

Who's The Boss? The Impact Of Professional Employer Organizations On Fidelity Coverage

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I. Introduction

As the number and complexity of employment-related laws and regulations have increased over the past two decades, staffing and human resources companies have grown in popularity to assist in managing various aspects of the employer-employee relationship.¹ These non-traditional employer-employee arrangements take various forms, including outsourcing, free-lancing, employee leasing, contract employment and professional employer organizations,² which have become increasingly popular in recent years.³ This article focuses on PEOs and the impact of this growing area of the staffing industry on fidelity coverage. As discussed below, because the PEO relationship is often described as a co-employment relationship, where responsibilities between the PEO and its client are shared and/or delegated between each other as regards particular employees, the fidelity practitioner must be knowledgeable about this new type of employment relationship in order to accurately assess coverage. The purpose of this article is to analyze issues that may arise in a fidelity bond claim involving a PEO.

II. Professional Employer Organizations

A. WHAT IS A PEO?

A PEO is a company that “contractually assumes and manages critical human resource and personnel responsibilities and employer risks for small to mid-size businesses by establishing and maintaining an employer relationship with worksite employees.”⁴ Generally, a PEO enters into a contract with its client, the worksite employer, to perform any or all of the following services: issuing pay checks, paying payroll taxes, managing employee benefits and ensuring compliance with workplace laws and regulations.⁵ Although the PEO receives a fee from its client to perform these services, it is legally obligated to pay

¹National Association of Professional Employer Organizations, *PEO FAQ's*, available at <http://www.napeo.org/what/questions.htm> (last visited May 31, 2002).

² Hereinafter PEO.

³ One PEO, Indianapolis-based Management 2000 LLC, reported recently that it started in 1994 and had \$5 million in wage billings. In 2001, it had \$80 million in billings and anticipates \$100 million in 2002. Dennis Hamilton, *PEOs Grow by Giving Small Firms Bigger Benefits*, IND. BUS. J., March 25, 2002, at A21. Another PEO, Adminiserve, reported a 9,344% growth rate from 1996 to 2000, with wage billings in 1995 of \$188,000 and growing to \$66 million in 2001. *Id.*

⁴ *PEO FAQ's*, *supra* note 1.

⁵ Pamela M. Prah, *Use of PEOs on the Rise*, KIPLINGER BUSINESS FORECASTS (May 24, 2002), available at 2002 WL 20611816.

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the employee and, in particular, to pay withholding and other taxes, regardless of whether the client reimburses them.⁶

PEO's differ from other outsourcing or temporary employee arrangements in one significant way: both the PEO and the worksite employer employ the worker, at least as respects certain aspects of the relationship. For example, unlike temporary staffing services, which recruit employees and assign them to clients to support or supplement the client's work force in special work situations, such as employee absences, temporary skill shortages or seasonal work loads, a PEO contractually assumes and manages employer responsibilities for certain functions for all or a majority of the client's work force.⁷ Similarly, the PEO relationship differs from employee leasing; workers are not fired by the worksite employer and rehired by the PEO. Rather, the worker is an employee of both the PEO and the worksite employer -- thus, the term "co-employment."⁸

In the co-employer relationship, both the PEO and the client company establish common law employment relationships with worksite employees. Each party may be solely responsible for certain obligations of employment while both parties may share responsibility for others. "When the facts and circumstances of a PEO arrangement are examined appropriately, both the PEO and the client will be found to be an employer for some purposes, but neither party will be found to be "the employer for all purposes."⁹ For example, depending on the particular contractual relationship between the PEO and the worksite employer, the PEO may or may not participate in the hiring or firing of the employee. Similarly, the PEO may or may not have detailed information regarding the employee's employment background, again, depending on the specific contract with the worksite employer. And the PEO may or may not have control over the daily activities of the employee.

According to the National Association for Professional Employer Organizations,¹⁰ both the PEO and its client, the worksite employer, have a right to direct and control worksite employees - "the PEO directs and controls worksite employees in matters involving human resource management and compliance with employment laws, and the client company directs and controls worksite employees in manufacturing, production and delivery of its products and services."¹¹

⁶ Society for Human Resource Management, *Liability Confusion: Who is the Employer?*, H.R. MAGAZINE, Sept. 1997, available at <http://www.shrm.org/hrmagazine/articles/default.asp?page=0997COVB.HTM> (last visited May 31, 2002).

⁷ PEO FAQ's, *supra* note 1.

⁸ *Id.*

⁹ *Id.*

¹⁰ Hereinafter NAPEO.

