

**GUIDELINES FOR REGULATIONS AND LEGISLATION  
ON WORKERS' COMPENSATION COVERAGE FOR  
PROFESSIONAL EMPLOYER ORGANIZATION ARRANGEMENTS**

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Appendix A: The NAIC PEO Guidelines

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## Executive Summary

This Implementation Commentary is designed to assist states, PEOs, and the insurance industry to implement a regulatory framework consistent with the *Guidelines for Regulations and Legislation on Workers' Compensation Coverage for Professional Employer Organization Arrangements* (#1950) adopted by the NAIC in 2007, which are attached as Appendix A. The Commentary provides a framework for considering the Guidelines and provides additional information concerning:

- The historical background of the Guidelines, including an overview of professional employer organization (PEO) arrangements;
- Differences between the Guidelines and earlier regulatory approaches;
- Statutory and structural considerations for implementation; and
- Key issues that might be essential for successful implementation.

The PEO business model for employment services outsourcing has continued to expand nationwide.<sup>1</sup> While employment services outsourcing and the concept of co-employment involve a number of issues for the states, one significant issue is how state workers' compensation systems adapt to address the requirements of this method of doing business. Presently, there is a broad disparity among the states as to how these and other types of outsourcing arrangements are regulated. The existing statutory frameworks in some states might not directly or adequately address issues related to workers' compensation, while other states are devoid of any significant statutory provisions.

The Guidelines are designed to provide the states with a possible regulatory framework for addressing the most significant workers' compensation issues that have arisen to date in PEO relationships, with an emphasis on a clear allocation of the respective rights and responsibilities of PEOs, clients, and insurers. In some cases, the Guidelines seek to clarify or codify current best practices, while in others, they mandate some significant changes from the status quo. The purpose of this commentary is to provide additional insight from the working group that developed the Guidelines.

### I. Historical Background of the Guidelines

The Guidelines are the culmination of more than 18 years of experience, effort, and deliberation by the NAIC, with input from the International Association of Industrial Accident Boards and Commissions (IAIABC). The Guidelines, as adopted in 2007, are the successor to a model statute and regulation, of far more limited scope, adopted by the NAIC in 1991. The Guidelines draw heavily upon the 2002 *Report on Employee Leasing and Professional Employer Organizations* produced by the NAIC/IAIABC Joint (C) Working Group, on input from that Joint Working Group, and on more than three years of deliberation and work by the NAIC Professional Employer Organization Model Law (C) Working Group of the NAIC Workers' Compensation (C) Task Force.

This historical overview is designed to provide a context for those who are seeking to use the Guidelines as a basis for statutory and regulatory actions. While the Guidelines pertain only to the issue of workers' compensation in PEO situations, an understanding of the broader context of the evolution of PEOs and of these Guidelines should assist those using them.

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<sup>1</sup> The National Association of Professional Employer Organizations (NAPEO) estimates that the PEO industry has grown to \$68 billion in gross revenues in 2008. One source for information about the PEO industry is the NAPEO Web site, [www.napeo.org](http://www.napeo.org).

## **A. Origins of the PEO Industry and the Initial Regulatory Responses**

The PEO industry began its evolution in the 1970s as the employee leasing industry. Initially, it involved a client terminating its entire workforce, a leasing company employing that workforce, and then the leasing company providing that same workforce back to the client as leased employees. The idea was for the leasing company to be “the employer” or general employer of the workers, who would be working for the client company as “borrowed servants.” Unlike traditional staffing entities that would provide additional temporary workers to a client for specific needs, such as seasonal work or filling in for absences, and then reassign those workers to another client when the need was over, this new concept involved entire workforces on a long-term basis.

The concept was designed to allow the client to focus on the core business of its enterprise and to leave the employment-related issues to the leasing company, which could save costs through economies and efficiencies of scale usually only available to larger enterprises. The leasing company maintained that, as the employer of the leased workers, it was both able to and required to secure workers’ compensation for the worksite employees leased to a client. However, the concept was also susceptible to abuse. As the 2002 NAIC/IAIABC report stated:

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.

In particular, a widespread abuse observed by regulators was the use of employee leasing arrangements for “mod laundering” — that is, the employee leasing company would claim that, as a brand-new employer, its workers’ compensation premium should not be affected by the accident experience of its clients before they had joined the employee leasing arrangement. The opaque, poorly documented nature of some employee leasing arrangements also fostered “shell games,” in which workers and worksites fell into gaps where neither the client nor the leasing company was paying the premium for the exposure. Occasionally, the leasing company simply charged its clients for insurance it never bought.

Over time, it was generally agreed that “employee leasing” was a misnomer for what factually transpired in the service relationship. From the employees’ perspective, their boss was still the client, which continued essentially the same employment relationship with the employees as before. On the other hand, most states recognized that the service firm did also enter into an employment relationship with the employees. Thus, both businesses had employment duties, which were shared and allocated according to the terms of the service contract between the service firm and the client.

Because of these facts, the initial “fire and lease back” concept of employee leasing has largely been abandoned and replaced by the “co-employment” relationship used by today’s PEOs. Under this concept, employer responsibilities are shared or allocated between the client and the PEO by contract (and, in some states, by law). Most states now recognize both the PEO and the client as having employer responsibilities with regard to a worksite employee.

Nonetheless, the movement of workers' compensation responsibilities for these employees from client to a leasing company and back, or from leasing company to leasing company, had a major impact on the experience rating system.

Under traditional rating rules, a client customarily lost its experience factor because its entire workforce was absorbed into the leasing company's larger workforce and became insured under a master policy covering the leasing company. As noted earlier, this system allowed unscrupulous leasing companies to offer high-risk, high-experience-factor clients a lower premium by moving the workforce into a leasing company with a lower experience modifier, often a recently organized (or reorganized)<sup>2</sup> company with a "unity" modifier, meaning no adjustment for experience. Experience rating concerns were the principal focus of the 1991 NAIC model act and regulation, which mandated that:

1. Leasing companies must be registered with any state where they did business;
2. A leasing company must use a multiple coordinated policy arrangement in the residual market instead of a master policy; and
3. An insurer in a master policy arrangement must be able to generate the information necessary to establish an accurate experience factor for a client that left a leasing arrangement.

## **B. Development and Objectives of the Guidelines**

As the leasing industry grew and evolved into the PEO industry,<sup>3</sup> the initial NAIC models proved inadequate. Experience rating issues continued to be a problem and additional regulatory concerns were identified. As a result, a second study was undertaken by the NAIC/IAIABC Joint Working Group, the NAIC rescinded the 1991 models, and the present Guidelines were developed.

Several fundamental decisions were made by the Joint Working Group at the outset, which guided development of the Guidelines:

1. **Limited Scope** – While the Joint Working Group recognized that there are multiple state law and regulatory issues related to PEOs (including other insurance issues, such as health benefits), the Guidelines would be limited solely to the issues of workers' compensation.
2. **Multiple Options** – The group recognized that there was significant variation across the states with regard to workers' compensation in PEO arrangements. Some states had adopted the initial NAIC models (or a variant of those models), some states required PEOs to use multiple coordinated policies in both the residual and voluntary markets,

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<sup>2</sup> Although the rating rules are designed to prevent employers from reorganizing with a clean slate whenever adverse experience develops, through provisions that combine the experience of predecessor and successor employers, the complexities in the employee leasing relationship and the structure of employee leasing companies as service providers (rather than "bricks and mortar" businesses) provided more opportunities for employee leasing companies and their clients to evade these rules by disguising continuity of operations.

<sup>3</sup> Over time, this type of arrangement has become known as a professional employer organization (PEO) co-employment arrangement, where both the PEO and the client have certain employer obligations.

and other states allowed master policy arrangements in the name of the PEO or leasing company. The Joint Working Group decided to provide guidance that could be adapted and used for any or all of these situations.

3. Voluntary vs. Residual Markets – The Joint Working Group, recognizing the peculiar responsibilities of the residual market, opted to maintain the requirement of a multiple coordinated policy or client-based policy in the residual market. Greater flexibility is allowed under the Guidelines for insurers and insureds in the voluntary market, as long as essential requirements for coverage, experience, and notice are met.
4. Implementation Commentary – Because of the complexity of the Guidelines, the need to address a number of issues legislatively, and the fact that the Guidelines address only the workers’ compensation aspects of PEO arrangements, it was decided to issue a companion paper to the Guidelines to give state insurance regulators and legislators additional context for implementation.

Significant changes occurred in the PEO industry and in state-based insurance regulation between the development of the first NAIC model rule and act in 1989–1991 and the efforts of the Professional Employer Organization Model Law (C) Working Group in 2003–2007. In 1991, only four states<sup>4</sup> had any kind of statutory scheme to regulate the PEO (then employee leasing) industry. By the NAIC adoption of the Guidelines in 2007, 32 states<sup>5</sup> had enacted some form of registration or licensing legislation for the industry. While some of these statutes are limited in scope, most of the more recent statutes are more comprehensive and provide significant legislative guidance as to the definition and treatment of the PEO industry. Some specifically address workers’ compensation issues and nearly all recognize a PEO as an employer for purposes of workers’ compensation.

As work on the Guidelines proceeded, the Working Group recognized the importance of looking, from the ground up, at the tripartite relationship among the PEO, the client, and the insurer, and carefully considering the contractual and financial obligations that each of them has toward each of the other two. As a result, the Guidelines have addressed several areas where the Working Group determined that existing laws and practices needed to be changed, or where vague situations needed to be clarified, including:

- A formal, documented obligation by the insurer to the client.
- Termination of one co-employer’s coverage does not automatically terminate the other co-employer’s coverage, especially when there has not been sufficient notice.
- Clear recognition of a payment structure under which the client’s obligation is to pay fees to the PEO and the PEO’s obligation is to pay premium to the insurer.
- Coverage issued through a PEO must cover the client’s full workforce, unless the client has other coverage that provides full “catch-all” protection for any employees who are not co-employed by the PEO.

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<sup>4</sup> Arkansas, Florida, Maine, and Utah.

<sup>5</sup> Alabama, Arizona, Arkansas, California, Colorado, Florida, Illinois, Indiana, Kentucky, Louisiana, Maine, Massachusetts, Minnesota, Montana, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oregon, Pennsylvania, Rhode Island, South Carolina, Tennessee, Texas, Utah, Vermont, Virginia, and West Virginia.

- Experience must be reported at the client level on an ongoing basis, not just when the client leaves the PEO.
- An experience modification factor will be calculated for all experience-rated clients, even in situations where the insurer and PEO choose to calculate premium on the basis of the PEO's experience.
- Disclosure requirements so that clients clearly understand their rights and responsibilities.

## **II. Some Legal Issues Relating to Implementation**

- **Existing Law**

One of the first issues for a state to consider, when seeking to use or implement the Guidelines, is to assess the status of current state law with regard to PEOs and employer status. The Guidelines are structured as a regulation, but state law must provide a proper statutory foundation in order to be able to adopt all or part of the Guidelines as a regulation. In many states, certain provisions contained in the Guidelines might be more cleanly adopted as statutes, while other states might have concerns about delegation of too much authority to an administrative agency. In addition, some provisions go beyond the traditional bounds of insurance regulation, such as the requirement for a PEO to provide clear and conspicuous written notice to clients if the PEO is not assuming responsibility for workers' compensation coverage. Although providing PEO services without workers' compensation coverage is not the norm, it is not an insurance transaction; it is the absence of an insurance transaction. Thus, unless the insurance regulator has already been given general regulatory authority over PEOs, or the Legislature has otherwise specifically addressed the issue, it would not ordinarily trigger the jurisdiction of the insurance regulator.

For these reasons, it is necessary for each state to analyze its individual situation to determine which provisions contained in the Guidelines are best addressed by directly making those changes to state law, and which provisions are best addressed through enabling language so that the state can adopt the Guidelines provisions through rulemaking.<sup>6</sup> It is important to consider these issues carefully, with due regard for possible unintended consequences. For example, some states, when implementing the 1991 recommendation to prohibit master policies in the residual market, phrased their laws in the form "a master policy shall be issued in the voluntary market," which would appear to prohibit the issuance of multiple coordinated policies in the voluntary market.

In states where "delegation of authority" issues are not substantial, one possible approach is to adopt broad enabling language, such as the following:

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<sup>6</sup> As the Drafting Note to Section 1 explains: "These guidelines are presented in the form of a regulation; however, some provisions may be more appropriately enacted as legislation in some states. Agencies promulgating regulations based upon these guidelines should ensure that statutes regulating PEOs or employee leasing arrangements, statutes regulating workers' compensation insurance, or other applicable law grant them adequate rulemaking authority. In states where another agency has regulatory jurisdiction over PEOs, the commissioner should consider jointly promulgating regulations with that agency. Agencies promulgating regulations or drafting legislation based upon these guidelines should also ensure that insurers, PEOs and regulators have adequate resources and infrastructure in place to make compliance feasible, including but not limited to the necessary information systems and the necessary reporting mechanisms for data and proof of coverage."

The Commissioner may adopt regulations establishing the terms and conditions governing the provision of workers' compensation insurance coverage for workers in a professional employer organization arrangement.

An informal survey of state insurance department counsel indicates that most states believe they would have the legal authority to take such an approach. However, some state constitutions or administrative procedure acts would require a more detailed delegation of authority, and states might also have public policy reasons for wanting to address some aspects of the Guidelines more explicitly by statute. There are also additional questions that each state must address:

- Is there an existing registration or licensing system that can be used for (or must be considered when adopting) the registration and reporting requirements?
- Are there existing definitions of PEOs or leasing companies that should or must be used, or that ought to be changed?
- How do existing statutes, regulations, and rating rules governing all employers apply to employers involved in "co-employment" relationships?
- Must statutory provisions be added or modified in order to allow for the Guidelines to be promulgated as a regulation or to make the regulatory approach effective?

The provisions for the exclusivity of the workers' compensation system for workplace injuries is a classic example of the last point, where changes in law might be needed and cannot be accomplished by regulation alone. Traditional statutes do not address employee leasing or PEOs from an exclusive remedy standpoint. Failure to address this by statute could lead to circumvention of the exclusive remedy and breed the types of litigation that workers' compensation was designed to prevent.

- **Key Issues Beyond the Scope of the Guidelines**

The Guidelines relate only to workers' compensation insurance issues. A state considering updating its regulation of PEOs through adoption of the Guidelines should consider whether or not it wishes to approach this area through a comprehensive statute addressing the regulation of the PEO industry, or a global effort to ensure that existing pieces of legislation are consistent with one another and gathering them into a single regulatory scheme, rather than piecemeal rulemaking addressing a limited set of issues against the background of existing law.<sup>7</sup> This is a policy decision that should be addressed with the state Legislature, and should depend in part on how recent and how thoroughly integrated the existing regulatory framework is.

As a part of this process, states should consider how well their existing laws address issues that were identified by the Working Group as being beyond the scope of the Guidelines. These include:

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<sup>7</sup> NAPEO, the largest trade association of the PEO industry, has actively promoted registration of PEOs and regulation of the industry. It has developed a model act that contains a comprehensive registration scheme, but its workers' compensation provisions are limited and address only a part of the Guidelines.

