proper adjustment of claims.

Mr. Wickman responded that comprehensive data on employee leasing is elusive as, for example, the working group is not clear on how many PEOs and employee leasing companies currently exist. Bob Aurbach (IAIABC—NM) suggested that better information is needed on PEO and employee leasing company state licensing and regulation requirements. Mr. Wake added that regulatory information on these entities is difficult to sort, since it may be spread between the insurance, Department of Labor, and workers’ compensation state codes.

The working group discussed the proposed Regulatory Options and Conclusion sections. Mr. Card, who originally drafted these proposed sections, explained that this was just a first attempt to wrap up the draft report and was open to other suggestions and drafts on these final sections. He further explained that the proposed sections were intended to bring together the concepts currently expressed in the draft report and the concerns and solutions expressed the past few months by working group members regarding the employee leasing environment. Mr. Wickman said that he believed the Experience Rating section he had
provided in the Oct. 2, 2001, draft report conflicted with what Mr. Card was saying in the proposed Regulatory Options and Conclusion sections.

It was proposed that a Drafting Subgroup be formed to complete the report. The Drafting Subgroup would cut and paste to change the order of sections and subsections when needed, as well as recompose, remove or write new sections and subsections if believed necessary. The following members were named to be on the Drafting Subgroup: Mr. Aurbach, Mr. Card, Mr. Cioppa, Mr. Krohm, and Mr. Wake.

Dec. 9, 2001, Meeting in Chicago, Illinois

Dr. Krohm said that he appreciated many aspects about the Dec. 5, 2001, draft report, with many sections primarily revised by Mr. Wake. Dr. Krohm noted that moving the Glossary and Synthesis of Survey Findings sections to the appendixes (Appendixes A and D, respectively) was a good idea. Dr. Krohm said he also appreciated the wordsmith efforts and the insights added in this latest revision. Mr. Wickman agreed with Dr. Krohm and added that a significant amount of redundancy has been eliminated from the draft report without removing anything of substance.

The working group agreed that it was in favor of the term “employee outsourcing” being used throughout the draft report in lieu of the terms PEO and employee leasing. It was agreed, however, that at frequent times in the report it would be important to use the terms PEO and employee leasing in lieu of the more general term “employee outsourcing.”

Listed at the end of the draft Conclusion section were various “important public policy questions.” Mr. Wake, who developed these public policy questions, explained that they were for consideration by the working group in completing the draft report. Mr. Wickman expressed satisfaction with the idea of listing public policy questions in either the Regulatory Options or Conclusion section of the final report. Dr. Krohm urged that Mr. Wake’s list of public policy questions in the report should be followed by a call for clear and unambiguous answers from policymakers in each state, whether in the form of statutes, rules, or agency procedures.

While a number of employee outsourcing issues are much in need of legislative or regulatory controls, Mr. Wake said, he now is more appreciative of the problems to be faced in revising the NAIC models. Any such revision is unlikely to be feasible, he added, especially in the area of substantive workers’ compensation laws where there are significant differences from state to state in both the legal framework and the benefit systems. Mr. Wake said he, therefore, feels that going for model revision now would be too much of a burden on the working group and that IAIABC also does not seem ready to bring such revised models to its membership.

Dr. Krohm expressed no objection to the NAIC separately pursuing revision to the models after adoption of the draft report. Mr. Krohm suggested that with the completed report the facts will speak for themselves, which might encourage model change through the NAIC.

Mr. Wake and Mr. Wickman, after further discussion on their draft Conclusion sections, agreed to work together in the next few weeks to better amalgamate their ideas and complete a Conclusion section for the draft report.
Both Mr. Cioppa and Dr. Krohm felt the draft report was very close to completion. With the body of the report finding general acceptance by the working group and with the revision of the Conclusion section in the next few weeks by two of our members, we have just about accomplished this, Dr. Krohm said. Both co-chairs acknowledged that the next step was to release for public comment the draft report—as currently completed—to obtain interested party comments before finalizing the draft for consideration of adoption by the working group.

Feb. 23, 2002, Meeting in Las Vegas, Nevada

The Dec. 20, 2001-A draft report was discussed. The draft report had been prepared to give an appearance of completeness in anticipation of presenting for comment to the parent committees, the IAIABC Executive Committee and the NAIC Workers’ Compensation (C) Task Force, subject to the working group’s approval to do so.

It was expressed at the meeting that although the draft report was about ready for release to the parent committees—and also interested parties—for comment, it was believed the report would take some additional work in various areas prior to its release. The purpose in now releasing the current draft was to receive further comments on it before later completing the report for requesting adoption by the parent committees. The working group then discussed the following areas of the draft report in need of further consideration:

- Changing the reference for “employee outsourcing” to the better accepted term as provided by the American Staffing Association of “employment services outsourcing” (Appendix F).
- Including some recent comments from the NCCI regarding the need to back up employee leasing regulation with “enforcement.”
- Discussing more fully reporting and recordkeeping and the associated costs of implementation and maintenance.
- Updating the factual material presented in the draft report.
- Updating the NAIC 1991 models on employee leasing.
- Procedural matters regarding the adoption of a completed report by the NAIC and IAIABC.

Upon discussing these matters, the working group decided to change the catchall word “employee outsourcing” to “employment services outsourcing” throughout the report, incorporate the NCCI suggestion pertaining to “enforcement,” elaborate more fully regarding reporting and recordkeeping, and seek to update the factual materials presented.

The Drafting Subgroup was tasked with preparing a newly revised draft report with the agreed-upon changes. Dr. Krohm remarked that he planned to present this revision for comment to the IAIABC Executive Committee and Mr. Card remarked that the revision would be presented to the Workers’ Compensation (C) Task Force for comment during the NAIC 2002 Spring National Meeting. It was also agreed at this meeting that in presenting for comment the draft report to the Workers’ Compensation (C) Task Force, mention would be made that the working group perceived a need to consider revising or withdrawing the NAIC 1991 employee leasing models, due to the changes that have occurred since the models were first adopted by the NAIC.

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It was announced that a June 1, 2002, news release from the IAIABC Executive Committee had endorsed the draft report as an important new study. It was explained that the IAIABC endorsement was based on a February 2002 version of the report, with the understanding there could be some minor modifications since the working group had not yet adopted the draft report and it had not yet gone through the NAIC adoption process.

The working group considered a proposed change to the experience rating subsection, but decided not to alter its language. A motion was made and unanimously carried to adopt the June 5, 2002, draft of the Report on Employee Leasing and Professional Employer Organizations. The June 5 draft report was adopted with amendment to add brief definitions for master policy and multiple coordinated policy where these terms are first introduced into the report. This suggestion was made so that the reader would not have to consult the glossary in the appendixes to understand these important terms.

