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U.S. companies ramping up contingent worker usage during the economic recovery and the busy holiday and production seasons should review basic legal contingent workforce issues.

Term Limits for Contingent Workers: Urban Legend or Necessary Fix?

By George Reardon, William Hays Weissman and Neil Alexander

Many companies that use contingent workers maintain policies that limit the duration of those workers' services. Under these policies, when a contingent worker reaches a prescribed time limit, that person's services must be terminated automatically, regardless of the person's job performance, and a replacement worker must be found or assigned by a contingent labor supplier.

While such term limiting policies may be well intended, they are not grounded in well-defined legal rules. As a result, there is little consistency in the policies that staffing clients have imposed. Some companies require replacement of contingent workers after a certain number of hours worked, but the maximum number of hours varies greatly, from just under 1000 to 4160, with many different rules in between. Others link limitations to the calendar, such as with 12-, 24-, or 36-month limits. After contingent workers are removed, additional rules may govern how soon they may return, varying from 31 days later, to one year later, to never.

Determining whether joint employment relationships exist for the purpose of legal liabilities is a fact-specific inquiry. Certainly working engagements lasting many years will be scrutinized by courts and by federal and state agencies. However, for most employment claims, it is the level of control exercised over the worker that is determinative of liability, not the length of the relationship.

Potential liability for Family and Medical Leave Act (FMLA) and benefits plans, due to misclassification, is the most common explanation for contingent worker term limits. Because eligibility for FMLA and many benefits are triggered by the length of employment and the number of hours worked, universally enforced term limits can admittedly limit or eliminate exposure for these narrow issues. However, term limits alone are not going to insulate staffing clients from legal liability for the vast majority of employment law claims. Further, these automatic replacements are unpopular with nearly everyone involved. They raise recruiting and training costs, can create discontinuity of service, raise special employment law issues, and (perhaps worst of all) systematically deprive high-performing workers of their ongoing employment for reasons that seem unjust and irrational to them. The questions are: "Are term limits for contingent workers necessary – or even helpful?" "Can the legal exposures be adequately mitigated in other ways?"

Where Term Limits Came From

Term limits arose from persistent concern about the May 1999 decision in *Vizcaino v. Microsoft*,[1] in which independent contractors and temporary employees claimed a right to receive the benefits that Microsoft provided to its directly employed workers.

An often overlooked consideration is that Microsoft actually won almost all of the issues, including its right to exclude contingent workers from its retirement and welfare plans. However, Microsoft did ultimately agree to a $97 million settlement related solely to its stock purchase plan, which is a kind of plan that most companies do not have. Notably, Microsoft conceded early in the case that the contingent workers should have been treated as employees. It is possible the result would have been different if it had not done so. The publicity about this case went viral in the legal, human resources, and benefits communities, and many staffing clients quickly imposed term limit policies as "feel good" protection against the risk of benefit claims by such contingent workers, which have come to be called the "retrobenefits" issue.

Are Retrobenefits Claims a Serious Risk?

To win a retrobenefits case, plaintiffs must prove **both** of two points.

First, a retrobenefits plaintiff must prove that contingent workers assigned or contracted to work in the staffing client's business are its common law employees. As long as the parties to the working relationship have exercised proper care in relation to the applicable contracts, policy manuals and the day-to-day control over the workers, this may be a difficult burden for the plaintiff to meet.

Second, even if retrobenefits plaintiffs can prove that they are common law employees of the staffing client, they must also prove the client's benefit plans cover them. Since there is no requirement for employers to provide these benefits, no automatic coverage of anyone will be assumed. Categories of common law employees can be and often are excluded from benefit plans. Coverage depends on the eligibility and participation rules and definitions stated in the plan documents. Retrobenefits plaintiffs must prove that they are covered and not excluded by the staffing client's benefit plans.

Most private employer retrobenefits cases post-*Microsoft* have held against contingent workers because the companies had fixed their benefit plan definitions and eligibility rules.[2] Many of the cases were won at the summary judgment stage and never even had to address issues about the nature of the employment relationship. Public sector clients have had a somewhat more difficult experience because of political forces and statutory factors that do not exist in the private sector.[3]

The "urban legend" that followed the *Microsoft* case has even inspired some staffing clients to believe that, without term limits, contingent workers would in time actually become entitled to be hired by them. This belief has absolutely no basis in the law.