- Concerns raised by cross-ownership of insurers and PEOs.
- Whether adjustments need to be made in existing state law for taxes and assessments when large-deductible policies are issued to PEOs.
- Whether compulsory coverage laws and proof-of-coverage laws need to be amended to clarify the status of PEOs and their clients.
- Whether laws need to be amended to address the employee status and opt-out rights of the owners of client businesses when those owners become PEO co-employees (what one regulator has called the “auto-leasing” problem).

### **III. Specific Issues Related to the Guidelines**

Rather than presenting a detailed section-by-section analysis of the Guidelines, this paper focuses on the issues that the authors of the Guidelines identified and how the Guidelines need to be applied in addressing those issues.

#### **A. Statutory-Regulatory Framework for PEOs**

A PEO performs a wide range of employment-related services, some of which involve significant amounts of money. These services are relied on by its clients, by employees, by insurers, and by government agencies — and the impact can be devastating if a large PEO becomes insolvent, fails to meet its obligations, or buys insurance and pays taxes based on incorrect information. For these reasons, there is a broad consensus among all interests involved, including leading PEO representatives, that PEO services should be a regulated industry.

There is no consensus, however, as to what form this regulation should take. Should PEOs be licensed or should they be required only to register? Should there be financial requirements and supervision and, if so, what should the requirements be? Almost any regulatory option one could imagine has been used by at least one state.<sup>8</sup> As noted earlier, one of the first and most fundamental questions the Working Group addressed was whether to propose a regulatory framework for PEOs. As important as the issue is, the Working Group concluded that it was not the appropriate body to set comprehensive standards, as its jurisdiction and subject-matter expertise was limited to workers' compensation. The former NAIC model act, adopted in 1991, set up a limited-purpose registration process, requiring a PEO to be registered in order to be issued a master workers' compensation policy or be covered under multiple coordinated policies. However, there was a strong consensus that such a piecemeal arrangement was not desirable, but rather that regulation of PEOs should be comprehensive in scope, involving not only workers' compensation insurance but also other areas, including substantive workers' compensation law, health insurance, unemployment compensation, taxation, and solvency.

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<sup>8</sup> Currently, the most common state regulators of PEOs or employee leasing companies are insurance departments (Arkansas, Illinois, Indiana, Louisiana, Maine, North Carolina, Oklahoma, and West Virginia); labor departments (Colorado, Connecticut, Montana, New Hampshire, New Jersey, New York, and Vermont); or the industrial or workers' compensation commissions (Alabama, Kentucky, Nevada, Ohio, Oregon, and Virginia).



Some of these issues are within the purview of other NAIC committees or the IAIABC, and the NAIC/IAIABC Joint Working Group has briefed those bodies and encouraged them to stay involved in these matters. Other essential elements of comprehensive PEO oversight are beyond the jurisdiction of both insurance and workers' compensation regulators. Therefore, the Guidelines are based on the premise that some sort of legislation already exists — as it does in most states — that defines what a PEO is, requires PEOs to be registered or licensed by the state, and recognizes some form of co-employment relationship (either by statute or case law). Section 4 of the Guidelines then provides that workers' compensation coverage may only be provided through a PEO arrangement if the PEO is properly registered (insurers are prohibited from issuing master policies to unregistered PEOs or entering into multiple coordinated policy agreements with them) and Section 15 provides for administrative enforcement by the insurance commissioner.

The Guidelines attempt to recognize the diversity of state laws currently regulating PEOs, and include a number of drafting notes to provide guidance. Drafting notes to Sections 1 and 15 suggest that if a different state agency has regulatory jurisdiction over PEOs, the regulations implementing the Guidelines should be promulgated jointly by that agency and the insurance commissioner. If a state does not currently register or license PEOs, and does not enact such a requirement at the time it implements the Guidelines, a drafting note to Section 4 suggests that as a fallback, the regulation could require a limited-purpose registration similar to the 1991 model act. Similarly, Subsection 3H appears in two versions, one for use in the states that already have a statutory definition of "PEO," incorporating the statutory definition by reference, the other version spelling out an explicit definition for use in the states that need one.

Other potential inconsistencies between current state laws and the Guidelines are less likely to have a substantive impact on the Guidelines, but still need to be addressed in some manner.<sup>9</sup> Implementation of the Guidelines is a good occasion for the states to review their current regulatory frameworks for PEOs to see if changes should be made and to evaluate how the Guidelines best fit. As recognized in various drafting notes, changes to the Guidelines to adapt to the state's structure and terminology might be necessary. In particular, references to "registration" of PEOs need to be changed to "licensing" in states that require licensure, the term "PEO" needs to be modified if the state uses some other terminology such as "employee leasing," and references to "co-employees" need to be changed in the states that do not recognize co-employment.

## **B. Master Policies and Client-Level Experience Rating**

As indicated above, the issue that originally prompted the concern of insurance regulators and workers' compensation regulators related to the inability of experience rating systems to track experience of individual employers when they became clients of employee leasing firms (later PEOs). Much of this concern is eliminated with multiple coordinated policies, because current insurance statistical and data handling structures have the ability to track experience from separate coordinated policies and to produce experience ratings using all of the client employers' past experience. The fundamental challenge has been "master policies," where multiple client employers are covered under a single policy issued in the name of the PEO.

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<sup>9</sup> A majority of the states have existing provisions addressing workers' compensation in PEO arrangements (some using the older "employee leasing" terminology).

For this reason, the Working Group gave serious consideration to recommending that master policies be prohibited entirely. However, because of the potential efficiencies that could be realized from the master policy model, representatives of the PEO and insurance industries strongly urged the Working Group to consider whether there was a way to permit master policies that could satisfy regulatory concerns. The Working Group, therefore, took as its starting point the recommendation in the 2002 NAIC/IAIABC Joint Working Group report that the only acceptable alternative to prohibiting master policies would be:

... 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.

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.<sup>10</sup>

Despite the skepticism that had been expressed, the Working Group and the interested persons were able to reach consensus on a regulatory framework for master policies. In particular, the Guidelines require experience reporting at the client level and the production of experience ratings on an ongoing basis for every client of sufficient size to be eligible for experience rating. This requires two essential enhancements to the current system. One is the ability to identify each client workforce as a discrete unit of coverage, even if coverage is provided to the PEO on a master policy and the client does not purchase a separate policy.<sup>11</sup> This is primarily a regulatory issue, and is one of a number of reasons the Guidelines have adopted a "certificate of coverage" requirement, under which each client is issued a coverage document outlining its rights and obligations under the master policy and clearly establishing both the identity and status of the client and the inception and termination dates of coverage.<sup>12</sup> This has occasionally been a source of misunderstanding because of the traditional usage of the term "certificate of insurance" in the context of the property/casualty insurance industry. Like the certificates issued by insurers under group life and health policies, this is a legally binding coverage document, not just a representation of the status of coverage at some point in time, and has the effect of making the client an additional insured under the policy.<sup>13</sup>

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<sup>10</sup> NAIC/IAIABC Joint Working Group *Report on Employee Leasing and Professional Employer Organizations* at 32.

<sup>11</sup> Section 11 of the Guidelines requires that all loss reporting be conducted in a manner that will allow for the experience rating of the client to be maintained on a stand-alone basis.

<sup>12</sup> Specifically, the certificate must: 1) specify the effective date of the client's coverage and the expiration date of the underlying master policy (with a renewal certificate issued when the master policy is renewed); 2) provide that coverage shall continue as long as the master policy and the PEO agreement between the PEO and the client both remain in force, spelling out any exceptions; and 3) provide that termination of coverage without replacement requires 30 days' advance notice to the client. Subsection 7D.

<sup>13</sup> Subsection 7B.

The other essential element of an improved experience rating system is an effective data reporting infrastructure. This is also necessary to make proof of coverage (POC) function effectively at the client level, but it is not something that can be established simply by legislative or regulatory decree. What is mandated must actually be feasible, and those implementation issues are discussed below in “Data Reporting.”

Although the Guidelines require the maintenance of separate experience modification factors for each client that is subject to experience rating, they do not mandate the use of those factors when setting premium rates for PEO coverage in the voluntary market. Although a prudent insurer could be expected to consider this information, the Guidelines leave the ultimate decision to the agreement of the parties. One reason for providing this flexibility is that, in some situations, if a PEO has a relatively stable or homogeneous client base, the PEO’s aggregate experience might provide meaningful information that client-level experience does not provide. This is because the individual client experience will likely be more volatile and less credible, especially for smaller clients, some of which might be too small to be subject to experience rating at all. Another reason a PEO is not necessarily merely the sum of its clients is that the PEO’s risk-management activities might also have an impact on anticipated losses, hopefully for the better. The enhanced data-reporting requirements under the Guidelines can help carriers evaluate whether a PEO is providing effective loss-control services.

The Guidelines also make provision for experience rating in split workforce situations, because the PEO co-employees and the client’s direct hire employees will, according to the Guidelines, have the same experience modification factor, but they might have very different risks, especially if the PEO takes on only the safest or most hazardous work units. In these situations — especially if separate experience modification factors cannot be calculated with reasonable accuracy — insurers are allowed to use their reasoned underwriting judgment.<sup>14</sup> The Guidelines also prohibit splitting a client’s risk between the residual and voluntary market, an arrangement that has caused problems in the past.<sup>15</sup>

In order to implement an experience rating plan that complies with the Guidelines, adoption of regulations might not be all that needs to be done. It will be necessary to ensure that the state’s workers’ compensation advisory or rating organization has submitted a compatible experience rating plan, and it also will be necessary to review the experience rating statutes for possible inconsistencies. In particular, any provision that might be construed as mandating the treatment of the PEO as “the employer” for experience rating purposes will need to be revised, and if the state chooses to adopt the provisions allowing the parties to choose an alternative experience rating methodology in the voluntary market, the mandatory experience rating provisions need to accommodate that flexibility by giving the Commissioner sufficient authority through the rulemaking process or the rating plan approval process.

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<sup>14</sup> Subsection 12B.

<sup>15</sup> Subsection 6D.

### C. Lack of Coverage, Gaps in Coverage, and Proof of Coverage

Coverage gaps and omissions are anathema to the workers' compensation ethic. Insurance regulators and workers' compensation administrators agree that the structure of the workers' compensation system should make gaps and omissions in coverage nearly impossible. A well-designed POC system is one essential tool in preventing coverage failures, which should rarely occur once a business has been identified by the system as having employees.

One of the Working Group's most pressing concerns, as it developed the Guidelines, was the awareness that the traditional approach to coverage for PEO arrangements has given rise to several sources of coverage failures:

- Tracking a client in and out of a PEO arrangement: Traditionally, coverage has been reported in the name of the policyholder, which is always the PEO in the case of a master policy and is often the PEO in the case of a multiple coordinated policy arrangement. Unless the POC system also tracks coverage at the client level, it will lose track of an employer when it becomes the client of a PEO and will be unaware of the existence of a new business that becomes a client of a PEO immediately upon its creation. While this might be unimportant when the employer remains a fully covered client of the PEO, it can become a problem when the PEO-client relationship comes to an end while the client's business continues. At that point, a POC system that has not been tracking the client will have no way to know that there is an active, operating employer whose workers' compensation coverage has terminated, unless and until the former client obtains replacement coverage.
- Disputes over client status: If a master policy provides generic coverage to all the unnamed clients of the PEO, it might be unclear and open to dispute whether a particular employer was a covered client. Even when there are clear records demonstrating that a PEO-client relationship existed, they might not be sufficient to establish conclusively when the relationship began, when it ended, or whether it was in place at the time of the accident.
- Split-workforce arrangements: A client employer may choose to engage a PEO for only a specified segment of its entire workforce. Ordinarily, all of an employer's employees within the state are covered under a single policy, but the split-employment arrangement results in split coverage when some work units are covered through the PEO and others are not. This can give rise to coverage disputes if the status of a particular employee is not clear. There is also the danger that the state's compensation administrator will receive a POC report from the PEO's insurer, but not realize that the coverage is only for some of the client's employees, and thus allow the client to operate with the rest of its workforce uninsured. Therefore, when split workforce coverage is permitted, the POC system must not only track the coverage at the client level, but also must identify which work units are covered under the policy and whether that coverage is partial or complete.
- "Orphan" employees: One of the most common and dangerous types of split-workforce arrangements is unintentional (or at least is not the stated and acknowledged intent of the parties). The parties intend for all of the client's employees to be co-employed by the PEO so, in theory, there is full coverage even if the policy's terms limit coverage to

the PEO's co-employees. However, because there is only one policy, if there is anyone who is not covered through the PEO, then that employee is not covered at all. The most common danger here is the employee who is not treated as an employee, and whose existence might even be unknown to the PEO and/or its insurer — this might be someone who is held out by the client (often in good faith) to be an independent contractor, or someone who is employed by an uninsured subcontractor of the client. If the policy were issued directly to the client, it would clearly cover all employees of the client, whether or not disclosed to the insurer. However, if the policy is issued to the PEO, these employees risk falling through the cracks because they were never employed by the policyholder. There also are cases where there is no dispute that the worker was employed by the client, but the PEO's insurer disputes whether the necessary steps were taken for the worker to be hired by the PEO, especially in the case of casual employees, such as day laborers who might not have been placed on the PEO's payroll.

- Insolvency: Another factor that increases the risk of coverage disputes is the insolvency of the PEO, the client, or an insurer. If the PEO becomes insolvent, its insurer might use the PEO's failure to comply with its obligations as a basis for contesting coverage. Often, in these cases, the situation is made worse because existing law generally gives the PEO the responsibility of notifying individual clients. When the PEO is already out of business, or generally defaulting on all of its other obligations, the clients are unlikely to be receiving the notice to which they are entitled. If the insurer becomes insolvent, the receiver or the guaranty fund might take a fresh look at the validity of categories of claims the insurer had been paying routinely, especially if PEO losses are perceived as a contributing factor in the insolvency. The receiver also will be cancelling coverage, and clients might not receive this notice in a timely manner when the PEO is the named insured. And, in split-workforce arrangements, the coverage difficulties already noted earlier are complicated, not only by the increased likelihood that any claim that can possibly be contested will be contested, but also by the possibility of additional grounds for disputing a claim. In particular, when there is a solvent insurer on the same risk — even if the insolvent insurer would clearly have had primary responsibility for the claim in the ordinary course of operations — a guaranty fund could argue that the other insurer must pay before the guaranty fund despite providing only secondary coverage.

The Guidelines provide regulatory language (or statutory language in states that enact these provisions by statute) to respond comprehensively to these potential sources of gaps or omissions. It must be emphasized, however, that these protections are incomplete unless the state's POC laws and the advisory organization's POC data system provide a mechanism that effectively tracks coverage at the client level. In addition, there must be an effective mechanism for verifying that PEOs doing business in the state are properly insured, which can be accomplished through either the PEO registration process, some type of two-tier POC system for PEO arrangements that simultaneously tracks worksite employers and a separate PEO category, or a combination of the two approaches. Currently, many states with a comprehensive regulatory framework for PEOs mandate separate reporting by a PEO of incoming and exiting clients. This might be considered as a part of, or supplement to, the present POC system.