On June 10, 2002, the NAIC Workers’ Compensation (C) Task Force adopted the report, as amended through the working group meeting two days earlier. Additionally, the task force created an NAIC focus group to consider how best to deal with the NAIC 1991 employee leasing models, since many regulators considered these models in need of revision in light of the report findings.
EMPLOYEE LEASING COMPANY AND
PROFESSIONAL EMPLOYER ORGANIZATION QUESTIONS
DIRECTED TO NAPEO AND NCCI
March 9, 2000

Cecilia Renn (National Association of Professional Employer Organizations—NAPEO) and Terri Robinson (National Council on Compensation Insurance—NCCI) responded to questions drafted by the working group regarding employee leasing companies and professional employer organizations. Alan Wickman (NAIC, NE) moderated the discussion on the following working group questions.

Question 1

The name employee leasing company and professional employer organization have been used synonymously. Please explain the differences between these terms and explain whether your organization believes both terms are still applicable.

Responses to Question 1

Ms. Renn suggested the term professional employer organization be utilized in lieu of the term employee leasing company. Ms. Renn explained that employee leasing company is an older term that has been generally replaced by professional employer organization to avoid confusion with temporary employee leasing arrangements. Ms. Renn acknowledged that state statutes might refer to either term, but that the preferred term today is professional employer organization. Ms. Robinson generally agreed with this assessment and noted that the two terms are generally used interchangeably today.

Question 2A

Please discuss any data or information you have that would indicate how many employers have in the past—and are currently—avoiding an unfavorable experience rating modification by being associated with a PEO.

Responses to Question 2A

Ms. Robinson acknowledged that some employers have been known to avoid an unfavorable workers’ compensation experience rating modification by being associated with a PEO. Ms. Robinson said the size of such abuse was not fully understood. Ms. Renn concurred by mentioning that she knew of some highly publicized cases of this kind, but believed such incidents were not common. Ms. Renn pointed out that as with other businesses, PEOs have a few unscrupulous operators. Ms. Renn stated the NAPEO would not endorse such PEOs and works with states to stop insurance fraud. Tim Bouchard (NAPEO) added that PEOs would likely shy away from a client with a high experience modification, since the PEOs workers’ compensation premium is loss sensitive.

Question 2B

Explain what happens to an employer’s experience rating modification when the employer first joins the PEO, during the time the employer is associated with the PEO, and the period of time immediately after the employer leaves the PEO.
Responses to Question 2B

Ms. Renn responded that this question is best explained with a matrix, since the answer to the question varies by state. Ms. Renn provided a matrix that indicated state-by-state regulatory information regarding PEOs. Mr. Bouchard commented that with a master policy, the client experience rating information continues to be reported after it joins a PEO to become a part of the PEOs experience rating promulgation. When the employer leaves the PEO, the insurance company that wrote the PEOs workers’ compensation coverage tries to abstract the information needed to promulgate a new experience rating modification for that employer—assuming the employer would now qualify for experience rating. Mr. Bouchard explained that until a new experience rating modification is fully developed, the departing employer, who would qualify for experience rating, would receive a modification of 1.00 if it had been with the PEO for a sufficient length of time. Ms. Robinson commented that in several states the past experience of the employer does not follow them into the PEO arrangement. Ms. Renn said some small PEOs might not have the ability to abstract the needed information for NCCI to promulgate an experience modification for the employers that have joined it. Ms. Robinson explained that in such cases, the qualifying employer would ordinarily receive either the PEOs experience rating modification, or a 1.00 experience rating modification, immediately after leaving the PEO.

Question 2C

Who is responsible for providing the data to allow the NCCI to calculate the experience modifier for an employer that is leaving the PEO?

Responses to Question 2C

Ms. Robinson explained that insurance companies are responsible for reporting to NCCI the data needed to promulgate experience rating modifications. However, Ms. Robinson said that the insurance company must obtain this information through the PEO. Therefore the quality of the information depends on the PEO and the relationship the insurance company has with the PEO. Ms. Renn agreed that the insurance company is responsible for providing the data to the rating organization.

Question 3A

With regard to a PEO master policy, explain how it typically would differ from a standard workers’ compensation policy.

Responses to Question 3A

Ms. Renn explained that aside from certain endorsements, a master policy issued to a PEO in the voluntary insurance market is identical to a standard workers’ compensation policy.

Keith Bateman (Alliance) asked how many states require an additional named insured endorsement to be used with the master policy. Ms. Renn replied that she was not aware of any states requiring this endorsement for a client under a master policy. Ms. Renn did say that an alternative employers endorsement should be attached to the PEO policy to extend coverage to the client for any liability it may have for injuries to co-employees under the policy. Ms. Renn said the alternative employers’ endorsement contains a waiver of the insurance company’s right to subrogate against the client.
Tony Georges (NAIC, NJ) commented that New Jersey requires a separate policy for each client, naming both the PEO and client as a named insured under Item 1 of the policy information page. Another working group member commented that the insurance industry is having a difficult time gathering accurate data on clients since some states prohibit the collection of separate data on clients under a master policy.

Ms. Renn said PEOs do need to keep administrative costs down to operate with the current level of services they offer clients. Ms. Renn expressed concern that requiring the issuance of separate policies for each voluntary market client (as required for residual market PEO arrangements via multiple coordinated policies) would add unacceptable costs into the PEO arrangement and would greatly curtail the PEOs advantages. Mr. Georges responded that although he agreed overhead is reduced for PEOs by allowing them to issue a master policy, he suggested that the individual policy concept as used in New Jersey would address many of the issues raised by the working group.

**Question 3B**

In regard to an employee leasing organization, explain how any of the answers provided in response to Question 3A would differ.

**Responses to Question 3B**

Essentially the policies are the same (both based off the standard workers’ compensation policy), although it was noted that individual employer policies are the rule for employee leasing companies.

**Question 3C**

Explain how states are handling proof-of-coverage issues when specified employees, who remain employed by the employer, are deleted from the employers workers’ compensation coverage provided through a PEO.

**Responses to Question 3C**

Ms. Renn explained that specific reporting requirements for new and terminated PEO client employees vary by state. Ms. Robinson said NCCI reports the proof-of-coverage information to the states as they have received it from the insurance companies and that this information is usually incomplete for proof-of-coverage purposes regarding the PEOs clients. Ms. Robinson mentioned that Georgia recently passed a law that requires identifying new and terminated clients of a PEO. Ms. Robinson said the recent Georgia proof-of-coverage law seems to be providing the client information needed.

**Question 4**

Which states allow “co-ownership” of employees under workers’ compensation policies?