How to Reduce Exposure to Retrobenefits Claims

The most effective way for companies that use contingent workers to avoid retrobenefits exposure is to modify their benefit plans and employment policies so that they clearly and unambiguously distinguish between direct employees and contingent workers – and then exclude all but the direct employees that are meant to be covered. This is best done by using definitions that specify not only who **is** covered (*e.g.*, direct employees of the client who receive a client paycheck) but also who is **not** covered (*e.g.*, independent contractors, leased employees, employees of staffing firms, and anyone else who is paid wages by anyone other than the client.) Plan language should also provide that the exclusion will still apply even if a court or other authority finds or deems the contingent workers to be common law employees.

Since this strategy wins retrobenefits cases, it also deters them. A plaintiff's lawyer looking for vulnerable defendant companies will pick companies who have not fixed their benefit plan documents. Thus, all companies utilizing contingent workers are strongly encouraged to review their benefit plans and ensure they contain adequate eligibility definitions.

Some companies are not aware of the broad latitude that they have to exclude categories of employees from benefit plans indefinitely. "Leased employees" under Internal Revenue Code section 414(n), for example, are one category of excluded employees that is so commonly excluded that the IRS forms that plan sponsors use to apply for tax qualification determination letters specifically ask about it.[4]

In qualified retirement plans, for example, up to 30 percent of a sponsoring firm's non-highly-compensated workforce can be excluded.[5] Most sponsoring companies, when they design retirement plans, do not want to exclude any of their direct employees from eligibility. As a result, this 30 percent "slack" goes largely unused and remains available to absorb the exclusion of large numbers of long-term, leased employees. Further, full-time temporary employees do not even get counted as "leased employees" (only to then be excluded from the plan) until they have worked 1500 hours during a year.[6] Thus, a careful analysis of retirement plan participation will often show that no rotation of contingent workers is required to mitigate this exposure.[7]

Companies sometimes impose six-month or 1000-hour term limitations because of a general awareness (but misunderstanding) of the ERISA "1000-hour rule."[8] That rule is a *waiting period* rule, not a *general eligibility* rule. ERISA says that *eligible* employees (those in categories intended to be covered eventually) cannot be required to put in more than one year of service (1000 hours, counted in particular ways) before they are allowed to actually participate in the plan. But *ineligible* employees can be kept out of the plan forever.

Certainly, a blunt and strictly followed term limit can eliminate this misclassification exposure; however, the operational difficulties of strict compliance often result in half-hearted compliance efforts that completely nullify the desired prophylactic effect. For example, the frequently used 30-day layoff of a full-time contingent worker between 12-month periods of continuous service would not constitute a break in service under ERISA[9] and would therefore be of no help in arguing against benefit entitlement. Nonetheless, many companies incorrectly assume that short discontinuities of service protect them. Further, production demands in many companies result in departmental attempts to circumvent the rules. Requiring workers to change staffing agencies, for example, has no beneficial value in reducing exposure, looks unethical and sneaky, and may result in contractual liability to contingent worker providers.

The law is even more permissive with respect to coverage under welfare and other types of benefit plans. There is no limit to exclusions under many types of plans; and certain other plans have non-discrimination tests that are similar (if not identical) to the ones described above, in that they usually allow for types and levels of exclusions that easily cover all of the client's leased employees.

Customary participation waiting periods also vary by type of plan. Only qualified pension and profit-sharing plans typically require one year of service for eligibility. Welfare benefit plans, such as life, health, accident, and disability income insurance, typically commence coverage immediately, on the first day of the next following month, or after a 30, 60, or 90-day waiting period. If there is a qualitative problem with the co-employment relationship (too much control exercised), with the identity of the common law employer, or with overbroad eligibility rules of the company's benefit plans, a six-month or one-year term limit will not cure it for purposes of these plans, some of which (life, disability, health) include the potential for very large retrospective claims.