Two important new safeguards against coverage failures established by the Guidelines are:

- The certificate of coverage mechanism discussed earlier, which — when properly implemented by insurers and regulators — ensures that even under a master policy, each client's coverage has a clearly established inception and termination date, with adequate advance notice to both the client and the POC system before a client's coverage can be terminated or replaced.<sup>16</sup>
- A presumption that a PEO's policy ordinarily provides full workforce coverage to all covered clients, meaning that coverage during the relationship is equivalent to the coverage a client would have under a stand-alone policy.<sup>17</sup> The PEO's insurer does have the right to issue a policy that limits the scope of coverage to PEO co-employees, but only a full-workforce policy can be used to satisfy the clients' coverage obligations,<sup>18</sup> so there is an expectation that PEOs and their clients will only be interested in non-full-workforce coverage, when they intend from the outset that the PEO arrangement will only cover a portion of the client's workforce.<sup>19</sup>

The provision making full-workforce coverage the norm and more limited coverage the exception was one of the most controversial decisions made by the Working Group. Insurers objected that making them cover any unknown employees of a PEO's clients would undermine the certainty they seek when they deal with the PEO. Regulators acknowledged this point, but ultimately decided that an essential feature of the workers' compensation system is that somebody must take responsibility for ensuring that there are no orphan employees. If it is not the PEO's insurer, then it must be the client's insurer, and reasonable steps must be taken to verify that the client does indeed have an insurer that provides the same all-inclusive coverage that any traditional statutory workers' compensation policy provides for all employees, whether or not listed on the employer's payroll.<sup>20</sup> The client's representation that it has no direct-hire employees is not sufficient; after all, if it were sufficient, the PEO's insurer would have no qualms about writing full-workforce coverage in the first place.<sup>21</sup>

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<sup>16</sup> West Virginia took a different approach in its new PEO law. Under the Guidelines, an insurer issuing a master policy has no responsibility to a client if no certificate of coverage or its equivalent was ever issued by or on behalf of the insurer, unless the insurer is in some way responsible for the failure to issue the certificate. The PEO is obligated to give clear written notice to the client if it provides PEO services without providing workers' compensation coverage, Paragraph 4C, but if the PEO fails to comply, it is the PEO that bears the liability to the client, not the insurer that did not provide the coverage. By contrast, under West Virginia's "stopgap" provision, the PEO's insurer is responsible if the client has no other coverage. See W. Va. Code St. R. § 85-31-6.1. These provisions do not bar the insurer from pursuing indemnification from any solvent party that may be at fault.

<sup>17</sup> Paragraph 7A(1): "If the PEO agreement with a covered client is a full workforce PEO agreement [as defined in Subsection 2(E)], the policy or certificate shall cover all PEO co-employees and shall also cover any other obligations of the client under [insert appropriate statutory reference] to the same extent as if the client had obtained a direct purchase policy in this state."

<sup>18</sup> Subparagraph 7A(2)(b), which also makes an exclusion for the client's direct hire employees unenforceable if the insurer has reported the policy to the POC system. A drafting note advises states to allow non-full-workforce policies to be reported as secondary coverage if a state's POC system tracks both primary and secondary coverage.

<sup>19</sup> The Guidelines contain a drafting note allowing for a "Designated Workplaces Exclusion Endorsement" in this situation where allowable under existing law and regulation. However, under such an exclusion, the client must maintain separate coverage for the workplace in question.

<sup>20</sup> Subparagraph 7A(2)(a): "A PEO's insurer may not issue or renew coverage with a direct hire exclusion unless it obtains satisfactory evidence demonstrating that the client has coverage for all of its other workers' compensation liabilities."

<sup>21</sup> Subparagraph 7A(2)(e).

Moreover, even if it issues a limited policy, a PEO carrier becomes liable under the Guidelines for full-workforce coverage if it does not promptly issue notice of termination after learning that the client's coverage has been cancelled or is otherwise not in effect. This provision does not address every potential gap in coverage, however, because it does not apply in a situation where the PEO carrier is not aware of the cancellation or termination of a client's policy. After considerable debate and consideration of input from carriers, the drafters of the Guidelines concluded that a cross-notice provision they had originally proposed was unfeasible, and that the offending client would have to bear the consequences of being treated as an uninsured employer.<sup>22</sup> The Guidelines also include provisions for the uninterrupted payment of benefits if the insurers dispute who is responsible for a claim (the client's insurer is provisionally responsible, subject to reimbursement by the PEO's insurer if the dispute is resolved in favor of the client's insurer),<sup>23</sup> and for situations where a PEO agreement is terminated but the workers covered by the PEO continue as employees of the client<sup>24</sup> or where there are two insurers and one becomes insolvent.<sup>25</sup>

#### **D. Notice and Cancellation of Coverage for PEOs and Clients**

Workers' compensation coverage is a mandatory requirement for almost every business in almost every state in the United States. It is essential, therefore, that employers who are clients of PEOs receive timely notice before their coverage is terminated without their consent. In a PEO arrangement, the client usually relies on coverage purchased by a third party (the PEO). Because the client remains fully responsible for workers' compensation benefits for its employees, the consequences for the client can be disastrous if that coverage can be terminated without the client's advance knowledge.

This is especially true in PEO relationships, because if a PEO should terminate its co-employment of the client's employees, the client would almost certainly continue its operations as the sole employer of its workers. Doing so without coverage would violate state workers' compensation requirements and be illegal. As a result, the client would be exposed to penalties for operating without insurance, possibly including closure of the business, and exposure to both workers' compensation and tort liability for workplace accidents. Recovery of any resulting losses or penalties from the PEO is likely to be uncertain, slow, and difficult at best. In fact, there would be no prospect of meaningful recovery in situations where the PEO itself has failed and there is no one left to pay a judgment, which unfortunately is one of the situations where the normal communication procedures are at the greatest risk of breaking down.

The 1991 NAIC *Employee Leasing Model Regulation* (#936) tried to address this issue by requiring the PEO to notify all of its clients within 15 days after receiving notice that its workers' compensation policy would be cancelled or nonrenewed. However, this left PEO clients with seriously diminished rights, as compared to employers who purchased coverage directly. It also left unaddressed the issue of termination of the PEO arrangement and placed notice issue in the hands of the PEO rather than the carrier.

<sup>22</sup> It should be noted that this approach also creates a risk of exposure for the uninsured employer fund, in states that have them. West Virginia has decided that concerns such as these outweigh the burden of holding the PEO's insurer responsible for the ongoing verification of client coverage.

<sup>23</sup> Subparagraph 7A(2)(d). In West Virginia, on the other hand, the PEO's insurer is responsible in these situations. See W. Va. Code St. R. §§ 85-31-6.1 & -6.2.

<sup>24</sup> Subparagraph 7A(2)(f).

<sup>25</sup> Subparagraph 7A(2)(g).

Under standard workers' compensation policies and practice, and typical state insurance laws, if an insurer fails to give its policyholder timely notice of cancellation or nonrenewal, the termination is invalid and the policyholder remains fully insured. However, where the policyholder is the PEO, or even if the policyholder is the client but its address of record is "care of the PEO," the insurer can comply with its own legal obligations without any guarantee that any notice will actually get to the client. Furthermore, under some scenarios, the client could already be without coverage before the PEO was required to give notice under the 1991 model.

An essential element of the Guidelines is to address what should be one of the client's most valuable rights: continued coverage until adequate notice of cancellation is provided.

The Working Group concluded that the insurer must be responsible for notice in every case where the client is dependent upon receiving timely notice in order to maintain coverage.<sup>26</sup> The insurer can still delegate this function to the PEO, but if that process breaks down, then the insurer must provide extended coverage to the client, subject to applicable premium charges, for the duration of the statutory notice period. Nothing in the Guidelines prevents the insurer from holding the PEO responsible for any failure to comply with its contractual duties, nor from requiring the PEO to post security for the performance of its obligations, but the insurer may not seek recourse from the client for the PEO's default.

For these reasons, cancellation or nonrenewal of a client's coverage is not valid unless either:

- Thirty (30) days' advance notice has been delivered to both the client and the POC system. If termination is initiated by the PEO, this notice may be delivered by the PEO (with notice to the insurer);
- The client initiates or affirmatively consents to the termination. However, the Guidelines expressly prohibit circumventing restrictions on involuntary termination through such devices as documents authorizing the PEO to cancel coverage "voluntarily" on the client's behalf;<sup>27</sup> or
- The PEO has replaced coverage with no break in coverage and provided advance notice to the insurer, the client, and the POC system. This exception only applies if valid replacement coverage has actually been obtained. In that case, any dispute over the cost or other terms of the replacement may be sorted out between the actual parties to the dispute without worrying that the client might go bare.

The relationship between the PEO and the insurer, on the other hand, is closer to the traditional insurer-policyholder relationship and, therefore, raises fewer unique issues that need to be addressed in the Guidelines. Accordingly, the Guidelines explicitly provide that, "A master policy or a coordinated policy may be cancelled or nonrenewed by the insurer on the same grounds and subject to the same conditions as any other workers' compensation insurance policy." It is important to keep in mind, however, that for the reasons discussed earlier, even though the PEO's default on its obligations may result in loss of coverage for the clients, there must be timely notice before that loss of coverage can be effective, and notice to the PEO can never

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<sup>26</sup> Section 10.

<sup>27</sup> Subsection 10E.



substitute for notice to the clients. Indeed, if the client's coverage must be terminated for reasons beyond the client's control, it is all the more important that the client be given ample time to obtain appropriate replacement coverage.

The Guidelines, therefore, expressly contemplate that even after cancellation or nonrenewal has taken effect as between the insurer and the PEO, the insurer might still have a continuing obligation to cover the client. If that happens, the insurer must implement some other mechanism for providing coverage to the client, and may bill the client directly for that coverage. This situation is especially likely to arise in states that allow expedited cancellation of workers' compensation policies for nonpayment.

A drafting note to the Guidelines advises that, "If applicable state law permits involuntary termination of workers' compensation coverage upon shorter notice in some or all situations, states may consider modifying this provision accordingly." The statutory basis for expedited cancellation of a policy is usually nonpayment of premium. However, states should recognize that nonpayment by the PEO to the insurer does not constitute fault on the part of the client, which might be having similar difficulties of its own if the PEO has stopped performing its obligations. The Guidelines make clear that a client's failure to pay fees when due to the PEO does not constitute nonpayment of premium.<sup>28</sup>

This raises another important issue not adequately addressed by the 1991 model; i.e., responsibility for premium payment. The essence of the PEO coverage model, whether it is implemented through a master policy or multiple coordinated policies, is that the PEO is responsible for paying the premium to the insurer. In turn, the PEO charges fees to its clients that are intended to be sufficient to cover its cost of workers' compensation insurance and all other services provided by the PEO. When the insurer has accepted that the PEO is serving this role, the client is entitled to rely on that acceptance unless and until the insurer has notified the client that any future bills must be paid directly to the insurer. Therefore, the Guidelines provide that, for coverage provided under a master policy or multiple coordinated policy agreement, the insurer's only recourse is against the PEO; i.e., if the PEO defaults on its obligations, the client is protected against being billed a second time for workers' compensation coverage after it has already paid the PEO in full. The need for the insurer to pursue recovery from the PEO might pose difficulties for the insurer, but these can often be mitigated by obtaining adequate security in advance.

But what if the client has not paid the PEO in full? The client's obligation to the PEO is important, but it is a contractual matter between the PEO and the client. Because of the broad and varied scope of PEO services, which extend to matters well outside the scope of an insurance department, the Working Group did not support the regulation of PEO fees. The Working Group considered, but did not favor, a proposal to treat the PEO as a payment intermediary with workers' compensation premiums itemized and billed separately. As a result, fee regulation under the Guidelines is limited to disclosure requirements and prohibitions against insurance-related misrepresentation (See "Pricing" below).

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<sup>28</sup> Subsection 8A.

This means that fee disputes and termination disputes between clients and PEOs cannot be resolved through the insurance department's administrative processes. The nature of the PEO-client relationship makes it unrealistic to require good cause for termination, let alone to require the PEO to maintain a client against the PEO's will if good cause is lacking.<sup>29</sup> And without regulated fees or pass-through billing of insurance premium, the complexity of the claims and counterclaims that might occur makes it inappropriate to treat fee disputes as similar to premium disputes. Accordingly, the Working Group did not adopt the PEO industry's request to allow expedited cancellation for nonpayment of PEO fees, in those states that allow expedited cancellation for nonpayment of premium. However, some states allow expedited cancellation for fraud, and those states should consider whether cases involving fraud committed by the client would be within the scope of the Drafting Note on expedited cancellation.

Another termination issue that the 1991 model does not address is the nature of the insurer-employer relationship under a multiple coordinated policy arrangement. Should the client have the right to convert its policy to a direct purchase policy if it leaves the PEO, or should leaving the PEO be a valid ground for terminating the client's coordinated policy? Some regulators felt that an insurer ought to make the same full-year commitment when it issues a coordinated policy covering a business as it does when it issues a direct-purchase policy. However, insurers replied that in the voluntary market, participation in a multiple coordinated policy arrangement through a PEO is often an essential condition for their acceptance of the risk, and termination of that arrangement represents a material change in circumstances that justifies termination of coverage. The insurer might not even have an applicable rating plan for direct-purchase coverage for that class of business. Based on those considerations, the Guidelines provide that the client should not have a legal right to convert to direct-purchase coverage if the PEO relationship terminates. The insurer has the option to allow this, but it also should have the option to terminate coverage once adequate notice can be provided. This means that if the PEO relationship is terminable at will at any time, then the insurance policy might be as well, but the insurer's obligation to provide full statutory notice means the client is left with time to shop for replacement coverage and is in essentially the same position as if it had not joined the PEO in the first place. It should be noted that, because cancellation of coverage must be initiated by the insurer, the process depends on the PEO giving timely notice to the insurer. Until this happens, the client continues to be covered and the PEO continues to be responsible for the premium.

Of course, if the Guidelines conflict with applicable cancellation statutes, then the statute must prevail. If termination of the PEO relationship is not considered a breach of a valid contractual condition or a sufficiently material change to justify cancellation under applicable state law, a drafting note to the Guidelines recognizes that those states must either amend the statute to provide a new permitted ground for cancellation, or revise their regulation to conform to the statute by mandating conversion to direct-purchase coverage in lieu of cancellation.

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<sup>29</sup> Although the Guidelines prohibit the cancellation of workers' compensation coverage until adequate notice has been provided, they expressly acknowledge that other PEO services may cease immediately upon termination of the PEO agreement to the extent permitted by law, and require this to be disclosed to the client. Paragraph 4D(3).

## **E. Policy Forms**

As we have seen, the Guidelines require a number of changes in the terms of the insurer-insured relationship, and also in how some of the existing terms are documented. This will require changes to the policy forms, and careful review by regulators. In addition, many of the existing standardized forms and endorsements developed by advisory organizations have been in place in substantially similar form for many years and, in some cases, the language reflects terminology, such as “employee leasing,” that is no longer in widespread use. If a significant number of states adopt an approach substantially similar to the Guidelines, the use of standard language will be helpful to all stakeholders, especially insurers, PEOs, and clients that do business on an interstate basis. This means the standardized endorsement language currently in place will need to be updated, and new standard forms will need to be developed: in particular, multiple coordinated policy agreements and master policy certificates of coverage. Insurers, PEOs, producers, clients, and regulators should all be working with the advisory organizations in this process.