**Responses to Question 4**

Ms. Renn clarified that Question 4 should refer to “co-employment” in lieu of “co-ownership,” as PEOs are in a co-employment relationship with their clients. Ms. Renn explained the PEO does not acquire an ownership interest in the business of its client companies. Ms. Renn said both the PEO and its client exhibit strong employer characteristics in such an arrangement and therefore a number of states deem the PEO an employer and authorize it to secure coverage for its co-employees. Ms. Renn said twenty-two states now extend exclusive remedy to PEOs. Mr. Wickman asked Ms. Renn if any states do not consider the PEO in a
co-employment relationship. Ms. Renn acknowledged that four states do not consider the PEO in a co-employment relationship.

**Question 5**

Which states permit the adding of standard workers’ compensation market non-combinable entities on the same workers’ compensation policy?

**Responses to Question 5**

Ms. Renn replied she was not aware of any states that allow the addition of non-combinable entities on a single workers’ compensation policy. Ms. Renn added that the PEO arrangement is that of co-employment, not co-ownership, so this matter is not an issue.

**Question 6**

Provide an estimate of the time and costs involved in designing a database to track (a) employers and (b) employers & employees (where employees are allowed to be split between policies) covered by a PEO, regardless of the PEO changes made by the employer.

**Responses to Question 6**

Ms. Robinson replied that NCCI has not estimated the costs to produce and maintain a database system as described in this question. Ms. Robinson added that NCCI has not really looked into this, but speculated that insurance companies may have difficulties reporting the needed information for the suggested database. Ms. Robinson then mentioned that Georgia’s approach to collecting PEO client data may help solve this tracking problem, but would not necessarily resolve all the experience rating issues.

Ms. Renn said that the NAPEO supports the development of a platform that will support reporting within a master policy format. Ms. Renn explained that NAPEO has appointed a task force to work on developing an efficient and consistent reporting format.

Mr. Wickman said he believed it would be necessary to identify all of the elements so that costs can be identified to decide if such a database is realistic. Mr. Wickman suggested that the Workers’ Compensation Insurance Organization might be the place to obtain technical assistance on this concept. Mr. Wickman and Cliff Hall (Insurance Services Organization) agreed to look further into this possibility.

**Question 7**

Compare how PEOs would relate differently with the employer in the workers’ compensation residual marketplace.

**Response to Question 7**

Ms. Renn replied that most states require PEOs in the residual marketplace to obtain workers’ compensation coverage through multiple coordinated policies as described in the NAIC Employee Leasing Model Regulation.
CONTRIBUTING MATERIALS
February 13, 2002

Mr. Bob Card  
Senior Regulatory Specialist  
National Association of  
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2301 McGee Street, Suite 800  
Kansas City MO 64108-2662

RE: NAIC/IAIABC Joint Working Group—Report on Employee Leasing

Dear Bob:

I very much appreciate the opportunity to talk to you today about the draft report on employee leasing and PEOs prepared by the NAIC/IAIABC Joint Working Group.

As I mentioned, the American Staffing Association represents the U.S. temporary staffing industry. ASA has over 1400 members that operate an estimated 14,500 offices throughout the country, representing over 75 percent of the industry’s sales volume. Our members include the world’s largest staffing companies, including Adecco, Manpower and Kelly Services.

The glossary attached to the Dec. 20, 2001 draft report states, on p. 38, that “temporary staffing arrangements have long been distinguished from PEOs and traditional employee leasing companies” and therefore “are not considered outsourcing arrangements within the scope of this paper.” We agree with that assessment. We also agree with the statement on p. 13 regarding the need to pay careful attention to terminology in this area because of the potential for confusion. In that spirit, we ask that the Joint Working Group consider making a minor change in the term used to describe the arrangements that are the subject of the report.

In the introduction and throughout the draft, the term “employee outsourcing” is used to describe the arrangements that are the subject of the report. The term was chosen, according to the introduction, because employee leasing no longer accurately describes the subject matter and has in many areas been supplanted by other alternative arrangements, mainly PEOs.

ASA believes that the term “employee outsourcing,” as used in the report, has significant potential for confusion with regulators and policy makers. Our concern is that the term “employee outsourcing” connotes obtaining employees from an outside supplier of labor and therefore could be construed as applying to companies, such as temporary staffing companies, that supply workers to clients. Since employee leasing and PEO companies do not supply workers but instead provide employer services to workers already employed by the client, we think “employment services outsourcing,” as used on p. 32 of the draft, would be the better term to use.
Accordingly, we respectfully request that the Joint Working Group use “employment services outsourcing,” instead of “employee outsourcing,” as the general term to describe the arrangements covered by the report.

I have discussed this with Bill Schilling, general counsel of NAPEO, and with Cecilia Renn, Vice President, Government and Regulatory Affairs for ADP TotalSource and chair of the NAPEO task force on workers’ compensation. They have advised me that NAPEO would have no objection to our suggested modification.

I am grateful for your invitation to attend the next meeting of the Joint Working Group in Las Vegas on Feb. 23rd to make our proposal in person. I will make every effort to do so. But in the event that I am unable to attend, I hope that you will provide a copy of this letter to the members of the Working Group for their consideration.

Sincerely,

Edward A. Lenz
Senior Vice President, Public Affairs and General Counsel
American Staffing Association
277 South Washington Street, Suite 200
Alexandria, VA 22314-3646
Direct dial (703) 253-2035
elenz@staffingtoday.net

cc. Bill Schilling
Cecilia Renn
ASA Legislative Committee
EMPLOYER SERVICES ASSURANCE CORPORATION (ESAC)

ESAC Background

The Employer Services Assurance Corporation (ESAC) was established in 1995 and has become the nationally recognized entity for providing financial assurance and establishing responsibility standards and certification for the Professional Employer Organization industry. Through its independent certification and accreditation process plus ongoing monitoring, ESAC evaluates PEOs’ compliance with important ethical, financial, and operational requirements. Once approved for membership, an accredited professional employer organization must complete quarterly evaluations by ESAC to maintain their membership status.

What is a Professional Employer Organization (PEO)?

A Professional Employer Organization (PEO) provides an integrated, cost-effective solution to the management and administration of the human resources (HR) and employer risks of its clients, by contractually assuming substantial employer risks and responsibilities. By aggregating the workforces of multiple clients, the PEO can afford to deliver comprehensive human resource services through a professional staff to small to mid-sized companies in an affordable manner. As a co-employer of its client’s workforce, the PEO performs the technical aspects of HR and allows clients to offer broader based benefits to their employees that otherwise are only available in large corporations. Additional information on the PEO industry may be obtained from the National Association of Professional Employer Organizations (NAPEO).