In addition to the qualified retirement plans, ERISA welfare plans, and other formal plans, most companies maintain other, informal benefit policies and practices – typically including vacation, sick leave, incentive bonuses, and miscellaneous fringe benefits (like parking, discounts, or health clubs). All such plans, policies, programs, and practices need to be reviewed and perhaps amended to distinguish between direct employees and contingent workers. Once these programs are amended, the risk of retrobenefits claims becomes virtually nonexistent.

As additional immunization, staffing clients should also pay close attention to the first prong of retrobenefits cases and manage the factors that determine who is the common law employer of the contingent workers. Several cases offer guidance on how common law employment relationships are established.[10] These factors significantly overlap with indicia of joint employment relationships for Title VII, the ADA, and other equal employment laws. A balance must be struck between quality control and limiting direction over these workers.

One retrobenefits case is particularly helpful in showing that, while attention should be paid to many different elements of common law employment, there is a very strong presumption that staffing firms, and not their clients, are the common law employers of their assigned workers.

In *Burrey v Pacific Gas & Electric*,[11] the plaintiffs had originally been PG&E employees, but had been transferred to staffing firms that immediately assigned them back to PG&E to perform their previous duties with virtually all of the elements of the positions unchanged (titles, credit cards, direct expense reimbursement, company cars, etc.). Even though this case presented a worst-case scenario of contingent workforce facts, the federal court, applying ten questions specified by the U.S. Supreme Court, ruled that the staffing firm's role in payroll, benefits, taxes, and discipline was so strong that there was not enough reason to deem PG&E to be the workers' common law employer, and the workers' claims for PG&E benefits were denied.

FMLA Leave

One other consideration relating to term limits is the possibility that a long-term contingent employee will become entitled to FMLA leave, which is unpaid but still potentially inconvenient for the staffing client. This is a real possibility for contingent employees, since FMLA eligibility is triggered by 12 months of total service and more than 1,250 hours of service in the last 12 months with the primary employer.

However, term limit policies only limit service to the assigned client. Contingent employees can arrive on their first day already eligible for FMLA leave because of their prior service for the staffing firm working on assignments to other customers. The FMLA regulations require the client, as a secondary employer, to accept the worker back in its workforce if the client is still utilizing other workers from the staffing firm.[12] Importantly, limiting a term of work for the purpose of denying or interfering with FMLA rights is also a violation of the FMLA.[13]

Non-Benefit Problems Caused by Assignment Limits

Term limits can create other legal problems that may be worse than the problems that they are intended to solve. For example, when people doing a good job are replaced without any explanation that makes sense to them (even if they may not agree with the explanation), they assume that the reason is too bad to be admitted and must therefore be unfair or illegal or both. Inevitably, a term limit policy will at some point replace a qualified person in a legally protected class with a person not in the protected class. That creates a *prima facie* case of discrimination. Although a goal of operational consistency for contingent workers may be asserted as a defense, it is not always going to be an appealing or convincing response.

Inconsistent application of term limits can also facilitate favoritism by front-line managers, who may inadvertently or intentionally discriminate in their selective and subjective replacement of contingent workers. Claims have been made not only by workers who are being replaced but also by workers who are next in line for the assignments of workers who are retained in violation of the policy. For example, one class action resulted from the concurrent introductions of a term limit policy and an English language proficiency requirement, which in combination, had the practical effect of replacing a largely Hispanic workforce with a largely African-American workforce. These unintended consequences may be far more serious – and expensive – than the risks associated with retrobenefits that are minimized by other fixes.

There are also costs associated with replacing workers, getting new workers up to speed with ongoing projects and understanding the culture and organizational structure that do not easily appear on a balance sheet or cash flow statement but which nonetheless impact a company's bottom line. Also, disgruntled workers, even if they do not bring legal actions, may spread negative perceptions about companies as a bad place to work among their friends and coworkers. If termed-out contingent workers express dissatisfaction with particular employers, it may create further recruitment challenges in the future.

Conclusion

Term limits only help limit employment liabilities in narrow and sometimes ineffective ways. The length of these relationships should admittedly be carefully monitored. The operational and business reasons for using contingent workers for staff augmentation should be evaluated if these relationships extend beyond a few years. However, it is clear that term limits have many disadvantages. End users lose seasoned workers, enduring an endless cycle of training and turnover. Staffing firms incur extra recruiting, screening, and orientation expenses repeatedly replacing their employees. In many communities, term limits can actually exhaust the supply of qualified workers.