¹¹ PEO FAQ's, *supra* note 1. The industry website supports the position that PEO's have a right to direct and control the worksite employee:

PEO's can manage the risks attendant to their personnel functions that they perform only if they establish an employment relationship with their worksite employees. Unless a PEO has a right to direct and control worksite employees, as well as a right to hire, supervise, discipline and discharge these employees, the PEO will merely assume liability without having a means to manage that liability. PEO's manage their employment liability exposure

B. WHO USES PEOs AND WHY?

The typical PEO client is a small to mid-size business with sixteen or fewer worksite employees.¹² In 2002, the number of workers employed through PEO's ranged from 2,000,000 to 3,000,000.¹³ Total revenues for PEO's, which include the salaries and wages that flow through them to workers, have increased from \$13.6 billion in 1995 to a projected \$45.4 billion in 2002.¹⁴

Small to mid-size companies are turning to PEO's because PEO's allow them to concentrate on the "business of business," while shifting the burden of compliance with workers' compensation, tax, and other worker-related laws to the PEO. In addition, particularly for small companies with a limited work force, contracting with the PEO allows the company to buy insurance as a part of the bigger company's pool, keeping costs down.¹⁵

C. FEDERAL AND STATE REGULATION OF PEOs

The growth in the PEO industry has prompted state and federal legislation regarding the effect of the PEO relationship on various employee-related areas. For example, the Internal Revenue Service recently issued guidance regarding the maintenance of defined contribution plans by PEO's.¹⁶ Similarly, bipartisan legislation has been offered by Congress to codify and clarify in what circumstances PEO's should be considered the

by monitoring and requiring compliance with employment laws, developing policies and procedures that apply to worksite employees, supervising and disciplining worksite employees, exercising discretion related to hiring new employees and ultimately terminating worksite employees who do not comply with requirements established by the PEO.

Id. Despite this NAPEO rhetoric, whether a particular PEO has any right or responsibility to control its employees with a particular client depends largely on the particular agreement reached with that client.

¹² *PEO FAQ's*, *supra* note 1; Prah, *supra* note 5.

¹³ Adam Geller, "Who's the boss? Workers are asking this question as employees turn to employee leasing," *THE JOURNAL RECORD*, May 28, 2002, available at 2002 WL 4935585; Prah, *supra* note 5; Internal Revenue Service News Release IR-2002-52, 20XX WL 1609639 (I.R.S.).

¹⁴ Geller, *supra* note 13. Other sources report PEO revenues reaching \$42 billion in 2001, up from \$24 billion in 1997. Prah, *supra* note 5.

¹⁵ Geller, *supra* note 13. If done properly, PEOs can expand the number of people getting benefits. Small companies that otherwise would not be able to handle the paper work associated with certain perks, such as 401Ks, are motivated to offer them once they know a PEO will handle their administration. See Prah, *supra* note 5.

¹⁶ According to an April 24, 2002 press release, the Internal Revenue Service announced a new revenue procedure which provides that a PEO that maintains a defined contribution plan that benefits workers of its clients can avoid disqualification for violating the exclusive benefit rule by adopting a multiple employer plan. Internal Revenue Service News Release, IR-2002-52, 20XX WL 1609639 (I.R.S. 2002). The exclusive benefit rule provides that a trust forming part of a qualified plan must be established and maintained by an employer for the exclusive benefit of that employer's employees. *Id.* If a plan provides benefits for individuals who are not the employees of the employer maintaining the plan, the plan could be disqualified because it would not satisfy the exclusive benefit rule. *Id.* Because a PEO's employees are also employees of its clients, prior to enactment of the IRS procedure described here, qualified plans for PEO employees could be disqualified for violating the exclusive benefit rule. *Id.*

employer.¹⁷ The Internal Revenue Service acknowledges that a PEO may be the employer for federal income and unemployment taxes.¹⁸ Various states recognize the co-employment relationship established through PEO contracts and provide some form of licensing,¹⁹ registration²⁰ or regulation²¹ for PEO's. Similarly, some states statutorily recognize PEO's as the employer or co-employer of worksite employees for purposes of workers compensation and state unemployment insurance taxes.²² For example, some states, such as Florida, consider the PEO the employer of record for worker's compensation purposes.²³ In Utah, the worksite employer is responsible.²⁴ Other states, such as Texas, recognize the PEO as a co-employer, but require the client's claims experience to be used for a certain period of time.²⁵

III. When a Fidelity Claim Involves a PEO

As one author has noted, "the essence of employee fidelity coverage is the existence of an employer-employee relationship between the insured and the alleged defalcator. In the absence of such a relationship, . . . , no fidelity coverage exists."²⁶ As with any fidelity claim, the first question to ask in a claim involving a PEO is whether the party committing the theft is an employee of the insured within the meaning of the policy. The analysis of this question will vary in complexity, depending upon whether the insured is the PEO or the worksite employer. If the defalcator is not an employee of the insured, then other coverages,

¹⁷This legislation (H.R. 2807/S. 1305) has been introduced but is unlikely to pass during this legislative year. Prah, *supra* note 5.

¹⁸PEO FAQ's, *supra* note 1.

¹⁹See MONT. CODE ANN. §§ 39-8-101-39-8-207 (West 2001) (Licensing, Disclosure, Workers Compensation Insurer Requirements); TEX. LABOR CODE ANN. § 91-011 (West 2002); UTAH CODE ANN. §§ 58-59-101 - 58-59-402 (1953-2001) (Professional Employer Organization Licensing Act).