ESAC’s Accredited Professional Employer Organization Brand Services Program

Through its Accredited Professional Employer Organization brand services program, ESAC monitors participating PEOs to ensure their adherence to industry standards and financially responsible practices. By electing to undergo ESAC examination, compliant PEOs who meet ESAC’s requirements for accreditation are able to advertise and conduct business under the Accredited Professional Employer Organization brand. Accordingly, ESAC’s Accredited Professional Employer Organization brand service program helps to maintain integrity, legal compliance and financial responsibility of participating PEOs and the PEO industry.

ESAC’s Client Assurance Program

ESAC’s Client Assurance Program provides clients of participating PEOs with verifiable assurance that the Certified PEO is meeting important industry standards and is financially responsible. ESAC members are continuously monitored for adherence to important financial, ethical and operational standards. ESAC provides clients of member companies with a Certificate of Membership demonstrating independent verification of the member’s performance of key employer responsibilities, as well as financial assurance of that performance. Financial assurance is provided through surety bonds held on behalf of each ESAC member by the Employer Services Trust, with a major national bank serving as Trustee. Clients of ESAC members also have the assurance of ongoing monitoring and verification of the member’s adherence to important industry standards. Compliance with these standards is reviewed by a Board of Directors of industry leaders and distinguished former regulators along with independent professional advisors. The assurances offered by this program for the PEO industry are similar to the assurances offered by the FDIC for the banking industry, the Security Investor Protection Corporation (SIPC) for the securities industry, and state insurance guaranty associations for the insurance industry. Upon the PEO client’s signature and receipt of a Certificate of Membership/Participation Agreement, the Client Assurance Program provides for
reimbursement of verified losses to clients, worksite employees, taxing authorities, and insurers in the unlikely event of a default by the member PEO in the payment of wages, taxes, employee benefit contributions, or insurance premiums.

Current Coverage Amount

Financial assurance is currently provided through individual $1 million surety bonds held by the Employer Services Trust on behalf of each ESAC member. A $3 million excess surety bond provides additional umbrella coverage for all participants in the Client Assurance Program. ESACs surety bonds are currently provided by Jason Jenkins, Assistant Vice President, ABD Insurance and Financial Services, Inc.

ESAC Member Requirements

To verify proper demonstration of ethical conduct, ESAC members undergo a certification process including:

- Continuous monitoring of critical elements of business conduct.
- Background investigations of owners and key managers with ongoing annual updates.

To demonstrate financial stability, ESAC members submit:

- Annual and quarterly financial statements to an independent “Big Five” accounting company for ongoing financial monitoring.
- Verification by an independent CPA of appropriate payment of taxes, benefit contributions and insurance premiums.
- Independent verification of adequate financial reserves for any loss-sensitive insurance plans.
- Independent verification of adequate amounts of errors and omissions, fidelity and liability insurance coverages.

ESAC members demonstrate continual operation as a regulatory-compliant service provider by:

- Submitting sales, marketing, contract, and service materials for independent legal review.
- Providing quarterly certification of compliance with operational standards and state and federal laws and being prepared to verify compliance through random onsite reviews.
## NCCI: PEO/EMPLOYEE LEASING ARRANGEMENTS—STATE BY STATE
### POLICY, REPORTING AND RATING REQUIREMENTS

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<table>
<thead>
<tr>
<th>States</th>
<th>Policy Requirements</th>
<th>Data Requirements</th>
<th>Experience Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>AL</td>
<td>NAIC EMPLOYEE LEASING MODEL REGULATION adopted in 18 states</td>
<td>AR, ME, MO, NM, SC and VT have existing statutes or regulation that mandate additional data requirements such as:</td>
<td>Separate Client Policies: Application and continued production of individual client modifications</td>
</tr>
<tr>
<td>AR</td>
<td>Voluntary: Master Policy or Separate Client Policies</td>
<td>• Registration/licensing</td>
<td>Master Policies: Application of PEO modification on master policy</td>
</tr>
<tr>
<td>IA</td>
<td>Residual Market: Separate Client Policies</td>
<td>• Maintenance of client data</td>
<td>For former clients of PEOs, application of individual client modification when separate client data is manually reported.</td>
</tr>
<tr>
<td>IN</td>
<td></td>
<td>• Reporting of client data or client list</td>
<td>For former clients, application of PEO modification for up to 3 years when separate client data is not manually reported.</td>
</tr>
<tr>
<td>KS</td>
<td></td>
<td>• Application of individual client experience</td>
<td>Exceptions:</td>
</tr>
<tr>
<td>LA</td>
<td></td>
<td></td>
<td>¹For former clients, NM requires separate client data. No application of PEO modification.</td>
</tr>
<tr>
<td>MD</td>
<td></td>
<td></td>
<td>²For former clients, CT &amp; DC apply PEO or client modification depending if master policy or separate client policies were issued.</td>
</tr>
<tr>
<td>ME</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>MO</td>
<td>*NAIC model regulation was not adopted in CT &amp; DC; however policies are issued similarly in the voluntary and residual markets.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>MS</td>
<td></td>
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<tr>
<td>NC</td>
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<td></td>
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<tr>
<td>NH</td>
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<tr>
<td>NM¹</td>
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<td>RI</td>
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<td>SC</td>
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<td>SD</td>
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<td>TN</td>
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<tr>
<td>VT</td>
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<td></td>
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<tr>
<td>CT*²</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>DC*²</td>
<td></td>
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<td></td>
</tr>
</tbody>
</table>

As of 2/06/01
**States** | **Policy Requirements** | **Data Requirements** | **Experience Rating**
---|---|---|---
AZ | Voluntary and Residual Market: Separate client policies | Report client data and/or client policy information separately or on scheduled basis. | Production and application of individual client modifications |
MA | | | |
MT* | *MT, OR, UT allow a master policy if individual client data is reported for the application of separate modifications on the master policy. | | |
NJ | | | |
NY | | | |
NV | | | |
OR* | | | |
UT* | | | |
FL3 | Master policies | These states except for MI have existing statutes or regulation that mandates additional data requirements on PEOs such as: • Registration/licensing • Maintenance of client data • Reporting of client data • Reporting of client list | Master Policies: Application of PEO modification on master policy Exceptions: 1In KY, the application of individual client experience ratings is required on the master policy. 2In IL, individual client experience ratings is applied when they are 50% higher than PEO modification. 3For former clients, FL, IL, KY, and VA require the reporting of separate client data and continuance of individual experience ratings. |
GA | | | |
IL2,3 | | | |
KY1,3 | | | |
MI | | | |
VA3# | *In VA master policies are allowed in voluntary market only. | | |
### NCCI: PEO/EMPLOYEE LEASING ARRANGEMENTS—STATE BY STATE POLICY, REPORTING AND RATING REQUIREMENTS