## **F. Data Reporting**

In order for workers’ compensation administrators and insurance regulators to maintain the experience rating and POC systems discussed in the previous sections, both they and the rating agencies or advisory organizations must have the statistical data essential to enforce and monitor the workers’ compensation system. The statistical data must be sufficient to enable the state’s compliance administrator to identify efficiently whether an employer within the state has the coverage required by law, and track the employer’s claims experience and benefit payments. The method of coverage chosen by an employer must be reported to the compliance administrator as proof that the protection exists on that job site, and subsequent changes to that method must also be reported. For experience rating, Subsection 11A of the Guidelines requires all loss and payroll reporting to be “conducted in a manner that identifies both the PEO and the client, and enables the calculation of experience modification factors” at the client level.

It was generally acknowledged during the development of the Guidelines that data reporting is not a significant issue where coverage is client-based (i.e., either through a stand-alone client-based policy or through a multiple coordinated policy arrangement where each client is identified on a separate policy). The main data issues appear to relate to master policies, or to multiple coordinated policies that are in the name of the PEO and do not adequately identify the individual client or do not adequately enable the reporting of client-level data needed for experience rating and POC systems. Concerns also have been expressed about the reporting of multiple coordinated policies when the policies are issued with the PEO, rather than the client, as the principal named insured, which is an option expressly permitted by the Guidelines as long as it is done “in a manner that clearly specifies the identities of the PEO and client and clearly describes the scope of coverage.”<sup>30</sup> Subsection 11A of the Guidelines mandates that all such data be maintained and reported by carriers at the client level, regardless of whether coverage involves a multiple coordinated policy arrangement or a master policy,<sup>31</sup> but does not dictate how this is to be done.

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<sup>30</sup> Subsection 7E.

<sup>31</sup> Subsection 7J; *see also* Sections 11 and 12.

There was significant debate as to the nature of the data-reporting issue, who was responsible, and how to resolve the difficulty. Various carriers said they were able (or were not able) to provide client-based data, rating agencies said they were (or were not) able to handle the data in PEO arrangements, and the states indicated varying levels of sophistication with regard to data collection and/or use. These technical issues are important, but establishing the necessary technical infrastructure is beyond the scope of the Guidelines. Instead, an effort was made to identify the goals of the Guidelines based on an assumption that the technical issues could be resolved.

The root of these technical issues is that present industry standards for the reporting and collection of data are based on separate policies for each employer. These standards support the constant exchange and use of data from carriers' systems to data-collection organizations and, subsequently, to many states' compliance systems. While some industry standards have changed to assist in the complex reporting of PEO-related data, the ability to make significant changes has been limited both by cost considerations and the need to be careful about preserving current capabilities for exchanging data. Additional requirements or changes to industry standards are meaningful responses only if compliance is technically feasible. A significant challenge with reporting and tracking client-level data is that clients can be added or terminated during the policy period, or move from one PEO relationship to another. These activities make it challenging to report and track individual client experience and coverage without separate policies and without substantial changes to industry standards and major costs.

The Workers *[sic]* Compensation Policy Reporting Specifications (WCPOLS) system, the electronic data-entry system jointly created by the nation's rating agencies, has for many years included a functionality that can identify whether a workers' compensation policy is related to a PEO arrangement. Similarly, the National Council on Compensation Insurance (NCCI), the country's largest advisory and rating organization and POC provider, has developed and implemented an MCP model that is widely used in the residual market. However, issues still remain as to how information on voluntary market policies is provided to and processed by rating agencies and users. For example, it is reported that the "PEO-related policy" flag is not used consistently, for example, and this information is not sufficient by itself to allow client-level data to be tracked effectively.

According to NCCI, a number of issues continue to be significant when determining how compliance requirements can be met and addressed. Under the 1991 model, the delivery methodology chosen for creation of an experience modification for a company leaving what was then called an employee leasing arrangement was the filing of a paper report and a manual calculation. Time has proven that to be both unreliable and inefficient.

Currently, an increasing majority of states statutorily recognize both a PEO and its clients as employers for purposes of workers' compensation. The Guidelines themselves provide the potential for multiple means of providing coverage in a PEO arrangement.<sup>32</sup>

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<sup>32</sup> Section 3.

One solution might be to develop some form of system for master policy situations that parallels the multiple coordinated policy framework for reporting data. This would require both carriers and rating agencies to be able to segregate data for clients of PEOs as if each had an individual policy. Carriers that are engaged in PEO coverage indicate a willingness to provide this client-level data, as do the PEOs themselves. NCCI has provided a technical supplement outlining various alternative mechanisms for reporting and compiling this information.<sup>33</sup> However, NCCI has warned that any option requiring significant changes to industry standards, including operating and reporting systems, would be difficult to implement and costly to the industry.

While insurers and rating agencies have historically managed their data systems to respond to both regulatory and industry needs, it is the states' ultimate responsibility to determine what data they need and what they will require rating agencies to do. Where possible, the Guidelines have attempted to generate greater, rather than less, flexibility, providing a clear mandate to provide both the states and the rating agencies the data that will allow experience rating programs and POC systems to operate at the client level, but without micromanaging the details of system design. There is, nevertheless, certain basic information that must be collected for both the PEO and its clients:

- Employer Identification – This includes the name of the employer and any Federal Employer Identification Number (FEIN) or Social Security Number (SSN) associated with the employer.
- Location – This includes the actual address of the client, and not just the mailing address of the PEO.
- Payrolls and Classifications – Payrolls must be assigned to appropriate class codes on a client-by-client basis, with the ability to identify the PEO that is involved.
- Loss Data – The same loss data that is required for all other policyholders, in a form that can be attributable to both the client and the PEO.
- Coverage Information – This includes policy dates, the nature of the policy, states that are covered, etc.

Regulators, and many within the industry, contend that this is information a well-managed insurer would want to collect anyway and, therefore, ought to be the wave of the future. One current impediment — the fact that some carriers issuing master policies simply do not track coverage at the client level in the first place — should vanish once the Guidelines' certificate-of-coverage requirements are in force. Carriers also must recognize that issuing coverage on a master policy basis is an option, not a necessity, and if they are unable to issue master policies in compliance with state laws and regulations consistent with the Guidelines, then they can switch to multiple coordinated policies, as some states currently require.<sup>34</sup>

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<sup>33</sup> See Appendix B.

<sup>34</sup> See, e.g., N.J. Admin. Code, Title 12, § 16-24.6.

Given that a large majority of states now statutorily recognize PEOs as employers for workers' compensation (and that number is growing rather than shrinking) and that the PEO concept of co-employment is likely to continue, the states and the requisite stakeholders (workers' compensation administrators, rating agencies, carriers, and PEOs) will need to work cooperatively to address system issues. In particular, this includes a nationwide effort to coordinate the evolution of data collection and processing in a consistent and cost-effective manner. At least for a period of time, those states seeking to adopt laws and regulations consistent with the Guidelines might find themselves having to deny carriers the ability to write PEO coverage on a master policy basis until they can have sufficient assurance that client-specific data to support POC and experience rating systems will be reported.

#### **G. Exclusive Remedy**

Workers' compensation was designed as a mandatory (in most states) no-fault system to guarantee compensation to a worker injured on the job and, in return, protect the employer from protracted litigation or extraordinary liability for normal worksite injuries. Employers are required to buy workers' compensation coverage (or, in the case of self-insurance, provide it themselves under regulatory oversight), and the insurance or self-insurance is required to cover all worksite injuries. The worker gains certainty of coverage for worksite injury but (except in certain egregious situations) gives up the right to sue in tort for those injuries. The workers' compensation system has become the "exclusive remedy" for recovery if the employer complies with its obligation to maintain coverage.

In most states (either by law or by interpretation), this exclusive remedy has been extended to protect employers that borrow workers from liability, if the employer supplying the workers provides workers' compensation insurance.<sup>35</sup> However, it is not always clear that this applies in the case of a "co-employment" relationship. Such clarification is necessary, because allowing the worker the option to collect the statutory workers' compensation benefits from the co-employer whose name is on the insurance policy or to sue the other co-employer for the same incident and injury would defeat the nature of the no-fault system. Both co-employers have agreed upon an arrangement that guarantees the availability of workers' compensation benefits, so both deserve the benefit of the exclusive remedy.

In implementing the Guidelines, it is recommended that a state review its workers' compensation provisions to ensure that the exclusive remedy provision will prevent "double-dipping" or create an incentive for more litigation that could undermine the purpose of exclusive remedy. The Working Group, when drafting the Guidelines, recognized that this was a statutory, rather than regulatory, issue, and that the applicable statutes are generally found in the workers' compensation laws, rather than the insurance laws.

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<sup>35</sup> Under this protection, for example, a client using temporary staff personnel would be afforded the exclusive remedy protection of the temporary employment service's workers' compensation coverage for injuries sustained during a temporary worker's assignment to the client.

In the case of a PEO relationship (or co-employment model), does state law clearly provide that both the PEO and PEO client are entitled to exclusive remedy protection?<sup>36</sup> Or is the exclusive remedy only extended to the party obtaining insurance coverage? Absent a provision clarifying the entitlement of both co-employers to the exclusive remedy, a state runs the risk that a business that chooses to avail itself of PEO services will, thereby, expose itself to tort lawsuits for workplace injuries, even though the business has been careful to make sure that full workers' compensation protection is available through the PEO. In the worst case, the client might be exposed to a "double-dip" lawsuit after the injured worker has already received workers' compensation benefits! (Or, conversely, a PEO that does not provide workers' compensation coverage could expose itself to tort liability for its clients' workplace injuries, even though it has provided only administrative services to its clients.)

States with more comprehensive PEO acts have routinely dealt with this issue when enacting that legislation.<sup>37</sup> If such a provision is not already in place, it should be added to the state's workers' compensation statute. This might require a cooperative effort of the insurance department with a state workers' compensation commission or labor department, depending on which agency is responsible for administering the state's workers' compensation system.

## **H. Residual Market Issues**

What should be the recourse if a PEO is unable to obtain voluntary coverage, either for its own employees or for those workers that it co-employs with its clients? At first glance, it might seem obvious that the PEO should be entitled to coverage in the residual market. However, the Working Group recognized that this is not the only way coverage can be issued. The PEO needs to be able to purchase coverage for its own home office employees on the same basis as any other employer — but as long as each client retains the right to purchase its own residual market coverage, the PEO does not absolutely need the right to buy coverage for all of its clients.

Therefore, the Working Group concluded that it is appropriate to allow the residual market to impose some minimum standards on PEOs that could not be applied to other employers. If a PEO is in good standing, it has the right to purchase residual market coverage on a multiple coordinated policy basis, just as it can under the 1991 model regulation and existing residual market plans. However, Section 6 of the Guidelines includes provisions under which the residual market may determine (subject to the PEO's right to appeal to the Commissioner) that a PEO is not in good standing and coverage for the clients' workforces must be purchased by the clients themselves:

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<sup>36</sup> The Indiana Code, for example, provides, at IC 27-16-9-2: "The protection of the exclusive remedy provisions of IC 22-3-2-6 and IC 22-3-7-6 apply to the PEO, the client, and each covered employee and other employee of the client regardless of whether the PEO or the client is responsible to obtain the worker's compensation coverage for the covered employees under the professional employer agreement."

<sup>37</sup> For example, the New York Professional Employer Act provides: "Both the client and the professional employer organization shall be considered the employer for the purpose of coverage under the workers' compensation law and both the professional employer organization and its client shall be entitled to protection of the exclusive remedy provision of the workers' compensation law irrespective of which entity secures and provides such workers' compensation coverage." New York Labor Code, Article 31, § 922 at paragraph 4.

- If the PEO or an affiliate owes past-due premium or otherwise does not meet the general qualifications for residual market coverage;
- If the PEO is unable to demonstrate the financial capacity to comply with its obligations under the multiple coordinated policy agreement; or
- If the PEO has been barred by regulators or found to have unfit management or ownership.

In addition, as discussed above in “Experience Rating,” an unimpaired ability to enter into split-workforce PEO arrangements might give the PEO and clients an incentive to “dump” the riskiest components of the clients’ workforces into the residual market, or for a PEO to buy voluntary market coverage for its best clients and “dump” the others. Therefore, Subsection 6D of the Guidelines makes split-workforce arrangements ineligible for residual market coverage, and gives the residual market the authority to deny or surcharge coverage if a PEO splits its client base.

A final issue that needed to be addressed in order to construct a nationwide model is that different states make residual market coverage available in different ways. Therefore, the Guidelines include two different versions of Section 6: one to be used in states with an assigned risk/servicing carrier program; the other to be used in states with a single statutory carrier of last resort. The Guidelines presume that such a carrier also has the authority to write voluntary market coverage, so states with a single carrier that only provides involuntary coverage should adjust the language accordingly.

## **I. Pricing**

The Guidelines impose no requirement that the PEO itemize the workers’ compensation portion of its billings to its clients.<sup>38</sup> Paragraph 4D(2)<sup>39</sup> requires the PEO to provide specific notice that the premium obligation of coverage provided through the PEO is that of the PEO alone, and not the client.

Although itemized charges for workers’ compensation are not required, the PEO may choose to provide them. In that case, the PEO has the obligation to be fair and accurate. It cannot, for example, advertise below-market workers’ compensation coverage if its true costs are higher and it conceals the difference elsewhere in its bill. Subsection 4F of the Guidelines requires that a PEO “not make any materially inaccurate, knowingly or recklessly misleading, or fraudulent representations to the client of the cost of workers’ compensation coverage.”

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<sup>38</sup> As discussed earlier, the Guideline drafters considered, but rejected, a proposal to require pass-through billing of premium. There was significant sentiment that amounts charged to clients for the workers’ compensation services elements of PEO services should be reflective of the costs of workers’ compensation coverage, but the ultimate agreement was that this is a commercial and market issue.

<sup>39</sup> “The PEO shall have a written agreement with the client, signed by the client before coverage becomes effective, including clear and conspicuous provisions ... Explaining that while the coordinated policy or certificate of coverage is in force, the PEO will be responsible for paying all premium obligations, including any audit adjustments and policyholder assessments, and will be entitled to any premium refunds. The written agreement shall further explain that although the PEO will charge fees to the client that reflect or include the cost of coverage, these fees are not considered insurance premium obligations of the client. If there is a policy deductible, the written agreement shall further explain that the PEO is responsible for reimbursing the insurer for the deductible and may not seek recovery from the client.”



In situations where a PEO itemizes the costs of workers' compensation, Subsection 4F requires that any such statement of costs be within defined bounds unless otherwise approved by the Commissioner.<sup>40</sup> This is of particular concern when the PEO assumes responsibility for most or all of the claims cost under a large-deductible or retrospectively rated policy and adopts its own "rating" methodology for recovering those claims costs from its clients. In some states, legislation might be necessary in order to give the Commissioner the authority to impose such restrictions, because they could be viewed as direct regulation of PEO fees and, thus, beyond the jurisdiction of insurance regulators. If a statutory amendment is proposed, it might logically be included in either the state's insurance rate regulatory act or its PEO act. Including the language in the PEO act allows the imposition of sanctions on a noncompliant PEO and, depending on the structure of laws already on the books, Section 4 of the Guidelines can essentially be "lifted" from the regulation and placed in the state's PEO act substantially intact. The state's rating law might be a less appropriate place for these provisions, as the PEO is not an insurance company; nevertheless, a cross-reference in the insurance laws might be necessary in order to give the Commissioner the necessary rulemaking authority.