²⁰LA. REV. STAT. ANN. § 23: 1761 - 1768 (West 2002) (Professional Employer Organizations) (requiring registration and outlining requirements for professional employer services agreements).

²¹GA. CODE ANN. § 34-7-6 (2002) (Professional Employer Organization: rights, powers and responsibilities); FLA. STAT. ANN. § 468.531 (West 2002) (Employee Leasing Companies - Prohibitions; Penalties).

²²For example, the Louisiana statute relating to unemployment compensation contains the following definition: "Co-employment relationship" means an employment relationship whereby both the client and the PEO have an employer/employee relationship with the covered employer and the direction and control of the covered employee is shared by or allocated between the client and the PEO pursuant to a PEO service agreement." Furthermore, the statute recognizes the PEO as the employer of employees covered by its service agreement and that, as the employer, it has certain rights and responsibilities with regard to those employees, such as paying wages, withholding and remittance of payroll taxes and establishing employee benefit and welfare plans. LA. REV. STAT. ANN § 23:1763.

²³See, e.g., FLA. STAT. ANN. § 440.11 (West 2002); *Caramico v. Artcraft Indus., Inc.*, 727 So. 2d 348 (Fla. App. 1999) (employee who received benefits from employee leasing company was "employee" of leasing company for workers compensation purposes).

²⁴UTAH CODE ANN. § 34A-2-103 (1953-2001).

²⁵TEX. LABOR CODE ANN. § 91-042 (West 2002). Similar to the Louisiana statute, the Texas statute requires that the contract between the staff leasing company and the client/employer provide that the leasing company not only assumes responsibility for paying payroll taxes and wages but also shares with the client company the right to hire, fire, discipline employers and the right to direct and control employment and safety policies. TEX. LABOR CODE ANN. § 91-032 (West 2002).

²⁶Carol A. Pisano, *The Outsourcer's Apprentice: Employee or Illusion*, 26 THE BRIEF 12, 13 (1997).

such as the Theft, Disappearance and Destruction Coverage Form, Coverage Form C,²⁷ should be reviewed to determine if the claim falls within that coverage. In analyzing the claim, some tangential issues may come into play, such as whether the insured had prior knowledge of a criminal history of the employee. None of these issues is new and this article will not analyze such basic fidelity issues. Rather, it will highlight how these well-known concepts can be complicated by the nature of the co-employer relationship.

A. WHO'S THE BOSS?

In determining who the employer is for purposes of coverage under Coverage Form A of the Commercial Crime Policy,²⁸ review of the policy definition of employee is the obvious first step:

“Employee” means:

- a. Any natural person:
 - (1) While in your service (and for 30 days after termination of service); and
 - (2) Whom you compensate directly by salary, wages or commissions; and
 - (3) Whom you have the right to direct and control while performing services for you; or
- b. Any natural person employed by an employment contractor while that person is subject to your direction and control and performing services for you excluding, however, any such person while having care and custody of property outside the “premises.”²⁹

Because the defalcator-employee in the PEO context can arguably be considered the employee of either the PEO or the worksite employer, different portions of the definition can arise. Where the insured is the PEO, subpart (a) would presumably apply, while subpart (b) would apply to a worksite employer insured. Each will be discussed in turn, below.

²⁷Commercial Crime Policy, ISO Form, Coverage Form (C) (Revised 1986) [hereinafter Commercial Crime Policy], reprinted in MILLER'S STANDARD INSURANCE POLICIES ANNOTATED (1995).

²⁸Commercial Crime Policy, Coverage Form (A).

²⁹Commercial Crime Policy, Crime General Provisions, Section C(1).

1. Where the PEO is the Insured

Courts analyzing coverage under subpart (a) have held that all elements of the definition must be met in order for persons to be deemed an employee.³⁰ A New York court set forth the following three-prong test:

The individual must be (1) compensated by the insured by salary, wages or commissions and (2) be subject to the insured's right to govern and direct at all times in the performance of his duties, and (3) not be a broker, agent, factor, commission merchant, consignee or contractor, or other agent or representative of the same general character.³¹

Commentators are generally in agreement that the most important factor of these is the second, the right to direct and control the employee's actions.³²

For example, in *Radiology Associates, P.A. v. Aetna Casualty & Surety Co.*,³³ the Court of Appeals of Arkansas reversed summary judgment in favor of the insurance carrier, finding that a temporary bookkeeper who embezzled money from the insured was the insured's employee as a matter of law. The temporary bookkeeper was paid by an employment agency which made salary deductions for social security withholding, workers' compensation and other deductions required by law. However, in all other respects she had the same duties and was treated in the same manner as the regular bookkeeper who was out on maternity leave.³⁴

The court emphasized that the "right of control is of major importance in determining the relationship" between the employer and employee. The employer had "control over [the employee] as to the manner in which she did her work; it hired her and it alone had the authority to fire her, or alter the terms of her employment, and she received wages paid by [the employer] in the agreed amounts."³⁵ That the temporary bookkeeper's salary was paid by an employment agency didn't matter: "the method by which [the employee] was paid is of little significance, since it is clear that the funds she received originated with [the employer]."³⁶

Similarly, in *Fortunoff Silver Sales, Inc. v. Hartford Accident & Indemnity Co.*,³⁷ the court cared little that the employee was paid a salary for his normal working hours by L&M

³⁰ *Charm Promotions, Ltd. v. Travelers Indem. Co.*, 447 F.2d 607, 609 (7th Cir. 1971); *175 Check Cashing Corp. v. Chubb Pac. Indem. Group*, 464 N.Y.S.2d 118, 120 (N.Y. App. Div. 1983).