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<table>
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<tr>
<th>States</th>
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<th>Data Requirements</th>
<th>Experience Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>CA</td>
<td>Client policies required if client is rated or 50% or more lease workers previously on clients’ payroll.</td>
<td>Report separate data for rated clients</td>
<td>Separate client mods will continue to be produced. Application of each client modification and ARD are required.</td>
</tr>
<tr>
<td></td>
<td>Master policy is written for non-rated risks</td>
<td></td>
<td></td>
</tr>
<tr>
<td>TX</td>
<td>Client policies or PEO policies. Policies, application of client modification required for first 2 years.</td>
<td>Regulation require: - Licensing - Reporting of client data and list</td>
<td>Apply client experience modification for 2 years on PEO policy</td>
</tr>
</tbody>
</table>

- 6 NCCI states presently do not have employee leasing rules: AK, CO, HI, ID, NE and OK
- AK C&R committee will be discussing leasing issues in it’s next meeting
- ID present statute section 72-103 indicates that the PEO has an option to secure coverage
- NE DOI and DOL are presently reviewing case law and various state approaches
- WA Administrative Code Chapter 296-17 requires the combination of employee leasing company and client experience for a single experience factor to be shared
- MN presently has preceding case law that deems the client company to be the employer
- PA Bureau indicated that client experience transfers to PEO
<table>
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<tr>
<th>State</th>
<th>Limitations on Carrier's ability to write PEO on master policy basis (Voluntary Market)</th>
<th>State has adopted NAIC Model Employee Leasing Regulation Or Similar; NCCI Item B-1276</th>
<th>Duty to provide coverage for statutory &amp; non-leased exposures (NAIC reg: client duty)</th>
<th>Treatment of WC data and experience</th>
<th>Treatment of incoming client experience For policy purposes</th>
<th>Methodology for calculation of mod when client terminates PEO relationship</th>
<th>Licensure, certification or Registration Required</th>
<th>Financial reporting requirement</th>
<th>Certification of Workers Compensation Reserves where PEO retains risk (deductible or assessable plans)</th>
<th>Methodology</th>
<th>Other Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alabama</td>
<td>PEO can maintain policy Common law basis</td>
<td>Yes</td>
<td>Client</td>
<td>Rules allow PEO to report data to carrier on an aggregated basis (but many carriers require PEO to report data grouped by client) Rating organization annually determines mod applicable to PEO based upon losses incurred under appropriate policy years</td>
<td>The experience mod of the party purchasing coverage (the PEO) applies to premium developed under policy. Although the client mod is not applied to the PEOs policy, it remains an important consideration for the PEO because the PEO must protect its own experience in order to remain profitable. PEO performs due diligence to evaluate claims history &amp; safety practices and to ensure compliance with the carrier’s underwriting guidelines.</td>
<td>If carrier extracts &amp; reports client data from PEO policy, the NCCI will develop an experience mod utilizing the reported data. If carrier does not report data, the mod of the PEO will be applied to the client policy until a mod is established for the client (up to three years). [referred to hereinafter as “PEO mod model”]</td>
<td>No</td>
<td>No</td>
<td>Homebuilders advanced PEO registration legislation in 2001 session; committee did not agenda bill</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Alaska</td>
<td>PEO can maintain wc policy Common law basis</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Arizona</td>
<td>Individual client policies on MCP basis; (in name of PEO) Carrier may apply volume discount</td>
<td>State Specific Regulations</td>
<td>Client</td>
<td>Insurer continues to apply client modification</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td></td>
</tr>
</tbody>
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<th>Methodology</th>
<th>Other Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>California</td>
<td>Mixed</td>
<td>State Specific Regulations</td>
<td>Client</td>
<td>State has adopted NAIC Employee Leasing Regulation Or Similar; NCCI Item B-1276</td>
<td>Client</td>
<td>Experience mod of party purchasing coverage applies to premium developed under policy</td>
<td>If segregated client data is not available, client will be assigned a unity mod of 1.0 &quot;Unity Model&quot;</td>
<td>Yes Colorado Rev. Stat. Sec.8-70-114</td>
<td>Yes Colorado Rev. Stat. Sec.8-70-114</td>
<td>Yes Colorado Rev. Stat. Sec.8-70-114</td>
<td>Yes Colorado Rev. Stat. Sec.8-70-114</td>
</tr>
<tr>
<td>Colorado</td>
<td>By statute, PEO can maintain WC policy</td>
<td>No</td>
<td>Client</td>
<td>Rules allow PEO to report data to carrier on an aggregated basis (but many carriers require PEO to report data grouped by client)</td>
<td>Experience mod of party purchasing coverage applies to premium developed under policy</td>
<td>unity model</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Connecticut</td>
<td>PEO can maintain WC policy on MCP basis (client level policies coordinated under PEO policy)</td>
<td>Old NCCI rules B-1275 and B-8010</td>
<td>Client</td>
<td>Rules allow PEO to report data to carrier on an aggregated basis (but many carriers require PEO to report data grouped by client)</td>
<td>Experience mod of party purchasing coverage applies to premium developed under policy</td>
<td>Unity Model</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Client must maintain POC where co-employees are covered under PEOs policy</td>
</tr>
<tr>
<td>Delaware</td>
<td>PEO can maintain WC policy</td>
<td>No</td>
<td>Rules allow PEO to report data to carrier on an aggregated basis (but many carriers require PEO to report data grouped by client)</td>
<td>Experience mod of party purchasing coverage applies to premium developed under policy</td>
<td>Unity Model</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td></td>
<td></td>
</tr>
<tr>
<td>District of Columbia</td>
<td>PEO can maintain WC policy</td>
<td>Old NCCI rules B-1275 and B-8010</td>
<td>Rules allow PEO to report data to carrier on an aggregated basis (but many carriers require PEO to report data grouped by client)</td>
<td>Experience mod of party purchasing coverage applies to premium developed under policy</td>
<td>Unity Model</td>
<td>No</td>
<td>No</td>
<td>No</td>
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</tbody>
</table>
### National Association of Professional Employer Organizations (NAPEO)