Staffing clients end up absorbing those extra costs. And the workers, of course, lose their income without any assurance of its immediate replacement. They may also lose respect for the client and staffing firms that decide to replace them without an understandable reason.

As discussed above, the most effective way of limiting liability is to have well drafted benefit and compensation documents, contracts, acknowledgments, policies and handbooks. Further, quality control needs must be balanced with the ability to limit day-to-day direction over the workers.

If there are potential concerns with exclusion and discrimination in benefit plans, do the actual calculations to see if the concerns are real, and, if they are real, consider whether a moderate, "as needed," rotation policy might not suffice. If term limit policies are to remain in place, make sure that the company can articulate good business reasons for them that promote the overall goals of the company, and also make sure that the company applies the policies in a consistent manner.

George Reardon is Special Counsel in Littler Mendelson's Houston office; William Hays Weissman is a Shareholder in the Walnut Creek office; Neil Alexander is a Shareholder in the Phoenix office. If you would like further information, please contact your Littler attorney at 1.888.Littler, info@littler.com; Mr. Reardon at greardon@littler.com; Mr. Weissman at wweissman@littler.com; or Mr. Alexander at nalexander@littler.com.

[1] *Vizcaino v. Microsoft*, 173 F.3d 713 (9th Cir. 1999).

[2] *See, e.g., Scruggs v. ExxonMobil*, 585 F.3d 1356 (10th Cir. 2009); *Edes v. Verizon Commc'ns, Inc.*, 417 F.3d 133 (1st Cir. 2005); *MacLachan v. ExxonMobil Corp.*, 350 F.3d 472 (5th Cir. 2003); *Montesano v. Xerox Corp.*, 256 F.3d 86 (2d Cir. 2001); *Wolf v. Coca-Cola Co.*, 200 F.3d 1337 (11th Cir. 2000); *Bronk v. Mountain States Telephone & Telegraph*, 140 F.3d 1335 (10th Cir. 1998); *Central Pennsylvania Teamsters Pension Fund v. Power Packaging, Inc.*, 2005 WL 2522163 (3d Cir. Oct. 12, 2005); *Martin v. Public Serv. Elec. & Gas Co.*, 2006 WL 3491063 (D. N.J. 2006); *Curry v. CTB McGraw-Hill LLC*, 2006 WL 228951 (N.D. Cal. 2006); *Moxley v. Texaco*, unpublished opinion, 2001 WL 840363 (C.D. Cal. 2001); *Casey v. Atlantic Richfield Co.*, unpublished order, 2000 WL 657397 (C.D. Cal. 2000). But when the definitions and rules are not sufficiently detailed, the opposite result can be reached, as in *Schultz v. Stoner*, 308 F.Supp.2d 289 (S.D.N.Y. 2009).

[3] For example, in *Metropolitan Water District of Southern Cal. v. Superior Court of Los Angeles County*, 112 Cal. Rptr. 2d 513 (Cal. App. 2001), in which numerous staffing firms were joined as defendants, the theory under which the employees would be entitled to benefits was based on statutory and contractual arrangements between a state agency and the California Public Employees Retirement System (CALPERS).

[4] *See, e.g.*, IRS Form 4461 (Application for Approval of Master or Prototype Defined Contribution Plan), lines 10(a)(10), 11(a).

[5] 26 C.F.R. § 410(b)(1)(A).

[6] I.R.S. Notice 84-11, 1984-29 I.R.B., Question and Answer No. 7.

[7] Some rotation program might be needed in rare cases when the staffing client has already excluded a large number of its own direct employees and has therefore used up the "slack" that benefit laws allow.

[8] 26 U.S.C. § 410(a)(3)(A).

[9] 26 U.S.C. § 411(a)(6).

[10] *See, e.g.*, *Nationwide Mutual Insurance Co. v Darden*, 503 U.S. 318 (1992).

[11] *Burrey v. Pacific Gas & Electric*, (unpublished order) No. C-95-4638DLJ (N.D. Cal. 1999).

[12] 29 C.F.R. § 825.106(e).

[13] 29 C.F.R. § 825.106(e); 29 C.F.R. § 825.220(a).