#### **J. Improper Extensions of Coverage (Piggybacking)**

Subsection 7C of the Guidelines is designed to limit coverage of a master policy to only one PEO or one PEO group. It also prohibits extension of coverage under a master or coordinated policy to another PEO, employee leasing company, temporary service agency, or other entity in the business of employment services outsourcing. This provision is designed to prevent "piggybacking" and provides an additional argument for a comprehensive legislative/regulatory approach to PEOs in any given state. It addresses an issue raised by the 2002 NAIC/IAIABC Joint Working Group report.

The classic "piggybacking" scenario occurs when PEO A, which has a master policy, then co-employs all of the employees and worksite co-employees of PEO B, thus seeking to extend coverage to PEO B's co-employees and clients. This represents a significant increase in the insurer's exposure, without any new underwriting by the insurer — and possibly without even the payment of additional premium. There are variations on this scheme, but the purpose is the same: to extend the insurance coverage beyond that for which it was originally intended or contracted. In one common variant, PEO A claims to have acquired PEO B, and asks its insurer to add PEO B to the policy, when the "purchase" is a sham transaction that does not really transfer actual ownership and control.

The drafters designed this provision not only to address piggybacking, but also to prevent a PEO contract with a client temporary staffing agency that, in turn, provides employees on a temporary basis to other clients. It was determined that having the on-site client employer more than one level removed from the employer securing coverage was too problematic.

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<sup>40</sup> "If the PEO charges the client an itemized amount for workers' compensation coverage, the PEO shall provide the client with a good faith estimate of the actual cost of coverage and an accurate and concise description of the basis upon which it was calculated and the services that are included. Without the prior approval of the commissioner, a PEO may not charge a client an itemized amount for workers' compensation coverage that is:

- (1) Materially inconsistent with the actual amounts charged by the insurer or reasonably anticipated loss-sensitive charges;
- (2) In conflict with the terms of the uniform classification system; or
- (3) Materially in conflict with the terms of the uniform experience rating plan."

On the other hand, this provision is not intended to prohibit: 1) a legitimate acquisition of one PEO by another; 2) a PEO providing services to an HR consulting or other entity that does not provide workers or W-2 co-employment services to client companies; or 3) a commonly owned PEO group procuring common coverage. However, pursuant to Subsection 7C, "For a master policy to be issued to a PEO group, all covered PEOs must be combinable for experience rating purposes, each member of the group shall execute a cross-guarantee of the premium payment obligations of the other members, and each covered PEO shall be expressly named as an insured PEO before the effective date of coverage."

The effectiveness of Subsection 7C is enhanced by a state's adoption of the Guidelines' recommendation for registration or regulation of PEOs generally. Once a state has a requirement for registration or licensing of PEOs doing business in the state, it is easier to identify PEOs, know their insurance relationships, and to prevent these types of improper extensions of coverage.

#### **K. Self-Insurance**

One fundamental question that arises, if a state recognizes a PEO as an employer, is whether the PEO should be allowed to self-insure its workers' compensation exposure on the same basis as other employers. Currently, some states permit self-insurance by PEOs and others do not.

The Working Group was concerned that a PEO self-insurance program is not true "self-insurance," as that term is commonly understood. In effect, a self-insured PEO is really insuring its clients, and allowing a PEO to self-insure would leave the clients and workers with no other recourse if the PEO failed, or would create unacceptable risk for the self-insurance guaranty fund in states that have such a fund. Therefore, the Working Group decided not to propose self-insurance by PEOs as one of the options for coverage in Section 3. Subsection 3B contemplates the possibility that a client might be allowed to self-insure (because not all PEO arrangements give the PEO responsibility for workers' compensation coverage), but not a PEO.

A drafting note to Section 3 acknowledges that some states permit self-insurance by PEOs and that states desiring to maintain such coverage will need to modify the Guidelines accordingly. However, a drafting note suggests that any states considering self-insurance:

... should seriously consider basing such authorization upon licensure as an alternative risk-bearing entity, similar to laws allowing licensure for multiple-employer welfare arrangements and group self-insurance pools, and upon compliance with standards substantially similar to those established by these guidelines for insurers issuing master policies.

#### **L. Loss-Sensitive Coverage**

The self-insurance question involved extensive discussions among the Working Group and interested parties concerning the nature of the risk assumed by a PEO with regard to workers' compensation. This risk differs from the risk ordinarily assumed by the employer that self-insures or has a loss-sensitive coverage plan. For a traditional employer, the workers' compensation risk is inherent in its operations, while for a PEO, the risk is assumed from its clients by contract (along with other employment-related risks). The client remains the owner of the operating business where the injury would occur. If a traditional employer self-insures or has a loss-sensitive arrangement, the self-insurance program is pure expense. Self-insurance

“pays off” if it is cheaper than buying standard insurance, but the employer can never actually make a profit, only reduce the expense or suffer a loss.

By contrast, a PEO in a loss-sensitive arrangement must estimate its clients’ likely workers’ compensation losses, and collect payments from the clients that are sufficient to cover the expected losses and the expenses of operating the program. If the PEO manages the workers’ compensation elements of its contract successfully and the losses are better than expected, the PEO makes a profit. If losses and expenses (adjusted to present value) are equal to the payments collected, this element of the PEO’s operations break even. And if the clients’ losses are significantly worse than expected, the PEO will incur a loss.

This analysis initially led some of the regulators on the Working Group to oppose any arrangement in which the PEO was involved in its clients’ coverage on any other basis than as a pure intermediary between the clients and a licensed insurer. The industry’s response, and that of some carriers, was that it was healthy for a PEO to assume some or all of its clients’ risk, because that gave the PEO an economic incentive to operate good risk-management programs, so that a PEO was not simply financing coverage but actually improving the operations of its clients’ workplaces. In this regard, the industry argued that the PEO’s position was not that of an insurer, but that — as a co-employer with multiple touch points with the workforce (payroll, human resources, benefits, health, and compliance) — it had far greater abilities to invest in and manage risk than a client would have. A PEO, it was argued, was in a better position than the traditional insurer to improve safety, manage return to work, identify fraudulent claims, and address workers’ compensation issues.

A consensus emerged on the Working Group that it should be permissible for a PEO to take on some degree of insurance risk. It was noted that the states already allow fronting arrangements in which unlicensed entities can assume insurance risk — as long as a licensed insurer assumes responsibility by issuing the primary policy, the insurer is then permitted to cede the risk to an unlicensed reinsurer, subject to reporting requirements and rules against taking accounting credit for unsecured reinsurance.

Regulators recognized that the rationale for prohibiting self-insurance does not necessarily apply to loss-sensitive coverage, because there is a significant difference between the risk that a PEO assumes under a large-deductible or retrospectively rated policy issued by a licensed insurer and the risk that a PEO assumes under a self-insurance program. With loss-sensitive insurance coverage, a licensed insurer has assumed full responsibility for all payments due under the policy, whether or not the PEO is willing and able to fulfill its obligations to the insurer, in the same manner as a fronting insurer that passes the risk to an unlicensed reinsurer.

Therefore, the Working Group determined that loss-sensitive coverage should be permitted, as long as adequate safeguards are in place. For loss-sensitive coverage, the safeguards established by the Guidelines are designed to ensure that the contract is exactly what it purports to be: an informed bargain between a willing insurer and a willing PEO to allocate risk between each other, without shifting those risks to third parties. As in the context of other issues, the most essential regulatory requirement in the Guidelines is that the insurer must make and honor an unconditional commitment to cover the clients and the workers.

Likewise, when the client has paid the appropriate fees up front, the PEO is not permitted to hit the client with additional charges down the road if claims experience goes sour. Beyond those restrictions, the focus is on transparency, making sure that all parties have all the information they need to make an informed decision. Transparency extends to regulatory reporting, as well. Subsection 11D of the Guidelines requires specific reporting by all insurers (foreign as well as domestic) in the domestic PEO market, and by domestic insurers on their nationwide PEO business. The content of the report is to be specified by the Commissioner, and a drafting note contemplates that it will include information on the rating methodologies, security arrangements, and reinsurance arrangements used, allowing regulators to evaluate whether PEO arrangements pose any material financial risk to the insurer.

## Conclusion

The Guidelines are the result of a lengthy effort by regulators and interested parties to address a number of concerns that have arisen in PEO arrangements over the years. While the PEO industry has been largely successful in providing coverage and other services to many businesses on a long term basis, this record of success has not been universal. It has become apparent that the PEO relationship creates a variety of complications in areas such as proof of coverage, experience rating, and notice — and open up opportunities for abuse that require enhanced regulatory oversight.

Some states have addressed PEO issues more comprehensively than others. Some have adopted systems that work particularly well for them, while others are looking to adopt regulations or revise regulations already in place. The ultimate goal of all of the states is to preserve a workers' compensation system where all workers are properly covered and claims are handled promptly and correctly. Additional goals are to preserve competition in the marketplace in an effort to keep workers' compensation rates affordable and, to the extent possible, continue to move coverage from the residual to the voluntary market. To this end, the Guidelines have sought to provide flexibility while addressing issues that have arisen in the past.

It has become clear that, the issue is not simply the needs of the insurance regulatory agency. Action in each state should include other important stakeholders in the process: the workers' compensation administrative agency and/or adjudicator, the advisory organization or rating agency, the insurance carriers involved in the PEO markets, and the PEOs themselves. All of these stakeholders should be involved in the process of developing the regulations necessary within each jurisdiction, while also striving to ensure some commonality for data-reporting and exchange of information nationwide. Implementation of these Guidelines might take time. They might require legislative efforts. They might require a phased approach over time. However, the Working Group believes that the end result will be a better workers' compensation system for all.

## Appendix A

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### Section 1. Authority and Purpose

This regulation is adopted pursuant to [insert applicable statutory authority] to ensure that professional employer organizations (PEOs), and their clients, properly obtain workers' compensation insurance coverage for all of their employees, including both direct hire employees and persons employed under PEO agreements; that the premium paid is commensurate with the anticipated claim experience; and that an appropriate procedural framework is in place for the inception, continuation, and termination of coverage.

**Drafting Note:** These guidelines are presented in the form of a regulation; however, some provisions may be more appropriately enacted as legislation in some states. Agencies promulgating regulations based upon these guidelines should ensure that statutes regulating PEOs or employee leasing arrangements, statutes regulating workers' compensation insurance, or other applicable law grant them adequate rulemaking authority. In states where another agency has regulatory jurisdiction over PEOs, the commissioner should consider jointly promulgating regulations with that agency. Agencies promulgating regulations or drafting legislation based upon these guidelines should also ensure that insurers, PEOs and regulators have adequate resources and infrastructure in place to make compliance feasible, including but not limited to the necessary information systems and the necessary reporting mechanisms for data and proof of coverage.

**Drafting Note:** The scope of these guidelines is limited to issues related to workers' compensation insurance. It does not provide a comprehensive regulatory framework for the PEO industry. States may wish to consider regulations or legislation based upon these guidelines as part of a more comprehensive registration or licensing regimen for PEOs. In particular, states should take appropriate measures to ensure, to the extent possible, that both a PEO and a client obtaining coverage in compliance with these guidelines are protected by the state's exclusive remedy provisions.

### Section 2. Definitions

- A. "Client" means an employer whose work force consists in whole or part of PEO co-employees.
- B. "Designated advisory organization" means the entity designated by the commissioner for the reporting of claims and experience data and for the administration of the workers' compensation experience rating system.

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**Drafting Note:** If state law or practice uses different terminology or an inconsistent definition, make the appropriate substitution. Where the term "commissioner" is used, states should substitute the title of their chief insurance regulator, if different.

- C. "Direct hire employee" of a client or a PEO means an individual who is an employee within the meaning of the Workers' Compensation Act and who is not a PEO co-employee as defined in Subsection J.
- D. "Direct purchase basis" means an arrangement in which all contractual obligations under the insurance policy run directly between the insurer and the client without the involvement of the PEO, whether the arrangement is negotiated solely between the client and the insurer or is negotiated with the assistance of the PEO on terms that might not be available to the general public.
- E. "Full work force PEO agreement" means a PEO agreement under which the PEO agrees to assume specified employment responsibilities for all of the client's employees within the state, except that a full work force agreement may exclude by name one or more owners and/or officers who have demonstrated that they are excluded from state workers' compensation benefits.

**Drafting Note:** States that permit the "Designated Workplaces Exclusion Endorsement" to be used in a master policy certificate or coordinated policy should add the following sentence: "A full work force PEO agreement may also exclude employees at one or more named workplaces that are subject to a Designated Workplaces Exclusion Endorsement issued in compliance with this regulation and other applicable legal and procedural requirements."

- F. "Master policy basis" means an arrangement under which a single policy issued to the PEO provides coverage for more than one client, and provides coverage to the PEO with respect to its direct hire employees. Two or more clients that are insured under the same policy solely because they are under common ownership are considered a single client for purposes of this definition.

**Drafting Note:** States that prohibit master policies should omit this subsection and all other references to master policies in regulations or legislation based upon these guidelines.

- G. "Multiple coordinated policy basis" means an arrangement under which a separate policy is issued to or on behalf of each client or group of affiliated clients but payment obligations and certain policy communications are coordinated through the PEO.
- H. **[Option 1]** "Professional Employer Organization" or "PEO" means a business entity that enters into agreements with other businesses, whether under a formal contract or otherwise and regardless of the terminology used by the parties to describe the relationship, under which the PEO assumes or shares employment responsibilities for all or a significant number of the worksite employees of the other business. However, "PEO" does not include a business entity that recruits and hires its own employees; assigns them to clients on a temporary basis to support or supplement the client's work force in special work situations such as employee absences, temporary skill shortages and seasonal workloads; and customarily attempts to reassign the employees to other clients when they finish each assignment.
- H. **[Option 2]** "Professional Employer Organization" or "PEO" means a business entity that is required to be *[insert appropriate term]* pursuant to *[insert reference to state's licensure or registration law for PEOs or employee leasing companies]*.

**Drafting Note:** Option 1 is for use in those states where these guidelines will not be part of a comprehensive regulatory scheme for PEOs requiring licensure or registration.

- I. “Professional employer agreement” or “PEO agreement” means an agreement between a PEO and a client under which the PEO agrees to assume specified employment responsibilities for all or part of the client’s work force.

**Drafting Note:** If the state has an existing comprehensive statutory scheme in place regulating PEOs, these guidelines should be reviewed for consistency with that statutory scheme and revisions should be made if appropriate. This may include revisions to the terminology used in this section if state law uses different terminology, including but not limited to “employee leasing company,” to describe some or all of the shared or delegated employer relationships that are the subject of these guidelines. Also, these guidelines presume that the state recognizes some form of employment arrangement under which both the PEO and client are considered employers for purposes of the workers’ compensation laws. States should review this definition for consistency with the applicable statutory or common-law definition and make any revisions that might be necessary.

- J. **[Option 1]** “PEO co-employee” means an individual who is an employee, within the meaning of the Workers’ Compensation Act, of both a PEO and a client.
- J. **[Option 2]** “PEO co-employee” means an individual whose employment responsibilities are shared between a client and a PEO, either by the terms of a PEO agreement or by operation of law.