**PEO/Employee Leasing Arrangements—State by State—As of 12/01/01**

<table>
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<tr>
<th>State</th>
<th>Limitations on Carrier's ability to write PEO on master policy basis (Voluntary Market)</th>
<th>State has adopted NAIC Model Employee Leasing Regulation Or Similar; NCCI Item B-1276</th>
<th>Duty to provide coverage for statutory &amp; non-leased exposures (NAIC reg: client duty)</th>
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<th>Licensure, certification or Registration Required</th>
<th>Financial reporting requirement</th>
<th>Certification of Workers Compensation Reserves where PEO retains risk (deductible or assessable plans)</th>
<th>Methodology</th>
<th>Other Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Florida</td>
<td>By statute, PEO can maintain WC policy (but see reporting requirements)</td>
<td>State Specific Regulations (Some elements are similar to model reg)</td>
<td>Client obligated by statute to secure non-leased exposures</td>
<td>PEO must maintain &amp; furnish to carrier on annual basis data grouped by client sufficient to allow calculation of mod if client terminates</td>
<td>Experience mod of party purchasing coverage applies to premium developed under policy</td>
<td>Mod is promulgated based on segregated data</td>
<td>Experience remains with PEO but is used to promulgate mod when client terminates</td>
<td>F.S. 468.529, et seq.</td>
<td>Audited financial Statement; Net worth requirement</td>
<td>Yes</td>
<td>FAC 61G7-10.0012, NCCI development factors, factors produced by carrier, or actuarial review</td>
</tr>
<tr>
<td>Georgia</td>
<td>By statute, PEO can maintain WC policy</td>
<td>No</td>
<td>Client</td>
<td>Rules allow PEO to report data to carrier on an aggregated basis (but many carriers require PEO to report data grouped by client)</td>
<td>Experience mod of party purchasing coverage applies to premium developed under policy</td>
<td>Unity Model</td>
<td>OCGA 34-8-155 &amp; 34-7-6</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hawaii</td>
<td>PEO can maintain WC policy</td>
<td>No</td>
<td>Common law basis</td>
<td>Rules allow PEO to report data to carrier on an aggregated basis (but many carriers require PEO to report data grouped by client)</td>
<td>Experience mod of party purchasing coverage applies to premium developed under policy</td>
<td>Unity Model</td>
<td>No</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Idaho</td>
<td>By statute, PEO can maintain WC policy</td>
<td>State Specific Regulations</td>
<td></td>
<td>Rules allow PEO to report data to carrier on an aggregated basis (but many carriers require PEO to report data grouped by client)</td>
<td>Experience mod of party purchasing coverage applies to premium developed under policy</td>
<td></td>
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</tr>
<tr>
<td>State</td>
<td>Limitations on Carrier's ability to write PEO on master policy basis (Voluntary Market)</td>
<td>State has adopted NAIC Model Employee Leasing Regulation Or Similar; NCCI Item B-1276</td>
<td>Duty to provide coverage for statutory &amp; non-leased exposures (NAIC reg: client duty)</td>
<td>Treatment of WC data and experience</td>
<td>Treatment of incoming client experience For policy purposes</td>
<td>Methodology for calculation of mod when client terminates PEO relationship</td>
<td>Licensure, certification or Registration Required</td>
<td>Financial reporting requirement</td>
<td>Certification of Workers Compensation Reserve where PEO retains risk (deductible or assessable plans)</td>
<td>Other Comments</td>
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</tr>
<tr>
<td>Illinois</td>
<td>By statute, PEO can maintain WC policy but see mod requirements</td>
<td>State Specific Regulations</td>
<td>PEO must maintain data sufficient to allow rating org to calculate mod for client if client terminates</td>
<td>Must use client mod To determine premium where client mod exceeds PEO mod by 50% first two years of leasing relationship; otherwise, PEO mod applies to premium developed under the policy</td>
<td>Client is assigned its pre-PEO mod PEO must furnish the mod (loss information) to terminating client within 30 days of client request</td>
<td>Yes 215 ILCS 113, et seq.</td>
<td>Yes</td>
<td>Yes</td>
<td>Methodology</td>
<td>Must maintain accounting &amp; employment records for 4 year</td>
<td></td>
</tr>
<tr>
<td>Indiana</td>
<td>PEO can maintain WC policy Common law basis (but stat recognizes PEO &amp; client for EX R)</td>
<td>Yes</td>
<td>Rules allow PEO to report data to carrier on an aggregated basis (but many carriers require PEO to report data grouped by client)</td>
<td>Experience mod of party purchasing coverage applies to premium developed under policy</td>
<td>PEO mod model</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>WC code extends exclusive remedy to both PEO and client per legislation (HB 3260) effective July 2001</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Iowa</td>
<td>PEO can maintain WC policy Common law basis Legislation pending</td>
<td>Yes</td>
<td>Rules allow PEO to report data to carrier on an aggregated basis (but many carriers require PEO to report data grouped by client)</td>
<td>Experience mod of party purchasing coverage applies to premium developed under policy</td>
<td>PEO mod model</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Recognition legislation pending</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kansas</td>
<td>No Master policy on Common law basis Legislation pending</td>
<td>Yes</td>
<td>Rules allow PEO to report data to carrier on an aggregated basis (but many carriers require PEO to report data grouped by client)</td>
<td>Experience mod of party purchasing coverage applies to premium developed under policy</td>
<td>PEO mod model</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Recognition legislation pending</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kentucky</td>
<td>By statute, PEO can maintain WC policy but see reporting restrictions</td>
<td>Yes</td>
<td>PEO must maintain data by client</td>
<td>Client mod must be applied to PEO policy</td>
<td>PEO mod must be revised upon client term; client experience transfers out</td>
<td>KRS sec. 342.615, et seq.</td>
<td>Yes</td>
<td>Yes</td>
<td>Methodology</td>
<td></td>
<td></td>
</tr>
<tr>
<td>State</td>
<td>Limitations on Carrier's ability to write PEO on master policy basis (Voluntary Market)</td>
<td>State has adopted NAIC Model Employee Leasing Regulation Or Similar; NCCI Item B-1276</td>
<td>Duty to provide coverage for statutory &amp; non-leased exposures (NAIC reg; client duty)</td>
<td>Treatment of WC data and experience</td>
<td>Treatment of incoming client experience For policy purposes</td>
<td>Methodology for calculation of mod when client terminates PEO relationship</td>
<td>Licensure, certification or Registration Required</td>
<td>Financial reporting requirement</td>
<td>Certification of Workers Compensation Reserves where PEO retains risk (deductible or assessable plans) or other requirement or methodology</td>
<td>Other Comments</td>
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<tr>
<td>Louisiana</td>
<td>By statute, PEO can maintain WC policy on MCP basis (client level policies coordinated under PEO policy)</td>
<td>PEO-specific rule</td>
<td></td>
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<td>(insert cite)</td>
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<tr>
<td>Maine</td>
<td>By statute, PEO can maintain WC policy</td>
<td>Yes</td>
<td>PEO must maintain data by client; PEO must maintain and furnish to carrier sufficient information to permit calculation of mod for each client</td>
<td></td>
<td>Client mod is applied to PEO policy for the first three years of the relationship</td>
<td>PEO mod model</td>
<td>32 M.R.S. sec 14051, et seq.</td>
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<tr>
<td>Maryland</td>
<td>PEO can maintain WC policy</td>
<td>Yes</td>
<td>Rules allow PEO to report data to carrier on an aggregated basis (but many carriers require PEO to report data grouped by client)</td>
<td>Experience mod of party purchasing coverage applies to premium developed under policy</td>