³¹ *Gross Veneer Co., Inc. v. Am. Mut. Ins. Cos.*, 424 N.Y.S.2d 743, 744 (N.Y. App. Div. 1980).

³² Armen Shahinian & Scott D. Baron, *Who is a Covered "Employee" Under the Financial Institution Bond?*, FINANCIAL INSTITUTION BONDS 103 (Duncan L. Clore ed., 1998); Timothy Sukel & Toni Scott Reed, *Bond Claims and the Impact of the Uniform Electronic Transactions Act, the Uniform Computer Information Transactions Act, and Other Technological Developments*, 36 TORT & INS. L.J. 735, 754 (2001); Pisano, *supra* note 26 at 5-6.

³³ 613 S.W. 2d 106 (Ark. 1981).

³⁴ *Id.*

³⁵ *Id.* at 107.

³⁶ *Id.*

³⁷ 459 N.Y.S.2d 866 (N.Y. App. Div. 1983).

Security Service, Inc., an entity entirely separate and distinct from the insured, with whom the insured had contracted for security services. The court found that the insured had the sole right to govern and direct the employees' duties and activities and was, in fact, solely responsible for directing and supervising the employee in the performance of his duties.³⁸

Control of the employee in question was also determinative of coverage in *Gross Veneer Co. v. American Mutual Insurance Co.*,³⁹ where the appellate court reversed and remanded a decision in favor of the insurance carrier, finding a question of fact whether the insured or the party who paid his wages governed and directed the conduct of the embezzling employee.⁴⁰ In *Gross Veneer*, the employee's compensation was paid not by the insured but a wholly separate company, Litchfield Park Corporation. The court noted that this arrangement was for "administrative convenience between related corporations" and remanded the case for a determination of who exercised control over the employee and whether the employee was really an agent of the insured.⁴¹ If either possibility did exist, then the policy definition "would compel the conclusion that [the employee] was not an 'employee' within the meaning of the policy."⁴²

The insureds in *Gross Veneer*, *Fortunoff Silver Sales*, and *Radiology Associates* all would be considered worksite employers in the PEO scenario. In another case, *Omne Services Group, Inc. v. Hartford Insurance Co.*,⁴³ the court considered whether a worksite employee could be considered to be an employee of the outsourcing company for the purposes of fidelity coverage.

The insured, Omne Services Group, provided outsourcing services for two customers, Metro Labor Solutions and four companies owned by Timothy Kraft. As per the typical PEO relationship, Omne entered into contracts whereby the other companies would outsource their employees to Omne. That is, the workers would be placed on Omne's payroll so that Omne had the legal responsibility to pay taxes and unemployment insurance premiums. Omne also assumed worker's compensation liability for all the companies' employees. The employees continued to provide services to their companies after they were added to Omne's payroll.⁴⁴

Omne alleged that Kraft placed friends, relatives, creditors, and investors on Omne's payroll, none of whom were bona fide employees of Kraft's company. According to Omne, Kraft then took the funds generated and diverted them to his own purpose while building up a large balance due from Omne. Eventually, Kraft absconded with the money, leaving Omne with a large loss.⁴⁵

³⁸ *Id.*

³⁹ 424 N.Y.S.2d 743 (N.Y. App. Div. 1980).

⁴⁰ *Id.* at 744.

⁴¹ *Id.*

⁴² *Id.*

⁴³ 2 F. Supp. 2d 714 (E.D. Pa. 1998).

⁴⁴ *Id.*

⁴⁵ *Id.*

Omne attempted to recover the money stolen by Kraft under its commercial crime policy. In considering whether Kraft was an employee of Omne, the court looked at whether Kraft had been “in [Omne’s] service,” and whether Omne had the right to direct and control him while he was performing services for Omne.⁴⁶ Although he had placed himself on the payroll, and Omne issued pay checks to him, the court found that Kraft was only an employee on paper, not an employee as defined in the crime policy.⁴⁷ Even if Kraft were to have performed services for Omne, the undisputed facts showed that Omne had “no right to direct and control [Kraft] while performing services for [Omne].”⁴⁸ Omne had no right to fire Kraft, or to discipline or control him in any way; the arrangement between Kraft’s companies in Omne was purely an outsourcing arrangement and, thus, did not fall within the policy’s coverage.

