

Employment Practices Liability Insurance Coverage in Non-Employer Situations

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Employment-related claims are not a surprise to PEOs. Changing rules, shifting standards, and conflicting duties have created a minefield of liability. Perhaps most distressing, employers have encountered (and hired) a new generation of workers for whom a job is viewed as an entitlement. The costs associated with the defense of employment-related claims and the claim liability itself are high and are generally not covered by most commercial general liability policies. While employment practices liability insurance (EPLI) is designed to help employers manage the risks inherent in the modern workplace, was it created in contemplation of the PEO employer?

Beginning in the early 1990s, insurers began offering EPLI. EPLI provides coverage for defense costs and compensatory damages arising out of lawsuits alleging certain wrongful employment practices. These policies reimburse employers for the costs of both judgments and settlements, and provide this reimbursement whether the company wins or loses the suit. However, EPLI policies generally do not cover punitive damages, fines, or penalties. Coverage is usually provided for an organization, its directors, officers, employees, and former employees. The cost of this

coverage generally depends on the type of business involved, the number of employees, and the company's history of employment-related claims.

Recognizing the rapid growth of professional employer organizations, some underwriters have attempted to revamp their products to make EPLI coverage available to PEOs and their client companies. PEOs have been able to take advantage of the risk management benefits of this coverage and, through a combination of volume-based pricing, the law of large numbers, and implementation of effective risk management and loss control principles, pass along benefits of insurance coverage to their clients who would not otherwise have such coverage available to them. Not surprisingly, PEOs eagerly market the availability of this EPLI coverage in an effort to attract new clients and distinguish themselves from their competitors.

The PEO industry has experienced a number of business model permutations, which have been based, more than any other factor, on the relationship of the PEO to the client company and the work-site employees. Quite simply, certain PEOs may be eligible for EPLI coverage while others may not. The risk, of course, is that a PEO may think it has secured sufficient EPLI coverage, only to learn there are gaps in coverage or a complete lack of coverage in this area.

EPLI Coverage and the PEO Model

A "conventional PEO model" (one seemingly codified under Florida and Texas law) anticipates that the PEO, as a co-employer, will be significantly involved in its clients' employment decisions. The underlying basis for offering EPLI coverage to PEOs is premised upon the fact that the risks attendant to such a business involve its co-employer status with the client workforce and the likelihood the PEO can favorably impact employment practices. Because the PEO is involved in all phases of the employment relationship (hiring, discipline, termination), an underwriter views the PEO as having meaningful input into the type of decisions that form the basis for evaluating liabilities covered by the insurance. The "input and participation" of the conventional PEO model provide the underwriter with the necessary confidence to offer the EPLI coverage to the PEO and its client companies.

EPLI Coverage and Non-Employer Models

There are a number of agency or non-employer models (most commonly the ASO model) that peacefully coexist along a different but concurrent path in the industry and are designed to respond to different needs of certain types of client companies. ASOs assist the client company or may act as its agent in various administrative functions. Unlike the conventional PEO, the ASO does not become a co-employer with the client company from most EPLI underwriters' perspectives, and does not assume any employment practice responsibilities. For these reasons, the elements necessary to establish the requisite risk management rela-

relationship with the client company are typically absent in the ASO model.

An underwriter generally will not provide EPLI coverage to an entity that is not, in any meaningful sense, an employer. Because an ASO does not oversee or participate in the employment-related decisions that serve as the basis for EPLI coverage, EPLI coverage is often not available without substantial underwriting of the client company. This, of course, often diminishes the cost/benefit economic justification of bundling the cost of EPLI coverage into the overall ASO services pricing. The ASO model tends to be a limited vehicle (albeit by design) vis-à-vis EPLI coverage.

The Continuum of PEO Models

It is fairly easy to examine the “conventional” PEO and ASO models in their purest forms and understand why underwriters are willing to extend EPLI coverage to one more readily than the other. However, the reality of today’s industry is that organizations cannot always be neatly labeled as either a conventional PEO or an ASO. This industry is growing and evolving, and traditional labels in this area are not always accurate or reliable. Therefore, these models are perhaps more accurately viewed as a continuum, with the conventional PEO model at one end and the ASO model at the other. In between, of course, are a variety of working models that incorporate aspects of each end of the continuum. It is in this “middle ground” where there is the potential for the evaporation of EPLI coverage the PEO thought it possessed.

Considerable risk awaits the organization that professes to be a co-employer PEO (and obtains EPLI coverage on that basis), but which, in reality, provides services that are more akin to an ASO. As an organization moves down the continuum away from the conventional PEO model,

the PEO moves into a precarious position with respect to EPLI coverage.

A coverage issue is most likely to manifest itself when, after a claim is made, an insurer determines that the alleged PEO performs more of an administrative function and does not qualify as an employer in its relationship with its client companies. At this point, the insurer could exercise its right to cancel coverage under the EPLI policy due to what it believes is a change in the risk. The insurer would argue that it issued the EPLI policy based on underwriting data submitted by the PEO that differs materially from the actual risk that exists. Such underwriting data involves whether the PEO would have significant input into employment practices. Most state insurance codes provide a statutory escape to insurers that would otherwise be bound to provide coverage for the entire policy period. The escape insurers most commonly use is the statutory provision that allows a short notice and cancellation if, for example, “There is substantial change in the scale of risk covered by the policy” (See§ 27-1-31-2(a)(2) of Indiana’s insurance code). Therefore, a PEO should not comfortably assume that, just because it has secured an EPLI policy, the insurer is bound to the policy for its term.

The difficulty of such a scenario extends beyond the gap or complete lack of coverage that would follow such a determination by the insurer. In addition to the direct monetary costs that would accompany any decision to fight the insurer’s cancellation of coverage, there would be collateral costs in the stability of the client base upon learning that the much-advertised EPLI coverage does not exist.

Gaps in Coverage Can be Avoided in the Underwriting Process

The underwriting process is the best opportunity to avoid confusion in EPLI coverage. This process is designed to permit an

evaluation of the risk to be insured. In the context of PEOs, this evaluation will be focused on the ability of the PEO to control the risks of its client companies’ workplaces. Insurers offering EPLI policies to PEOs generally have an appreciation for the different permutations of PEO models that exist, and the underwriting process will involve a careful analysis of the extent to which the PEO will be involved in the employment practices of its client companies. A PEO should expect premium quotes to rise as the underwriters appreciate that the PEO’s model more closely approximates the ASO model.

It is critical a PEO provide the proposed underwriter with full disclosure of its business model. Those PEOs seeking to rely on EPLI coverage as a risk management strategy are urged to carefully examine their business models to determine whether they have sufficient participation in the employment practices of their clients to secure a right of coverage. In this way, the PEO will gain confidence that the coverage it is buying is the coverage it will ultimately receive.■

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