**Drafting Note:** Generally, a client’s direct hire employees are reported for tax purposes under the name and identification number of the client, while its PEO co-employees are reported for tax purposes under the name and identification number of the PEO. However, the determination whether the PEO is an employer of an individual for workers’ compensation purposes is outside the scope of these guidelines because employer status is not governed by insurance laws. Although the PEO agreement should provide a clear process for determining which members of the client’s workforce are PEO co-employees and which (if anyone) are direct hire employees, state law must control if the PEO agreement is inconclusive or is inconsistent with the law. If state law does not recognize co-employment, different terminology such as “PEO worksite employee” should be used and the definition should be revised to be consistent with state law.

### **Section 3. Insurance Coverage on PEO Co-Employees**

The following are the methods approved by the commissioner as providing coverage for a client and a PEO that have entered into a PEO agreement, sufficient to meet their statutory obligation for coverage as employers under [insert appropriate statutory reference] of their PEO co-employees:

- A. The client obtains a standard workers’ compensation policy from an insurer on a direct purchase basis, covering all of the client’s PEO co-employees and direct hire employees, subject to the same requirements and conditions as if the client were the sole employer of its PEO co-employees. The policy may name the PEO as an additional insured. If licensed as a producer, and authorized by the insurer, the PEO may negotiate coverage, collect premiums on behalf of the insurer, and otherwise act as an intermediary with respect to direct purchase coverage as permitted by law;

**Drafting Note:** States whose law uses other terminology such as “agent” or “broker” should modify this provision accordingly.

- B. The client obtains authorization from the [insert appropriate state official] pursuant to [insert applicable self-insurance licensure statutes] to self-insure its workers’ compensation obligations;

**Drafting Note:** States that allow a PEO as an entity to self-insure should modify this subsection accordingly. However, states considering allowing PEOs to self-insure should seriously consider basing such authorization upon licensure as an alternative risk-bearing entity, similar to laws allowing licensure for multiple-employer welfare arrangements and group self-insurance pools, and upon compliance with standards substantially similar to those established by these guidelines for insurers issuing master policies.

- C. The PEO purchases insurance providing workers' compensation coverage on a multiple coordinated policy basis in compliance with this regulation, with a policy providing coverage to the client and to the PEO with respect to the PEO co-employees at the client; or
- D. The PEO purchases a master policy, with a certificate of coverage issued in compliance with this regulation providing coverage to the client and to the PEO with respect to the PEO co-employees at the client.

#### **Section 4. Requirements for PEOs**

- A. A PEO shall be registered as a professional employer organization with the [insert appropriate state official] pursuant to [insert applicable statutes]. An insurer may not enter into or maintain a multiple coordinated policy agreement with, or issue a master policy to, an unregistered PEO. If a PEO providing multiple coordinated policies, or covered under a master policy, ceases to be registered or has been subject to disciplinary sanctions, the [insert appropriate state official] shall promptly notify the insurer of record.

**Drafting Note:** Substitute "licensed" for "registered" in states with licensing laws. States that have no formal regulatory framework for PEOs may modify this subsection to impose a requirement for registration with or notice to the commissioner, or may omit this subsection entirely.

- B. A PEO may not enter into or remain in a multiple coordinated policy agreement with an insurer or be issued a master policy if it is ineligible for coverage pursuant to [insert appropriate statutory citation here if applicable] as a result of a default on a workers' compensation premium or assessment debt.
- C. If the services that a PEO offers to a client do not include securing workers' compensation coverage on a master policy or multiple coordinated policy basis, the PEO shall provide the client with clear and conspicuous written notice, before entering into a PEO agreement with the client, that the client will remain responsible for obtaining its own workers' compensation coverage for both PEO co-employees and direct hire employees, and the written PEO agreement shall also clearly set forth that responsibility.
- D. If a PEO offers any client services that include securing workers' compensation coverage on either a master policy or multiple coordinated policy basis, the PEO shall have a written agreement with the client, signed by the client before coverage becomes effective, including clear and conspicuous provisions:
  - (1) Explaining that insurance coverage does not take effect until the effective date designated by the insurer on the policy or certificate of coverage;



- (2) Explaining that while the coordinated policy or certificate of coverage is in force, the PEO will be responsible for paying all premium obligations, including any audit adjustments and policyholder assessments, and will be entitled to any premium refunds. The written agreement shall further explain that although the PEO will charge fees to the client that reflect or include the cost of coverage, these fees are not considered insurance premium obligations of the client. If there is a policy deductible, the written agreement shall further explain that the PEO is responsible for reimbursing the insurer for the deductible and may not seek recovery from the client;
- (3) Explaining the procedures by which the client or PEO may terminate the PEO agreement, including any fees or costs payable upon termination, and that except as otherwise expressly provided or required by law, all services provided by the PEO to the client shall cease immediately on the effective date of the termination. The written agreement shall explicitly state that the client's coverage under any workers' compensation insurance shall terminate immediately on the termination date of the PEO agreement, subject to the client's right to receive at thirty (30) days' advance notice before workers' compensation insurance coverage may be terminated involuntarily and to purchase an extension of coverage at the client's expense for the remainder of the notice period if the notice period extends beyond the termination date of the PEO agreement;

**Drafting Note:** In states where Section 10 is revised to permit shorter notice in some or all situations, this provision should be modified accordingly.

- (4) Explaining that the insurer has the right to inspect the premises and records of the client;
- (5) Explaining that the client's loss experience will continue to be reported in the name of the client to the designated advisory organization, and will be available to subsequent insurers on request;
- (6) If coverage is provided under a multiple coordinated policy arrangement, explaining whether the client may elect to purchase coverage directly from an insurer in lieu of participating in the multiple coordinated policy arrangement;
- (7) If the PEO agreement is a full work force PEO agreement, explaining that the policy or certificate will cover all employees of the client within the state who are not excluded from workers' compensation benefits. If the PEO agreement is not a full work force PEO agreement, explaining that the policy or certificate will cover only those employees acknowledged in writing by the PEO to be PEO co-employees, and that the client shall at all times maintain other valid coverage for its direct hire employees and shall provide evidence of coverage satisfactory to the PEO's insurer; and

**Drafting Note:** States that permit the "Designated Workplaces Exclusion Endorsement" should add the following additional sentence between the first and second sentences. "If the client's policy or certificate is subject to a Designated Workplaces Exclusion Endorsement, the above disclosure shall be modified to reflect the terms of the exclusion and shall expressly state the client's obligation to provide separate coverage for the excluded workplaces."

- (8) Explaining that the client may take complaints to the [insert applicable regulator] in accordance with [insert applicable law].

**Drafting Note:** A state that does not have an established regulatory process for complaints by clients against PEOs should consider adding a provision establishing a complaint process for workers' compensation issues.

- E. The PEO shall promptly notify the workers' compensation insurance carrier of the termination of any PEO agreement with a client that is covered on a master policy or multiple coordinated policy basis.
- F. The PEO shall not make any materially inaccurate, knowingly or recklessly misleading, or fraudulent representations to the client of the cost of workers' compensation coverage. If the PEO charges the client an itemized amount for workers' compensation coverage, the PEO shall provide the client with a good faith estimate of the actual cost of coverage and an accurate and concise description of the basis upon which it was calculated and the services that are included. Without the prior approval of the commissioner, a PEO may not charge a client an itemized amount for workers' compensation coverage that is:
  - (1) Materially inconsistent with the actual amounts charged by the insurer or reasonably anticipated loss-sensitive charges;
  - (2) In conflict with the terms of the uniform classification system; or
  - (3) Materially in conflict with the terms of the uniform experience rating plan.
- G. The PEO shall provide any information requested by the commissioner relating to the provisions of its PEO agreements that relate to or have an impact on workers' compensation benefits or coverage, the methods by which the fees charged to clients are calculated to the extent that they are based upon or attributed to the cost of workers' compensation coverage, and any other information relevant to the PEO's workers' compensation coverage arrangements.
- H. The PEO shall not impose any fee increase upon a client based upon the actual or anticipated cost of workers' compensation coverage without giving the client at least thirty (30) days' advance notice and an opportunity to withdraw from the PEO agreement without penalty.
- I. If a client receives notice of the termination or nonrenewal of coverage, and the client obtains replacement coverage, the client shall have the right to withdraw from the PEO agreement without penalty even if the PEO's coverage has been reinstated or replaced.
- J. Except with prior approval of the commissioner and full written advance disclosure to clients, the PEO shall not impose any fee or other charge upon a client that relates to workers' compensation coverage and could become due after the termination of the PEO agreement, other than:
  - (1) Fees and charges due and billed while the PEO agreement was in force, and fees for the final period of PEO services to the extent normally and customarily billed in arrears;
  - (2) Reasonable charges for additional services requested by the former client after termination of the PEO agreement;

- (3) The cost to the PEO of workers' compensation coverage, including reasonable administrative expense, during any extension of the coverage period after termination of the PEO agreement;
- (4) Reasonable interest on overdue fees and charges; and
- (5) Reasonable charges for late payment of fees or early termination of the PEO agreement.

## **Section 5. Multiple Coordinated Policy Agreement**

If a PEO secures workers' compensation coverage on a multiple coordinated policy basis, it shall first enter into a written agreement with the insurer establishing the terms and conditions under which multiple coordinated policies will be issued to the PEO and each client. The agreement may consist in whole or part of an endorsement to the coordinated policy covering the PEO's direct hire employees. The agreement shall include provisions addressing the following issues and such other reasonable provisions as the parties consider appropriate:

- A. A copy of the policy form to be used for each coordinated policy issued under the agreement;
- B. The premium discount, if any, to be applied to policies issued under the agreement, and any other modifications of the insurer's standard underwriting guidelines and rating plan;
- C. The provision of financial and ownership information and coverage history by the PEO to the insurer, the form and amount of security to be held by the insurer, and the conditions under the insurer may draw upon it;

**Drafting Note:** States with laws limiting an insurer's ability to require prepayment of premium should consider whether it is necessary to clarify that a requirement to post a reasonable level of security under this subsection is not considered a prohibited prepayment requirement.

- D. Whether a client may elect to purchase coverage directly from the same or another insurer in lieu of participating in the multiple coordinated policy arrangement;
- E. The designation of a third-party administrator, if one is to be used. Any third-party administrator must be licensed by the commissioner;

**Drafting Note:** Omit second sentence if the state does not license third-party administrators, or if workers' compensation insurance is outside the scope of the state's administrator law. States with third party administrator laws that do not encompass workers' compensation coverage should consider amending them.

- F. Provisions for billing and claims reporting and for enforcement of these requirements;
- G. Provisions addressing the obligations of the PEO and the insurer when the PEO acquires a new client or terminates a relationship with an existing client, including notice to the insurer and to the [workers' compensation regulator];
- H. Procedures for termination and renewal of the multiple coordinated policy agreement. Grounds for cancellation by the insurer and procedures for providing notice of cancellation or nonrenewal to the PEO shall be substantially consistent with the restrictions on policy termination set forth in [insert law regulating cancellation of workers' compensation policies]. Termination of PEO registration and continuing material noncompliance with reporting

requirements shall be mandatory grounds for cancellation. The PEO shall have the right to a hearing before the commissioner upon a claim that the insurer has cancelled the agreement unlawfully or has failed to provide proper notice of cancellation or nonrenewal;

- I. Provisions establishing the conditions and procedures, if any, under which a specific policy may be cancelled or nonrenewed while the multiple coordinated policy agreement remains in force; and
- J. Provisions, if any, for conversion of coordinated policies to direct purchase policies upon termination of a PEO agreement, or upon termination of the multiple coordinated policy agreement between the PEO and the insurer.

## **Section 6. Coverage in the Residual Market**

**[Option One]:** This version of Section 6 is for use by states where the residual market is an assigned risk plan or pooling mechanism. States should make appropriate revisions to the extent that this section is not consistent with the state's residual market structure.

- A. The [residual market manager] shall file with the commissioner a standard multiple coordinated policy agreement that shall be made available to all registered PEOs in good standing. The terms of the standard agreement shall be subject to approval by the commissioner and shall include:
  - (1) Provisions under which, to the extent feasible, the policies covering all clients of the same PEO within this state shall be assigned to the same servicing carrier, and reasonable efforts shall be made to assign a common servicing carrier on an interstate basis;
  - (2) Provisions under which any client that is otherwise eligible for coverage may obtain direct purchase coverage with no break in coverage if the coordinated policy covering the client terminates for any reason; and
  - (3) A premium discount schedule that appropriately reflects any cost savings created by multiple coordinated policy arrangements.

**Drafting Note:** Omit Paragraph (3) in states where there is no premium discount available to large employers in the residual market.

- B. If a PEO is not in good standing, residual market coverage for its clients shall be issued in the name of the client on a direct purchase basis. A PEO is not in good standing for purposes of this section if the residual market manager, subject to the PEO's right of appeal to the commissioner, determines that the PEO, an entity that controls or is controlled by the PEO, or an entity in which the PEO or an entity controlling the PEO directly or indirectly holds a 25% or greater ownership interest or actively manages:
  - (1) Is in default on an undisputed workers' compensation premium or assessment, either for its own coverage or for its clients' coverage, or otherwise fails to qualify as an eligible employer under the terms of the residual market plan;

**Drafting Note:** Omit the word "undisputed" in states that allow the denial of coverage while a dispute is pending.

- (2) Is unable to demonstrate the financial capacity to comply with its obligations under the multiple coordinated policy agreement;
  - (3) [Insert appropriate reference here if state has a disciplinary provision in its PEO laws that when triggered would restrict a PEO's ability to provide workers' compensation coverage to clients.]; or
  - (4) Has, or is owned or managed by persons who have, a history of material noncompliance with the law or with contractual obligations, including but not limited to a felony conviction, multiple criminal convictions, judgments of liability for fraud or material representation, or multiple cancellations of insurance policies or multiple coordinated policy agreements.
- C. A master policy may not be issued to a PEO in the residual market.
- D. An employer that is a client of a PEO is not eligible for issuance or continuation of a residual market policy, nor is the PEO eligible for issuance or continuation of residual market coverage with respect to PEO co-employees at that client, if there is voluntary market coverage with respect to some other portion of the client's work force. With the approval of the commissioner, the residual market may deny coverage, or may charge rates reasonably designed to reflect the additional risk assumed, to a PEO requesting coverage on a multiple coordinated policy basis for some but not all of its clients in this state, if the PEO has other coverage on a master policy or multiple coordinated policy basis for other clients in this state.

## **Section 6. Coverage by the [Statutory Carrier of Last Resort]**

**[Option Two]:** This version of Section 6 is for use by states in which the residual market is a competitive state fund or other statutory carrier of last resort. States should make appropriate revisions if this section is not consistent with the powers and duties of the carrier of last resort; for example, if that carrier does not also compete in the voluntary market.

- A. [Statutory carrier of last resort] may negotiate master policies or multiple coordinated policy agreements with PEOs on a voluntary basis. [Statutory carrier of last resort] shall file with the commissioner a standard multiple coordinated policy agreement that shall be made available to all registered PEOs in good standing. The terms of the standard agreement shall be subject to approval by the commissioner and shall include a premium discount schedule that appropriately reflects any cost savings created by multiple coordinated policy arrangements.

**Drafting Note:** Change "shall" to "may" in the last sentence in states where there is no requirement to provide a premium discount to large employers with involuntary coverage, and omit the last sentence entirely where premium discounts are prohibited.