In sum, when analyzing coverage under the commercial crime policy, a court most likely will focus not on whether the PEO pays the employee’s salary and benefits, but on whether the PEO had the right to direct and control the actions of the employee. Moreover, because the PEO may have the right to control the employee with respect to certain functions of the job, but not others, the issue will be intensely factual. Primary sources for determining whether the PEO had the right to control the employee with respect to the functions at issue, of course, are the contract between the PEO and its client, as well as testimony of representatives of the worksite employer as to who directed and controlled the actions of the employee.

2. Where the Insured is the Worksite Employer

Where the insured is the client/worksite employer, subsection (b) of the Commercial Crime Policy definition should apply to govern whether the defalcating party is an employee of the worksite employer. Pursuant to that subsection, a person employed by an “employment contractor” is an employee within the meaning of the policy where the person is subject to the direction and control of the insured and performing services for the insured.

There are few reported decisions construing the language in subsection (b). In a recent decision, *Mansion Hills Condominium Ass’n v. American Family Mutual Insurance Co.*,⁴⁹ the Missouri Court of Appeals, when determining whether an employee was employed by an employment contractor within the meaning of subsection (b), held that the term was ambiguous, and thus ruled in favor of the insured as to whether the defalcating party was an employee.⁵⁰

The issue on appeal was whether an office manager who embezzled funds from the insured, Mansion Hills Condominium Association, was the employee of an “employment contractor,” thereby allowing coverage for financial losses Mansion Hills suffered.⁵¹ Mansion Hills had obtained a business and property insurance policy with the defendant,

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ *Id.* at 718.

⁴⁹ 62 S.W. 3d 633 (Mo. Ct. App. 2001).

⁵⁰ *Id.* at 640.

⁵¹ *Id.* at 636.

American Family Mutual Insurance Company, including an employee dishonesty endorsement with the same the definition of employee as in Coverage Form A.

KEM Construction Company was created to develop and manage the Mansion Hills Condominium complex.⁵² Mansion Hills paid KEM an annual fee to provide an on-site office manager, Pat Ducharme, who was paid by KEM. Ducharme received her W2 form directly from KEM. Mansion Hills had no direct employees of its own. Ducharme's duties as the office manager included collecting monthly condominium fees from residents, paying expenses, and hiring independent contractors to perform maintenance work as needed. In carrying out these duties she was subject to the direction and control of Mansion Hills.⁵³ She had the authority to write checks from the Mansion Hills checking account as well as from KEM's checking account.

Ducharme misappropriated funds from the Mansion Hills checking account,⁵⁴ and Mansion Hills submitted a claim to American Family under the employee dishonesty endorsement. American Family refused to pay the claim, contending that Ducharme was not the employee of an "employment contractor" within the meaning of the endorsement.⁵⁵

The court noted that there were no reported cases on point with respect to how to construe the term "employment contractor." American Family employed an interesting (but ultimately unsuccessful) strategy in defining "employment contractor": it pointed the court to the Southwestern Bell Yellow Pages for the Greater St. Louis Area, specifically pointing to the pages listing various entities under the heading of "Employment Contractors Temporary Help."⁵⁶ The businesses listed there included Account Temps, Kelly Services and Manpower as well as lesser-known businesses. American Family contended that the term "employment contractor" (1) had an accepted ordinary meaning such that "the average Joe Citizen would believe the term to mean," and (2) that the meaning is limited only to "an employment agency which provides 'temporaries' to a particular business on a 'fill-in' basis."⁵⁷

The court disagreed, finding the Yellow Pages are "an advertising medium, not a reference guide for discerning the meaning of words and phrases."⁵⁸ The term "employment contractor," the court said, "simply does not have any readily discernable ordinary meaning."⁵⁹ As such, the term was ambiguous and a reasonable policyholder might have assumed that "employment contractor" meant any third party contracted to provide workers

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ Mansion Hills would have had a strong argument that, because it directed and controlled the actions of Ducharme, she would have been considered an "employee" under subpart (a) (but it did not so argue). That an annual fee was paid to KEM, rather than paid directly to Ducharme for her services, likely would not have presented a bar to coverage, as noted above.

⁵⁶ *Id.* at 638.

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ *Id.* at 638-39.

for another.⁶⁰ Furthermore, there was no substantive difference between the arrangement Mansion Hills had with KEM and which other temporary services agencies had with their clients. “The substance of the transaction is identical: Mansion Hills pays a third party to hire someone to staff its office; that party then places one of its employees in the office to perform work under the direction of Mansion Hills. In this regard, a reasonable insured might assume that KEM was no less an employment contractor merely because it was not listed as such in the Yellow Pages.”⁶¹

Considering the nature of the contractual relationship between a PEO and its client, the worksite employer, it is unlikely that a court would perform the lengthy analysis of the *Mansion Hills* court in considering whether subsection (b) of the employee definition applied to a claim by a worksite employer. PEO’s are in the business of providing employment services to their clients. It is interesting to note, however, that in *Mansion Hills*, both the court and the insurance carrier focused on that aspect of the staffing industry dealing with temporary placement of workers. The PEO relationship differs from such services because the employee is employed by both the PEO and the worksite employer on a permanent basis. In addition, the employee is not placed with the worksite employer but is typically hired directly by the worksite employer.