<td>PEO mod model</td>
<td>No</td>
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<tr>
<td>Massachusetts</td>
<td>PEO can maintain WC policy on MCP basis (client level policies coordinated under PEO policy)</td>
<td>State Specific Regulations</td>
<td>PEO must maintain data by client to permit calculation of mod for the carrier</td>
<td>Experience of all leased employees applies to client company and resulting mod applies to PEO policy</td>
<td></td>
<td>Recognition legislation pending</td>
<td></td>
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<tr>
<td>Michigan</td>
<td>PEO can maintain WC policy</td>
<td>No</td>
<td>Client must maintain MPP (agency interpretation)</td>
<td>Experience mod of party purchasing coverage applies to premium developed under policy</td>
<td>No</td>
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<tr>
<td>Minnesota</td>
<td>By statute, PEO can be eligible to maintain WC policy</td>
<td>No</td>
<td>Rules allow PEO to report data to carrier on an aggregated basis (but many carriers require PEO to report data grouped by client)</td>
<td>Experience mod of party purchasing coverage applies to premium developed under policy</td>
<td>Unity Model VERIFY</td>
<td>Minn. Stat. Sec. 79.255 et seq.</td>
<td>Multiple agency task force is reviewing industry regulation</td>
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<tr>
<td>State</td>
<td>Limitations on Carrier's ability to write PEO on master policy basis (Voluntary Market)</td>
<td>State has adopted NAIC Model Employee Leasing Regulation Or Similar; NCCI Item B-1276</td>
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<tr>
<td>Mississippi</td>
<td>PEO can maintain wc policy Common law basis</td>
<td>Yes</td>
<td>Client</td>
<td>Rules allow PEO to report data to carrier on an aggregated basis (but many carriers require PEO to report data grouped by client)</td>
<td>Experience mod of party purchasing coverage applies to premium developed under policy</td>
<td>PEO mod model</td>
<td>No</td>
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<tr>
<td>Missouri</td>
<td>PEO can maintain wc policy Common law basis</td>
<td>Yes (Modified reporting)</td>
<td>PEO must maintain data by client</td>
<td>Experience mod of party purchasing coverage applies to premium developed under policy</td>
<td>PEO mod model</td>
<td>No</td>
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<tr>
<td>Montana</td>
<td>By statute, PEO can maintain wc policy See reporting requirements</td>
<td>State Specific Regulations</td>
<td>PEO must maintain data by client; Carrier must report data grouped by client to NCCI Mon. Stat. 39-8-403(2)</td>
<td>Carrier must utilize client mod to determine premium applicable to PEO Policy Mon. Stat. 39-8-403(1)</td>
<td>PEO must report maintain &amp; furnish to carrier “sufficient information to permit calculation of mod”</td>
<td>Mont. Code Sec. 39-8-101, et seq</td>
<td>Annual Audited Financial Statement</td>
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<tr>
<td>Nebraska</td>
<td>PEO can maintain wc policy Common law basis</td>
<td>No</td>
<td>Rules allow PEO to report data to carrier on an aggregated basis (but many carriers require PEO to report data grouped by client)</td>
<td>Experience mod of party purchasing coverage applies to premium developed under policy</td>
<td>Unity Model</td>
<td>No</td>
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<tr>
<td>Nevada</td>
<td>PEO can maintain wc policy on MCP basis (client level policies coordinated under PEO policy)</td>
<td>State Specific Regulations</td>
<td></td>
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<td>Insurer continues to apply client modification</td>
<td>Nev. Rev. Stat. Sec. 616B.670, et seq</td>
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<tr>
<td>New Hampshire</td>
<td>By statute, PEO can maintain wc policy</td>
<td>Yes</td>
<td>Client</td>
<td>Rules allow PEO to report data to carrier on an aggregated basis (but many carriers require PEO to report data grouped by client)</td>
<td>Experience mod of party purchasing coverage applies to premium developed under policy</td>
<td>PEO mod model</td>
<td>N.H. Rev. Stat. Sec. 277-8:1 et seq</td>
<td>Audited Financial Statement</td>
<td></td>
<td>Must notify DOL of new, termed clients w/in 10 days</td>
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<tr>
<td>State</td>
<td>Limitations on Carrier's ability to write PEO on master policy basis (Voluntary Market)</td>
<td>State has adopted NAIC Model Employee Leasing Regulation Or Similar; NCCI Item B-1276</td>
<td>Duty to provide coverage for statutory &amp; non-leased exposures (NAIC reg: client duty)</td>
<td>Treatment of WC data and experience</td>
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<td>New Jersey</td>
<td>By statute, PEO can maintain wc policy (effective 1/1/02)</td>
<td>Yes</td>
<td>Client</td>
<td>PEO must maintain data grouped by client; Experience follows client</td>
<td>Client mod must be applied to Policy Client mod does not revert to the mod of PEO</td>
<td>Insurer continues to apply client modification</td>
<td>(insert cite)</td>
<td></td>
<td>Recognition legislation will be effective 2002</td>
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<tr>
<td>New Mexico</td>
<td>PEO can maintain wc policy but client must be &quot;co-insured&quot; on PEO policy</td>
<td>State Specific Regulations</td>
<td>PEO</td>
<td>PEO &amp; Carrier must maintain data grouped by client; Experience follows client</td>
<td>PEO mod must be revised to incorporate client mod</td>
<td>Mod is developed from data and applied to new policy</td>
<td>N.M. Stat Sec. 60-131-1, et seq.</td>
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<tr>
<td>New York</td>
<td>PEO can maintain wc policy on MCP basis (client level policies coordinated under PEO policy) Individual policies issued to clients in PEOs name</td>
<td>State Specific Regulations</td>
<td>May combine premium for discount purposes</td>
<td>Insurer continues to apply client modification</td>
<td>No</td>
<td>No</td>
<td>Recognition legislation pending; if enacted, PEO will deemed an employer for wc purposes</td>
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<tr>
<td>North Carolina</td>
<td>PEO can maintain wc policy Common law basis</td>
<td>Yes</td>
<td>Client</td>
<td>Rules allow PEO to report data to carrier on an aggregated basis (but many carriers require PEO to report data grouped by client)</td>
<td>Experience mod of party purchasing coverage applies to premium developed under policy</td>
<td>PEO mod model</td>
<td>No</td>
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<tr>
<td>North Dakota</td>
<td>Monopolistic state</td>
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<tr>
<td>Ohio</td>
<td>Monopolistic state; PEO can maintain policy</td>
<td>State Specific Regulations</td>
<td></td>
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<td>Must notify state of new &amp; termed clients</td>
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<tr>
<td>State</td>
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<td>Oklahoma</td>
<td>Rules allow PEO to report data to carrier on an aggregated basis (but many carriers require PEO to report data grouped by client)</td>
<td>Experience mod of party purchasing coverage applies to premium developed under policy</td>
<td>Unity model</td>
<td>VERIFY</td>
<td>No</td>
<td>Notify DWC of new &amp; termed clients; report client list</td>
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<tr>
<td>Oregon</td>
<td>Carrier must collect data necessary to establish client mod &amp; report on &quot;scheduled basis&quot; (multiple client data is reported via a single unit stat card)</td>
<td>Client mod applies to its leased and non-leased employees. PEOs mod only applies to its non leased workers</td>
<td>Mod must be developed based on experience of client</td>
<td>Yes Oregon Rev. Stat. Sec. 656.850, et seq.</td>
<td>Audited financial statement or current fiscal year end FS</td>
<td>Notify DWC of new &amp; termed clients; report client list</td>
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<tr>
<td>Pennsylvania</td>
<td>Rules allow PEO to report data to carrier on an aggregated basis (but many carriers require PEO to report data grouped by client)</td>