- B. If a PEO is not in good standing, coverage for its clients by [statutory carrier of last resort] shall be issued in the name of the client on a direct purchase basis. A PEO is not in good standing for purposes of this section if [statutory carrier of last resort], subject to the PEO's right of appeal to the commissioner, determines that the PEO, an entity that controls or is controlled by the PEO, or an entity in which the PEO or an entity controlling the PEO directly or indirectly holds a 25% or greater ownership interest or actively manages:

- (1) Is in default on an undisputed workers' compensation premium or assessment, either for its own coverage or for its clients' coverage, or otherwise fails to qualify as an employer eligible for coverage as of right with [statutory carrier of last resort];

**Drafting Note:** Omit the word "undisputed" in states that allow the denial of coverage while a dispute is pending.

- (2) Is unable to demonstrate the financial capacity to comply with its obligations under the multiple coordinated policy agreement;
  - (3) [If state has a disciplinary provision in its PEO laws that when triggered would restrict a PEO's ability to provide workers' compensation coverage to clients, insert appropriate reference here]; or
  - (4) Has, or is owned or managed by persons who have, a history of material noncompliance with the law or with contractual obligations, including but not limited to a felony conviction, multiple criminal convictions, judgments of liability for fraud or material representation, or multiple cancellations of insurance policies or multiple coordinated policy agreements.
- C. The terms of any master policy issued or multiple coordinated policy agreement entered into by [statutory carrier of last resort] shall include provisions under which any client that is otherwise eligible for coverage may obtain direct purchase coverage with no break in coverage if the coordinated policy covering the client or the client's coverage under the PEO's master policy terminates for any reason.
- D. An employer that is a client of a PEO is not entitled to issuance or continuation of coverage as of right by [statutory carrier of last resort], nor is the PEO entitled to issuance or continuation of coverage as of right by [statutory carrier of last resort] with respect to PEO co-employees at that client, if there is voluntary market coverage with respect to some other portion of the client's work force. With the approval of the commissioner, [statutory carrier of last resort] may deny coverage, or may charge rates reasonably designed to reflect the additional risk assumed, to a PEO requesting coverage on a multiple coordinated policy basis for some but not all of its clients in this state, if the PEO has other coverage on a master policy or multiple coordinated policy basis for other clients in this state.

## **Section 7. Policy Issuance**

- A. A master policy or coordinated policy shall unconditionally obligate the insurer to pay all benefits due under the workers' compensation laws, whether or not the PEO and client comply with their obligations under the policy, for all injuries to covered employees occurring while the policy is in force, including any extension of coverage required pursuant to Section 10 of this regulation.
- (1) If the PEO agreement with a covered client is a full work force PEO agreement, the policy or certificate shall cover all PEO co-employees and shall also cover any other obligations of the client under [insert appropriate statutory reference] to the same extent as if the client had obtained a direct purchase policy in this state.

**Drafting Note:** States that permit the “Designated Workplaces Exclusion Endorsement” should add the following language at the end: “ ... or subject to the terms of a Designated Workplaces Exclusion Endorsement in a form approved by the commissioner, consistent with all other applicable legal and procedural requirements, that is properly executed, attached to the policy, specifically identified in the PEO agreement and contingent upon the client’s obligation to maintain coverage at the designated workplaces and upon the insurer’s obligation to give notice of the exclusion to the [workers’ compensation regulator] when filing proof of coverage.”

- (2) If the PEO agreement is not a full work force PEO agreement, the policy or certificate may exclude coverage for direct hire employees and may specify that only those employees acknowledged in writing by the PEO as PEO co-employees shall be covered, subject to the following conditions and requirements:
  - (a) A PEO’s insurer may not issue or renew coverage with a direct hire exclusion unless it obtains satisfactory evidence demonstrating that the client has coverage for all of its other workers’ compensation liabilities under [insert appropriate statutory reference]. A direct hire exclusion is not valid if the insurer issues the policy or certificate without first obtaining evidence of coverage for the client’s other workers’ compensation liabilities, or if the coverage for the client’s other workers’ compensation liabilities has terminated and the PEO’s insurer has failed to act promptly to cancel the policy or certificate after learning of the termination.
  - (b) A direct hire exclusion is not valid if the PEO’s insurer has provided proof of coverage on behalf of the client to the [workers’ compensation regulator]. In lieu of providing proof of coverage, an insurer that issues a coordinated policy or a master policy certificate with a direct hire exclusion shall provide notice to the [workers’ compensation regulator] in a form prescribed by the commissioner in consultation with the [workers’ compensation regulator].

**Drafting Note:** States with proof-of-coverage reporting systems that are capable of tracking both primary and secondary coverage should replace this provision with a requirement to report PEO coverage with a direct hire exclusion as secondary coverage for the client in order for the exclusion to be enforceable.

- (c) A policy or certificate with a direct hire exclusion shall provide that loss of coverage for direct hire employees is a ground for cancellation, unless the client obtains replacement coverage with no break in coverage.
- (d) If a client’s insurer has issued coverage for direct hire exposure, and an injured employee is entitled to workers’ compensation benefits but there is a dispute as to whether the employee is a direct hire employee or a PEO co-employee, the client’s insurer shall pay the benefits, subject to reimbursement of claims costs and loss adjustment expenses by the PEO’s insurer if it is determined that the claimant is a PEO co-employee.
- (e) A representation that the client has no direct hire employees does not constitute proof of coverage for direct hire employees. A client representing that its PEO agreement is not a full work force agreement but that it has no direct hire employees within the state must maintain a valid policy of insurance written on an “if any” basis.

- (f) Upon the termination of separate coverage for PEO co-employees, they shall be considered direct hire employees for purposes of the client's policy, and premium shall be charged accordingly. The client's policy may include an endorsement requiring the client to provide prompt reporting of any notice of termination by the PEO's insurer and advance notice of any voluntary termination, and, if issued in the voluntary market, may provide that termination of the PEO coverage is a ground for cancellation of the client's policy.
  - (g) If the PEO and its client have obtained separate policies in compliance with this subsection, and one of the insurers becomes insolvent, coverage obligations shall be allocated between the solvent insurer and the [guaranty association] in the same manner as if both insurers were solvent.
- B. A master policy shall be issued in the name of the PEO, and shall provide that all clients holding certificates of coverage are additional insureds to the extent provided in the certificate of coverage.
- C. A master policy may cover only one PEO or one PEO group. For a master policy to be issued to a PEO group, all covered PEOs must be combinable for experience rating purposes, each member of the group shall execute a cross-guarantee of the premium payment obligations of the other members, and each covered PEO shall be expressly named as an insured PEO before the effective date of coverage. A PEO, employee leasing company, temporary service agency or other entity in the business of employment services outsourcing may not be covered as a client under a master policy or coordinated policy. Each client's coordinated policy or certificate of coverage, and any policy issued to a PEO for the sole purpose of covering its direct hire employees, shall include a Labor Contractor Exclusion Endorsement or similar provision excluding coverage for employees furnished by the client to other entities or with respect to whom the client acts as a PEO.

**Drafting Note:** If applicable state law regulates PEO groups, this subsection should be revised as necessary for consistency, and if applicable should include a provision requiring the PEO group to be registered or licensed as such.

- D. The insurer or its authorized representative shall issue a certificate of coverage to each client covered under a master policy.
  - (1) The certificate shall specify the effective date of the client's coverage and the expiration date of the underlying master policy. A renewal certificate shall be issued to each client each time the policy is renewed.
  - (2) The certificate of coverage shall provide that coverage shall continue as long as the master policy and the PEO agreement between the PEO and the client both remain in force, or shall expressly set forth any exceptions.
  - (3) The certificate of coverage shall provide that the client is entitled to thirty (30) days' notice before coverage may be cancelled or nonrenewed without the client's consent, except:



- (a) When replacement coverage is provided by the PEO with no break in coverage;  
or
- (b) When the insurer has notified the client and the [workers' compensation regulator] at the time the certificate is first issued that the master policy will be cancelled or nonrenewed in less than thirty (30) days.

**Drafting Note:** In states where Section 10 is revised to permit shorter notice in some or all situations, this provision should be modified accordingly.

- E. Coordinated policies, except for the policy covering the PEO's direct hire employees, shall be issued in a manner that clearly specifies the identities of the PEO and client and clearly describes the scope of coverage:
  - (1) Coverage may be issued in the name of "[PEO] and [client] as co-employers," or substantially similar language, as long as the policy clearly indicates which named insured is the PEO and which named insured is the client.
  - (2) Coverage may be issued in the name of "[PEO] as labor contractor for [client]," or substantially similar language, as long as the policy clearly provides coverage for the client's obligations as employer under the workers' compensation laws.
  - (3) Coverage may be issued in the name of "[client], for employees co-employed with [PEO]," or substantially similar language, or in the name of the client with the PEO as an additional insured, as long as the policy clearly provides coverage for the PEO's obligations as employer under the workers' compensation laws.
  - (4) If a client participates in more than one PEO agreement, employees affiliated with different PEOs shall be covered under different policies unless both PEOs, and both PEOs' insurers, agree to the issuance of a single policy providing comprehensive coverage to the client's entire workforce, comprising direct hire employees and PEO co-employees from all sources.

**Drafting Note:** If applicable state law specifies a different procedure for designating the named insureds on the policy, this Subsection should be omitted or revised accordingly. States that require coordinated policies to be issued in the name of one of the parties to the PEO agreement should take appropriate measures to ensure that the other party is also adequately protected, particularly on the employer's liability side of the policy.

- F. A coordinated policy shall be issued on a standard workers' compensation policy form, with an endorsement or endorsements clearly describing all variations from the terms of the insurer's direct purchase policy, consistent with the terms of the multiple coordinated policy agreement and this regulation, including without limitation provisions establishing that premium payment is the sole obligation of the PEO and clarifying the client's rights and obligations with respect to policy cancellation and, if applicable, policy conversion.
- G. All policies for clients issued under a multiple coordinated policy agreement with a PEO shall have the same termination date. If a client enters into a PEO agreement during a policy period, the initial policy will be written for less than a twelve-month period. Subsequent policies shall be written with the same effective date as the policies for other clients. Termination of the PEO agreement between the PEO and client shall be grounds for cancellation of the client's coordinated policy or, if agreed between the insurer and the client, for conversion to a direct

purchase policy.

- H. The insurer shall send each coordinated policy to the PEO, and shall send the client a certificate adopting by reference the policy form attached to the multiple coordinated policy agreement together with any amendments that may be expressly set forth in the certificate, and providing a method by which the client may obtain a copy of the entire policy on request.
- I. The insurer shall use its standard underwriting and rating rules for coordinated policies, except as modified by the terms of the multiple coordinated policy agreement.
- J. Regardless of the basis on which coverage is provided, the insurer shall report payroll and claims data for each client to the designated advisory organization in a manner that identifies both the client and PEO, and experience modification factors shall be calculated for each client as if the client were the sole employer of all PEO co-employees. The designated advisory organization may also establish rules for the calculation of an experience modification factor for PEOs which may be used by agreement between a PEO and an insurer in accordance with Section 12A.
- K. Policies for clients issued on either a direct purchase or multiple coordinated policy basis shall be issued with a Labor Contractor Endorsement limiting coverage under the policy to PEO co-employees and those direct hire employees who are not covered under a separate policy.
- L. An insurer, directly or through an advisory organization authorized to act on its behalf, shall file all applicable master policy forms, master policy certificate of coverage forms, multiple coordinated policy agreement forms and coordinated policy forms with the commissioner at least thirty (30) days before issuing master policies or multiple coordinated policies subject to this regulation, or no later than the effective date of this regulation for forms already in use. If a master policy or a multiple coordinated policy agreement is written on a manuscript basis or materially varies from the forms on file with the commissioner, the insurer shall file the contract as soon as practicable, and no later than ten (10) days after the effective date.

## **Section 8. Premium Payments**

- A. The PEO is responsible for payment to the insurer of any premiums, policyholder assessments or deductible reimbursement charges under a master policy or coordinated policy, whether or not the PEO has received timely payment from the client. A client's failure to pay fees when due to the PEO does not constitute nonpayment of premium within the meaning of [insert reference to law regulating cancellation of workers' compensation policies and law or residual market operating rule requiring denial of coverage to employers with outstanding premium debt]. Unless the PEO and client are under common ownership, a client may not be denied coverage pursuant to [insert reference to law or residual market operating rule requiring denial of coverage to employers with outstanding premium debt] on the ground that its PEO has failed to pay premium to the insurer when due.
- B. A master policy or multiple coordinated policy agreement shall include provisions requiring the insurer to take prompt action to cancel a client's coverage or convert it to direct purchase coverage, at the carrier's option, if notified by the PEO that the PEO agreement has terminated.

- C. An insurer may not issue a master policy or multiple coordinated policies with deductibles or with retrospective or other loss-sensitive rating unless the insurer has applicable program policy forms on file with the commissioner.

**Drafting Note:** If state law prohibits deductibles, omit reference to deductibles.

- D. The client's direct hire employees, if any, shall be included in the client's payroll for rating and classification purposes unless the policy or certificate was issued with a direct hire exclusion pursuant to Section 7A(2).
- E. If a coordinated policy is converted to or replaced with a direct purchase policy, the insurer shall provide clear and timely notice to both the PEO and client explaining when the PEO's premium payment obligations end and the client's premium obligations begin. The insurer shall conduct a premium audit within 120 days to determine the PEO's final premium obligation under the policy. Unless otherwise agreed between the insurer and the former PEO client, a converted policy shall have no deductible and shall be rated according to the insurer's generally applicable rating plan.

**Drafting Note:** If applicable state law provides a different time frame for premium audits, states may consider modifying this provision accordingly.

- F. If a client's negligence or fraud results in a substantial understatement of the estimated premium for coverage of the client under a master policy or coordinated policy, or if the PEO's negligence or fraud results in a substantial understatement of the estimated premium for a client's direct purchase policy, the PEO and client are jointly and severally liable to the insurer for the premium actually owed.

## **Section 9. Verification of Classifications and Payroll**

- A. At least annually, and more often if reasonably requested by the insurer, a PEO shall furnish to the insurer a complete payroll record of all PEO co-employees covered pursuant to a master policy or multiple coordinated policy agreement, itemized by policy or certificate number and by workers' compensation class code. The insurer may visit the client to review ledger records or may request copies of payroll information from the client to determine the actual amounts paid to PEO co-employees, and to direct hire employees if the direct hire employees are not covered under a separate policy.
- B. An insurer shall be permitted access to inspect the client's workplace to determine the proper classifications for insurance purposes. If either the PEO or client disagrees with the insurer's classification assignment, it may ask the designated advisory organization to do an inspection to determine the proper classification, subject to a further right of appeal to the commissioner. This subsection does not limit the insurer's or PEO's right to conduct safety inspections as appropriate.

## Section 10. Policy Cancellation or Nonrenewal

- A. A master policy or a coordinated policy may be cancelled or nonrenewed by the insurer on the same grounds and subject to the same conditions as any other workers' compensation insurance policy. In addition, the insurer shall cancel or nonrenew a coordinated policy covering a client, or may at its option convert it to a direct purchase policy, if the multiple coordinated policy agreement is cancelled or nonrenewed, voluntarily or involuntarily, or if the PEO agreement between the PEO and the client terminates for any reason. The termination or conversion of coverage shall be concurrent with the termination of the multiple coordinated policy agreement or PEO agreement if adequate advance notice can be given in compliance with this regulation and applicable contractual provisions.