A more interesting and factually intense analysis would be whether the employee was subject to the direction and control of the worksite employer when the defalcation took place. Because subsection (b) also requires that the employee be performing services for the insured at the time of the defalcation, the employee likely will be acting under the direction and control of the worksite employer if also performing services for the worksite employer.

3. Can the Worksite Employee Be the Employee of Both the PEO and The Worksite Employer?

Even if both the PEO and the worksite employer claim to be the employer, that would not necessarily preclude coverage. In *Wooddale, Inc. v. Fidelity and Deposit Company of Maryland*,⁶² for example, the court considered whether fidelity bond coverage existed for alleged misappropriations by the president of a related company who was also an employee of the insured company.⁶³ The carrier argued that the president was not an employee as defined under the policy and was, furthermore, specifically excluded thereunder as a contractor.

The employee in question, Wendall Caldbeck, was president of and operated a general contracting business under the name of Caldbeck Construction. Caldbeck formed another entity, Caldbeck, Inc., the predecessor to the appellant, Wooddale, which performed work on bonded construction jobs. Upon receiving payment from an owner on a bonded job, Caldbeck would deposit the check in the Caldbeck, Inc. checking account and issue a check

⁶⁰ *Id.* at 639.

⁶¹ *Id.* The court also noted that, had American Family wished to limit the scope of “employment contractor,” it could have done so by adding an endorsement or other limiting language to the policy which it did not.

⁶² 378 F.2d 627 (8th Cir. 1967).

⁶³ *Id.* at 629.

to Caldbeck Construction. He would then invoice Caldbeck, Inc., in the name of Caldbeck Construction. Caldbeck was fired by Wooddale after he wrote checks from the Caldbeck, Inc. account for his personal use.⁶⁴

In determining whether Caldbeck was acting as a contractor or employee under the bond, the court looked to master-servant principles of Iowa law. There was nothing in the bond preventing an employee from serving two masters or in two distinct capacities, and “dual employment per se does not defeat coverage under a fidelity bond.”⁶⁵ Under the circumstances of the case, the court held that Caldbeck could be considered to be an employee of Caldbeck, Inc., even though he acted as president of Caldbeck Construction. Therefore, coverage existed under the bond.⁶⁶

B. WHERE THE PEO EMPLOYEE STEALS FROM THE WORKSITE EMPLOYER

In addition to the worksite employees for whom the PEO pays payroll and other benefits pursuant to its client contracts, the PEO also employs its own workers to perform functions for its business such as making the payroll and managing benefit and health plans. Where one of those PEO employees steals from the worksite employer, most likely the worksite employer would look to the carrier for coverage under one of the other coverage parts of the Commercial Crime Policy, such as Coverage C for Theft, Disappearance and Destruction:

- A. Coverage - We will pay for loss of Covered Property resulting directly from the Covered Causes of Loss.
 - 1. Section 1 - Inside the Premises
 -
 - b. Covered Causes of Loss
 - (1) “Theft”
 - (2) Disappearance
 - (3) Destruction
 - 2. Section 2 - Outside the Premises
 -
 - b. Covered Causes of Loss
 - (1) “Theft”
 - (2) Disappearance
 - (3) Destruction
 -

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ *Id.*

D. ADDITIONAL EXCLUSIONS CONDITIONS AND DEFINITIONS:
In addition to the provisions in the Crime General Provisions, this Coverage Form is subject to the following:

1. Additional Exclusions: We will not pay for loss as specified below:
.....
 - b. Acts of Employees, Directors, Trustees or Representatives: Loss resulting from any dishonest or criminal act committed by any of your “employees”, directors, trustees or authorized representatives:
 - (1) acting alone or in collusion with others; or
 - (2) while performing services for you or otherwise.

Because under this scenario there can be no question that the PEO employee is not the employee of the worksite employer, the question is whether the PEO employee would be considered to be the authorized representative of the worksite employer, thus implicating Exclusion 1(b). Several recent cases indicate that the PEO employee might well be considered to be the authorized representative of the employer, precluding coverage under Coverage Part C.

In *Stop & Shop Cos v. Federal Insurance Co.*,⁶⁷ the First Circuit Court of Appeals reversed the trial court’s decision in which Federal Insurance Company was required to indemnify its insured, The Stop & Shop Companies, for loss arising out of theft by officers of Hamilton Taft & Company, a company employed by Stop & Shop to process and pay payroll taxes.⁶⁸ The First Circuit concluded that the authorized representative exclusion barred recovery by Stop & Shop.