<td>Per rule adopted by PCRB (&quot;Rule M&quot;) experience of client &amp; PEO must be blended</td>
<td>No</td>
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<td>Rhode Island</td>
<td>Rules allow PEO to report data to carrier on an aggregated basis (but many carriers require PEO to report data grouped by client)</td>
<td>Experience mod of party purchasing coverage applies to premium developed under policy</td>
<td>PEO mod model</td>
<td>Yes Rhode Is. Gen. Code Sec. 44.30.71.4</td>
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<tr>
<td>South Carolina</td>
<td>Rules allow PEO to report data to carrier on an aggregated basis (but many carriers require PEO to report data grouped by client)</td>
<td>Experience mod of party purchasing coverage applies to premium developed under policy</td>
<td>PEO mod model</td>
<td>S.C. Code sec. 40-68-10 et seq.</td>
<td>Audited Financial statement</td>
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</tr>
</thead>
<tbody>
<tr>
<td>South Dakota</td>
<td>PEO can maintain wc policy Common law basis</td>
<td>Yes</td>
<td>Rules allow PEO to report data to carrier on an aggregated basis (but many carriers require PEO to report data grouped by client)</td>
<td>Experience mod of party purchasing coverage applies to premium developed under policy</td>
<td>PEO mod model</td>
<td>No</td>
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<tr>
<td>Tennessee</td>
<td>By statute, PEO can maintain wc policy</td>
<td>Yes</td>
<td>Rules allow PEO to report data to carrier on an aggregated basis (but many carriers require PEO to report data grouped by client)</td>
<td>Experience mod of party purchasing coverage applies to premium developed under policy</td>
<td>PEO mod model</td>
<td>Tenn. Code Ann. Sec. 62.43.101</td>
<td>Financial statement</td>
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<tr>
<td>Texas</td>
<td>By statute, PEO can maintain wc policy</td>
<td>State Specific Regulations</td>
<td>Separate unit stats must be submitted for the first two years client–PEO relationship. Client mod applies for the first two years PEO mod applies thereafter If the client was with PEO for more than two years, the lower of the client or the PEO mod applies, if less than two years, the higher mod applies</td>
<td>If the client was with PEO for more than two years, the lower of the client or the PEO mod applies, if less than two years, the higher mod applies</td>
<td>Texas Staff leasing Services Act Art. 9104, sec.91.001 et seq.</td>
<td>Audited Financial statement</td>
<td></td>
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<td>Must give ee’s wallet cards or bi-annual notice of PEO relationship on paycheck stub</td>
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<tr>
<td>Utah</td>
<td>PEO can maintain wc policy but Client must be listed as an additional insured</td>
<td>State Specific Regulations</td>
<td>Must collect data necessary to establish client mod &amp; report on “scheduled basis” Client mods must be applied to develop premium under policy Mod must be developed based on experience of client</td>
<td>Client mods must be applied to develop premium under policy</td>
<td>Utah Code Ann. Sec. 58-99-102</td>
<td>Audited Financial Statement</td>
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<td>Certificates must be filed with Industrial Commission</td>
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<tr>
<td>Vermont</td>
<td>By statute, PEO can maintain wc policy</td>
<td>Yes</td>
<td>Rules allow PEO to report data to carrier on an aggregated basis (but many carriers require PEO to report data grouped by client)</td>
<td>Experience mod of party purchasing coverage applies to premium developed under policy</td>
<td>PEO mod model</td>
<td>Vermont Stat. Ann. 12.1031 et seq.</td>
<td>Audited Financial Statement</td>
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<tr>
<td>Virginia</td>
<td>By statute, PEO can maintain WC policy</td>
<td>No</td>
<td>Client</td>
<td>PEO reports policy data to carrier on an aggregated basis (effective 1/1/2001)</td>
<td>Experience mod of party purchasing coverage applies to premium developed under policy</td>
<td>If client terms within three years, NCCI assigns client its pre-PEO mod; otherwise, NCCI assigns mod of PEO until client has developed sufficient experience for individual rating</td>
<td>Sec. 65.2-803, et.al. Code of Va (effective 1/1/2001)</td>
<td>No</td>
<td>No</td>
<td>PEO must report client companies to Commission on an annual basis</td>
</tr>
</tbody>
</table>
| Washington| Monopolistic state  
Client must apply for coverage                                                                                                                                                    | No                                                                               |                                                                                  |                                                                                  |                                                                                  |                                                                                  | No                                                                                     | No                                                                                     |                                                                                       |
| West Virginia | Monopolistic state  
Yes                                                                                                                                                                                                                                         | No                                                                               |                                                                                  |                                                                                  |                                                                                  |                                                                                  | No                                                                                     | No                                                                                     | PEO must notify of new & termed clients |
| Wisconsin | PEO can maintain WC policy  
Common law basis                                                                                                                                                                                                                | No                                                                               |                                                                                  | Rules allow PEO to report data to carrier on an aggregated basis (but many carriers require PEO to report data grouped by client) | Experience mod of party purchasing coverage applies to premium developed under policy | Unity Model                                                                                                                               | No                                                                                     | No                                                                                     |                               |
| Wyoming   | Monopolistic state  
Client must apply for coverage                                                                                                                                                    | No                                                                               |                                                                                  |                                                                                  |                                                                                  |                                                                                  | No                                                                                     | No                                                                                     |                                                                                       |