**Drafting Note:** The lawful termination of any essential component of the tripartite agreement among the insurer, the PEO purchasing the coverage, and the client should be a ground for policy termination, especially where the insured risk no longer conforms to the description in the policy. However, in some states the grounds for termination described in this subsection may be prohibited by statute or public policy, and these states should either amend the law or revise this subsection to mandate conversion to direct purchase coverage in lieu of cancellation and should also make corresponding revisions to subsections 4(D)(3), 7(D)(2) and (7H).

- B. Cancellation or nonrenewal of a PEO's or client's coverage at the initiative of the insurer without the written consent of that party is not effective as to that party unless the insurer has given at least thirty (30) days' advance notice to that party and the [workers' compensation regulator] in compliance with [insert citation to law regulating cancellation of workers' compensation policies].

**Drafting Note:** If applicable state law permits involuntary termination of workers' compensation coverage upon shorter notice in some or all situations, states may consider modifying this provision accordingly.

- C. Cancellation or nonrenewal of coverage under a master policy or coordinated policy at the initiative of the PEO or client shall be governed by the applicable contractual provisions, except as otherwise provided in this regulation.
- D. Cancellation or nonrenewal of a client's coverage at the initiative of the PEO without the written consent of the client is not effective as to the client unless either:
- (1) The insurer has given at least thirty (30) days' advance notice to the client and the [workers' compensation regulator];
  - (2) The PEO has given at least thirty (30) days' advance notice by certified mail to the insurer, the client and the [workers' compensation regulator]; or
  - (3) Coverage for all covered clients has been replaced with no break in coverage, and the PEO has given advance notice to the insurer, the clients, and the [workers' compensation regulator].

**Drafting Note:** If applicable state law permits involuntary termination of workers' compensation coverage upon shorter notice in some or all situations, states may consider modifying this provision accordingly.

- E. A request for termination of coverage by a client, or a client's or PEO's consent to waiver of notice under Subsection B or D of this section, is not effective:

- (1) If the request or consent is executed in blank without specifying the termination date at the time of execution, or is executed in advance as security for a future obligation;
- (2) If the request is made or the consent is given pursuant to a power of attorney that was executed in advance or by an attorney that was not chosen solely by and acting in the sole interest of the party on whose behalf the request is purportedly being made or on whose behalf the waiver is purportedly being given; or
- (3) If the request or consent is received by the insurer after the specified termination date, unless the insurer also receives satisfactory evidence demonstrating that coverage has been replaced with no break in coverage.

## **Section 11. Statistical Reporting and Experience Rating**

- A. All loss reporting for injuries to PEO co-employees and all payroll reporting for PEOs shall be conducted in a manner that identifies both the PEO and the client and enables the calculation of experience modification factors in accordance with this section.
- B. The experience modification factor for the client shall be based on all experience of both PEO co-employees and direct hire employees during the experience period.
- C. If some or all of the client's experience is unavailable or unreliable because relevant experience was not reported in the name of the client during all or part of the experience period or in some or all of the states where the client had operations, an experience modification factor shall be calculated in accordance with procedures established by the designated advisory organization and approved by the commissioner.
- D. All domestic insurers providing workers' compensation coverage to PEOs and all foreign insurers providing workers' compensation coverage to PEOs registered in this state shall file an annual report with the commissioner on the coverage provided in this market sector, at a time and in a format specified by the commissioner.

**Drafting Note:** The information to be collected may vary from state to state according to their respective regulatory needs, and states may wish to specify the information to be collected in more detail when promulgating regulations or drafting legislation based upon these guidelines. The information to be collected could include the following: the number of PEOs and number of clients covered; premium and loss information; the rating methodologies, security arrangements, and reinsurance arrangements used; and cancellations and replacements of coverage.

## **Section 12. Rating Methodology**

The premium an insurer charges a PEO for a client's operations shall be rated using the client's experience modification factor, with the following exceptions:

- A. If an experience modification factor has been calculated for the PEO in accordance with procedures established by the designated advisory organization and approved by the commissioner, the insurer and PEO may agree to use that experience modification factor or, with the approval of the commissioner, a formula that takes into account both the PEO's and the various clients' experience modification factors.

- B. If coverage is rated on the basis of the client's experience and some of the client's operations are to be covered under one or more policies issued by a different insurer, the insurer may, as one of the terms under which it offers to issue or renew coverage and separate from any other applicable credits or surcharges, either:
- (1) Use an experience modification factor based on the portion of the client's operations that are covered by that insurer if such a factor can be calculated with reasonable accuracy; or
  - (2) Adjust the premium in a manner that in the insurer's reasoned underwriting judgment appropriately reflects the difference in risk between the insured operations.

**Drafting Note:** Section 12 is not appropriate for jurisdictions that have not adopted Section 11, since Section 12 presupposes the existence of an effective mechanism for implementing experience rating at the client level and is not intended as an exemption from the requirements of Section 11. Also, since Section 12 permits the use of a negotiated alternative rating formula, it is not appropriate in jurisdictions that require insurers to adhere to a uniform rating plan.

### **Section 13. Interstate Coverage**

- A. If the PEO or client has its *bona fide* principal place of business outside this state, the insurer may request that the commissioner grant a variance from one or more requirements of this regulation to enable the PEO's or client's interstate operations to be covered under a single policy or multiple coordinated policy arrangement. The commissioner shall have the discretion to grant a variance upon a determination that the coverage arrangement preserves the statutory rights of employees and clients and offers protections substantially equivalent to those required by this regulation, that the risk is appropriately rated and that the loss experience of individual clients in this state is accurately reported.
- B. If the client has operations in multiple states, an interstate experience modification factor shall be used for the client if the client would be subject to interstate modification if it were the sole employer of its PEO co-employees and an accurate loss history is available for the client's interstate operations.

### **Section 14. Confidentiality**

If any information filed with or provided to the commissioner pursuant to this regulation is a trade secret or otherwise exempt from public disclosure under the [insert citation to applicable open records law], the commissioner shall withhold it from public disclosure if the person or entity providing the information makes a written request for confidential treatment that specifies with particularity why the document should be exempt from disclosure under the [insert citation to applicable open records law]. PEO client lists or other information from which the identity of clients may be inferred are presumed to be trade secrets and may not be disclosed to the public except on a finding by the commissioner that the specific information sought to be disclosed is not a trade secret or that failure to disclose the information would tend to conceal fraud or otherwise work injustice.

**Drafting Note:** In states where residual market employer lists are published, add the following sentence: "If a PEO is covered in the residual market, it shall not be named in the published listing of employers with residual market coverage at any time, and its clients shall not be named until residual market coverage has been in force for sixty (60) consecutive days and shall not be designated as clients of the PEO."

## **Section 15. Remedies**

- A. Violations of this regulation by a PEO, client or insurer are subject to penalties as provided in [insert citation to general disciplinary law or other applicable law]. Disputes involving a PEO, client or insurer arising out of a claimed violation of this regulation may be resolved by an adjudicatory hearing before the commissioner.

**Drafting Note:** In states where another agency has regulatory jurisdiction over PEOs, there should either be a provision specifying procedures for referring disciplinary actions for PEOs to that agency, or provisions under which regulations are jointly promulgated by the agency regulating PEOs and establishing remedies under that agency's regulatory authority.

- B. It is a deceptive practice in the business of insurance within the meaning of [insert appropriate citation to unfair trade practices act] for a PEO to represent to clients or prospective clients that they have or will have workers' compensation coverage except when a coordinated policy or certificate of coverage is issued in compliance with this regulation or a duly authorized agent of the insurer has issued a valid temporary binder; for a PEO to purport or threaten to terminate workers' compensation coverage except in accordance with this regulation; or for a PEO to knowingly or recklessly fail to provide the notices or disclosures required by this regulation. If the violation is knowing or willful, it is a fraudulent insurance act within the meaning of [insert appropriate citation to insurance fraud act].

## **Section 16. Effective Date**

The effective date of this regulation is [insert appropriate lead time], except that no later than [one month earlier], the [statutory carrier of last resort or residual market manager] shall file its proposed standard multiple coordinated policy agreement with the commissioner, pursuant to Section 6 of this regulation, and the designated advisory organization shall file proposed state special modifications to its experience rating plan if any are required. This regulation applies to all policies issued or renewed and any applications submitted on or after the effective date of this regulation.

## **Appendix B**

### **NCCI Alternatives and Technical Supplement on Data Reporting**

#### **Purpose of Proof of Coverage (POC) and Experience Rating Data**

Workers' compensation administrators and insurance regulators rely on POC and statistical data to enforce and monitor the workers' compensation system. For states that recognize the PEO and their clients as co-employers, compliance programs and regulations need to consider the impact of insurance coverage as it relates to the PEO and the client employer. Regardless of the existence of a PEO or employee leasing arrangement, the integrity of experience rating and POC programs must be effectively maintained with statistical data that is:

- Sufficient to enable the state's compliance administrator to efficiently track and identify whether an employer within the state has the coverage required by law to ensure that injured employees' claims will be processed and the required benefits paid. At a minimum, POC data must identify the worksite employer's name, location, covered work units, and date of inception/cancellation/termination of coverage.
- Detailed enough to allow for the accurate reporting and tracking of payroll and losses attributable to the worksite employer, and enabling the calculation of experience modification factors at the client level.

#### **Master Policy Considerations**

The Guidelines support the master policy model when the following conditions are met:

- Client-specific notice requirements and payroll, loss, and other data reporting requirements give the client a status similar to that of an individual insured employer while insured under a master policy;
- Current insurance statistical and data reporting structures have the ability to track client experience and produce client experience ratings using all of the client employers' past experience, whether or not that experience is from the master policy;
- The insurer or the PEO cannot terminate or materially alter coverage without reasonable advance notice to the client;
- Insurers maintain and report data in sufficient and accurate detail to permit the calculation of meaningful client-specific experience ratings and verification of POC on the client level;
- Experience ratings are produced on an ongoing basis for every client that is eligible for experience rating;
- Ability to identify each covered client's workforce as a discrete unit of coverage under the master policy;



- The master policy adopts a “certificate of coverage” requirement, under which each client is issued a coverage document outlining its rights and obligations under the master policy and clearly establishing both the identity and status of the client and the inception and termination dates of coverage.

Considering these conditions, the Master Policy could be issued using the following structure:

- Standard workers’ compensation policy (master policy) is issued to the PEO, as the primary named insured;
- Each client company of the PEO is listed as an additional named insured (as provided in Subsection 7(B) of the Guidelines);
- Information page schedules are attached to the master policy to identify each client company’s name, FEIN, and job location;
- Each client company is issued a “certificate of insurance” coverage document outlining its rights and obligations under the master policy that clearly establishes both the identity and status of the client, and the inception and termination dates of coverage;
- Each client workforce is identified as a discrete unit of coverage, and corresponding endorsements are attached to specify notice requirements, and policy conditions for each client company covered under the master policy;
- Experience modification factor applicable to the master policy would include the combined experience of the PEO and each client company, including any past experience;
- Pricing and experience rating rules may be adjusted to allow for the combinability of experience and combination of premiums and eligibility for discounts, such as large deductible programs, retrospective rating, and group modification factor.

### **Data Reporting Options for the Master Policy**

The root of the technical problems with obtaining client-level data under a master policy is that present industry standards for the reporting and collection of data are based on the issuance of a separate policy for each employer. These standards support the constant exchange and use of data from carriers’ systems to data collection organizations, and subsequently, to many states’ compliance systems. The existence of a separate policy identifies the employer as a potential candidate for experience rating and results in the submission of unit statistical data that provide the payroll and losses of the employer used in the experience rating calculation. While some industry standards have changed to assist in the complex reporting of PEO-related data, the ability to make significant changes to the current system is limited both by cost considerations and the need to preserve current capabilities for exchanging data. Adding requirements or changing industry standards is only meaningful if compliance is technically feasible.

Following are two Master Policy options for the reporting of client-level detail. To consider coding changes and system implementation, an 18 to 24 month industry lead time would be required. Should any of these alternatives be considered (or possibly others), it is important to take into account the full range of data reporting and experience rating challenges presented by the Master Policy when client-level detail is required. Both options require the reporting of unit reports for each client that can be linked together for experience rating purposes; the major difference between the options relates to how policy (and POC) data is reported. A third option presented is to convert the current manual reporting system to electronic form. This would support reporting under the 1991 NAIC Model Regulation, but would not be consistent with the Guidelines.

**Option 1:       Single master policy issued with the reporting of separate client policy and unit data**

**Data Reporting Requirements**

Option 1 sets up a data reporting system for master policy situations that parallels the multiple coordinated policy framework. Separate policy data for each client company and the PEO would be reported as if separate client policies were issued. Separate unit data (payroll and loss) for each client would also be reported, thereby allowing for the reporting and maintenance of client level experience, in addition to the calculation of a group modification factor based on the combined experience of the PEO and its clients. This option would require the reporting of data in sufficient detail to permit the calculation of meaningful client-specific experience ratings, upon termination of a PEO agreement, and verification of POC at the client level. Additionally, policy reporting would need to be sufficient to identify the connection between all the client level policies to ensure that the separate unit data would also be rolled up to the PEO master policy level.

**Option 2:       Single master policy issued with the reporting of single policy data and separate client-level unit data (Multiple Coordinated Units)**

**Data Reporting Requirements**

Option 2 attempts to support the continuation of reporting a single master policy, but requires the reporting of separate unit data (payroll and loss) for each client. It utilizes the single PEO Master policy and requires multiple coordinated units to be reported. With Option 1, both client-level policy and unit data would be reported; however, with Option 2, only client-level unit data would be reported. As a result, Option 2 would require more detailed policy reporting requirements and the expectation of multiple unit reports for a single master policy. This option would call for significant changes to industry standards, including operating and reporting systems, and might be difficult to implement and costly to the industry.

**Option 3:       Electronic Reporting of Former Client Experience Rating Data**

Currently, when a client leaves a master policy, the PEO carrier reports the client's payroll and loss data to NCCI for experience rating purposes on a hard copy form through a manual process. Option 3 automates the current experience rating manual process, so that carriers would be able to electronically report and collect the individual data of former client companies to NCCI. This option supports the 1991 NAIC Model Regulation, which requires submission of client-level data only after the termination of an employee leasing arrangement; however, it would require changes in industry standards, additional costs, and may prove inadequate if business limitations exist for accurate and timely maintenance and reporting of client-level payroll and losses. This option does not address the maintenance of client-level data while the client is part of the master policy, and therefore is not consistent with the Guidelines.

*Chronological Summary of Actions (all references are to the Proceedings of the NAIC)*

*2007 Proc. 2<sup>nd</sup> Quarter, Vol. I 100, 111, 129-135, 219, 425, 627, 647 (adopted).*

*2007 Proc. 4<sup>th</sup> Quarter, Vol. I 116, 125, 141-142, 167-169, 403-405, 438-440, 484-488 (amended).*

*2010 Proc. 2<sup>nd</sup> Quarter, Vol. I 103, 124, 270-315 (amended).*