In February 1990, Stop & Shop purchased a crime insurance policy from Federal which provided coverage for “direct losses caused by the . . . disappearance, wrongful abstraction or Computer Theft of Money and Securities . . .”⁶⁹ The policy excluded coverage for loss due to the “[t]heft or any other fraudulent, dishonest or criminal act . . . by any [e]mployee, director, trustee or authorized representative of the Insured whether acting alone or in collusion with others.”⁷⁰ Stop & Shop had entered into a tax service agreement in 1987 with Hamilton Taft by which Stop & Shop would deposit funds with Hamilton Taft, which would use them to pay taxing authorities on behalf of Stop & Shop.⁷¹ The agreement allowed Hamilton Taft to commingle Stop & Shop funds with deposits from other customers and to use the money for its own investments and expenses so long as tax payments owed by Stop & Shop were made when due.

⁶⁷ 136 F.3d 71 (1st Cir. 1998).

⁶⁸ *Id.* at 72.

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ *Id.*

On four separate dates for which Stop & Shop had tax payments due, Hamilton Taft employees prepared the checks and recorded them as payments made in their accounting logs. However, the checks were not mailed in the required period of time. Upon discovering that its tax payments had not been made, Stop & Shop contacted Hamilton Taft, which ultimately paid the liabilities. Around the same time, a former Hamilton Taft comptroller reported to about thirty Hamilton Taft clients that the company's executives, most notably chief executive officer Connie Armstrong, were diverting client funds intended for tax payments and using these funds for their personal use or for investment in other Armstrong-owned companies.⁷² Three Hamilton Taft clients petitioned the company into involuntary bankruptcy and a trustee was appointed.

Thereafter, the trustee demanded that Stop & Shop repay the bankruptcy estate for the tax payments made by Hamilton Taft, arguing that they were voidable preferences.⁷³ After litigation in which the Ninth Circuit agreed that the payments were voidable preferences and subject to repayment, Stop & Shop settled with the trustee and then filed a claim for indemnification with Federal for its remaining losses. Federal argued that it had no obligation to indemnify because Stop & Shop's loss was not direct and the policy's authorized representative exclusion barred recovery for theft perpetrated by Hamilton Taft executives.⁷⁴ The district court found direct loss and held the exclusion inapplicable.

On appeal, the First Circuit first looked to Black's Law Dictionary to determine whether the term "authorized representative" was ambiguous, as held by the district court. The court was persuaded that an "authorized representative" can be either a person or company empowered to act on an entity's behalf.⁷⁵ Stop & Shop argued that only Hamilton Taft, the corporation, was its authorized representative, not the individuals who committed the theft. The First Circuit disagreed, finding that, while a corporation does have a non-corporeal and independent existence, it can conduct its affairs only through its officers and employees:

[T]he reality is that the grant of authority to the executives of Hamilton Taft enabled their diversion of funds. When we consider, to, that employee exclusion clauses have been construed to encompass theft for personal benefit, and that the policy excludes illegal acts by employees, directors or authorized representatives without distinguishing between these groups, the intent of the exclusion is most readily understood as an effort to bar coverage of wrong committed by persons who have been granted access to the corporate funds.⁷⁶

If it were to accept Stop & Shop's argument that an insurance company must bear the full cost of theft only when it was committed by an individual working for the insured

⁷² *Id.*

⁷³ *Id.* at 73.

⁷⁴ *Id.*

⁷⁵ *Id.* at 74.

⁷⁶ *Id.*

company's authorized representative, but acting contrary to the representative's interest, the court observed, the exclusionary clause would not accomplish much.

The policy underlying the exclusion, which includes, without distinction, employees, directors, trustees and authorized representatives, is most readily understood as an effort to place on the insured the risk of picking a faithless agent. It makes little sense for the exclusion clause to encompass self-interested acts on the part of employees, but not on the part of those working for the authorized representative."⁷⁷

In conclusion, the court held that the use of the term "authorized representative" is a "straightforward effort to embrace all statuses that are 'authorized,' and thus are the insured's responsibility to supervise."⁷⁸ Accordingly, the exclusion for "authorized representatives" applied, and Stop & Shop was not entitled to coverage.⁷⁹

In a subsequent California decision, construing almost identical facts, the Ninth Circuit Court of Appeals followed *Stop & Shop* to find that coverage for a similar loss was precluded by the "authorized representative" exclusion. In *Stanford University Hospital v. Federal Insurance Co.*⁸⁰, the Ninth Circuit Court of Appeals also reversed a trial court decision finding coverage for losses resulting from the misappropriation of funds by Connie Armstrong at Hamilton Taft. The court easily found that Hamilton Taft, the corporation, was an authorized representative for the insured, Stanford University Hospital, finding that "inherent in Hamilton-Taft's status as an authorized representative for tax purposes is its authority to possess and disburse the funds of the [insured] in carrying out that duty. Its authorized access to these funds, on the premises of the insured or in transit, thus rendered it an "authorized representative" within the meaning of the theft policy's exclusionary clause."⁸¹

The more complicated issue for the *Stanford University* court was whether Armstrong, CEO of Hamilton Taft, also was considered an authorized representative for the insured. The *Stanford University* court agreed with the First Circuit's *Stop & Shop* ruling, finding that the plain meaning of the "authorized representative" language in the policies is not ambiguous and covers those who, by authorization of the insured, are given access to and permitted to handle the insured's funds. The court further noted that there "would be no force or effect to the exclusionary cause if the term 'authorized representative' did not include employees and officers of the authorized company."⁸²

The court in *Colson Services Corp. v. Insurance Co. of North America*⁸³ applied similar reasoning to find that a loss suffered by an insured agent by a bank's trust department purchase of worthless commercial paper with client funds fell within the exclusion for

⁷⁷ *Id.* at 76.

⁷⁸ *Id.*

⁷⁹ Because the court determined that Armstrong was an authorized representative of Stop & Shop, it did not reach the issue of whether Stop & Shop sustained a direct loss. *Id.*

⁸⁰ 174 F.3d 1077 (1999).

⁸¹ *Id.* at 1084.

⁸² *Id.* at 1086.

⁸³ 874 F. Supp. 65 (S.D.N.Y. 1994).

dishonest acts committed by an authorized representative. In *Colson*, the insured company, Colson Services Corporation acted as a fiscal and transfer agent and collection and paying agent for various clients.⁸⁴ Colson maintained accounts with the trust department of the National Bank of Washington and used that account to deposit funds which it received as fiscal agent on behalf of its clients. One of Colson's clients, the Small Business Administration,⁸⁵ authorized Colson to make conservative overnight investments with the money held on its behalf.⁸⁶ The agreement between SBA and Colson placed limitations on the types of investments and included an indemnification agreement. Colson authorized the bank to decide which overnight investments would be made with the funds in accordance with certain guidelines. In practice, Colson gave the bank complete discretion in choosing which investments to make with those funds.

Among those investments were overnight purchases of commercial paper issued by Washington Bancorporation.⁸⁷ This commercial paper was not an improved investment pursuant to Colson's agreement with SBA. Eventually, WBC defaulted on its commercial paper obligations.⁸⁸ Colson filed a claim with the carrier to recover under the Theft, Disappearance and Destruction Coverage Form. The court determined that the phrase "authorized representative" was unambiguous and would encompass an entity like the bank, which was given the authority by Colson to act as Colson's agent in choosing which investments to make each day with the money held in the account.⁸⁹

Applying these cases to the PEO scenario, a court, when faced with a loss caused by theft from the worksite employer by a PEO employee, would have to examine the nature of the theft and whether the PEO and its employees could be considered authorized agents of the employer. Due to the nature of the contractual relationship between the PEO and the worksite employer, there is some question whether the PEO acts as an agent or representative of the worksite employer or as a separate entity with its own separate legal responsibilities and obligations. In some states, for example, the PEO is considered the employer for purposes of workers' compensation and unemployment taxes and is legally responsible for paying payroll withholding taxes. Due to the co-employer relationship, the court would have to determine whether the co-employment relationship is simply a legal fiction such that the PEO, in reality, acts as the representative or agent of the worksite employer for administrative convenience. The appellate results in the *Stop & Shop* and *Stanford University* cases indicate that courts are receptive to such an argument.

1. Did the Employee Have a Criminal History And Who Knew About It?

The standard coverage form provides that the policy is automatically cancelled as to any employee when the employer discovers that the employee has committed a dishonest act. Coverage Part A. includes the following condition:

⁸⁴ *Id.* at 66.

⁸⁵ Hereinafter SBA.

⁸⁶ 874 F. Supp. at 66.

⁸⁷ Hereinafter WBC.

⁸⁸ 874 F. Supp. at 67.

⁸⁹ *Id.*

2. Additional Condition

Cancellation As To Any Employee:

This insurance is cancelled as to any “employee”:

a. Immediately upon discovery by:

(1) You; or

(2) Any of your partners, officers or directors not in collusion with the “employee”;

of any dishonest act committed by that “employee” whether before or after becoming employed by you.

b. On the date specified in a notice mailed to you. That date will be at least 30 days after the date of mailing.

Whether this condition comes into play will depend on the particular contract between the PEO and its client. The contract must be reviewed to determine whether the PEO, the worksite employer or both were involved in any activities for which knowledge of an employee’s conduct, both before and during his employment, could be gained. Such activities include the hiring process, disciplinary proceedings or monitoring the day-to-day work of the employee. Because either or both may have some involvement in these areas, the fidelity practitioner should carefully examine the particular circumstances of the case, including files maintained by its insured on the employee at issue, to determine if this condition is implicated.

IV. Conclusion

As PEOs become more common – and they will unless state or federal legislation prevents or restricts their operations – it is likely that more claims involving PEOs will arise. The key to evaluating such a claim is to recognize that PEOs have a strictly contractual relationship with their clients. The PEO agreement should spell out the responsibilities of each with respect to the employee in question. Whether the PEO has any ability or responsibility to direct or control the actions of the defalcating employee is the critical issue to resolve, regardless of whether the practitioner is evaluating coverage under Coverage Form A or other coverages included in the particular policy. Federal and state statutes also should be reviewed to determine whether statutory requirements, such as sharing of responsibilities for directing and controlling the employee, impact the analysis.