EMPLOYEE STATUS AND 'RIGHT TO CONTROL'

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Likely the most significant case impacting the PEO industry is *Nationwide Mutual Insurance Company v. Robert T. Darden*, 503 U.S. 318, 112 S.Ct. 1344 (1992). Decided in 1992, when the PEO industry was in its infancy, *Darden*'s application of the common-law principles of agency to determine "employee" status has significantly impacted employment case law, PEO legislation, and PEO operations.

Remember, when *Darden* was decided, there was virtually no PEO law at either the state or the federal level. This dearth of PEO law meant there was no established authority for a PEO to provide benefits (401(k) or group insurance), purchase workers' compensation coverage for worksite employees, or collect and remit employment taxes. The industry's response was to attempt to establish that the PEO (or employee leasing company under the vernacular of the day) was the "employer" of the worksite employee. Because there were little to no specific statutes[1] stating the PEO/leasing company was an employer, the PEO had to qualify as a "common-law employer;" hence the pivotal importance of *Darden*, which defined the elements necessary for such status.

THE CASE

Robert T. Darden (Darden) brought an Employee Retirement Income Security Act of 1974 (ERISA) action against Nationwide Mutual Insurance Company (Nationwide) after it threatened to disqualify him from receiving retirement benefits. Darden, an insurance agent, had entered into various agent agreements with Nationwide, which, among other terms, required Darden to sell only Nationwide products and not to compete should the relationship end. In exchange, Nationwide agreed to pay sales commissions and enroll Darden in Nationwide's retirement plan. Nationwide terminated its relationship with Darden and Darden subsequently violated his covenant not to compete. Nationwide notified Darden that retirement benefits were therefore forfeited and Darden filed suit.

ERISA claims may only be brought by a benefit plan "participant," who is defined under the statute as "any employee or former employee of an employer…." Accordingly, the issue in *Darden* centered on whether Darden was an employee of Nationwide even though he had many attributes of an independent contractor. Id. at 503 U.S. at 320-321 (citing 29 U.S.C. §1002(7)).

In determining whether Darden was a Nationwide employee or an independent contractor, the United States Supreme Court first looked to ERISA's definition of "employee." ERISA, like several other federal statues, defines an "employee" as "any individual employed by an employer." *Darden*, 503 U.S. at 320-321 (citing 29 U.S.C. §1002(6)). ERISA's circular definition of an "employee" was of no help to the *Darden* court; according to the court, this "nominal" definition of employee "explains nothing." Id. at 323. Recognizing ERISA's vagueness and finding no other specific guidance in this statute to define the term "employee," the *Darden* court applied a common-law agency test for determining who qualifies as an employee under ERISA. Id. at 323. In so doing, the court noted that construing ERISA in accordance with traditional agency principles would not thwart Congressional intent or lead to "absurd results." Id. at 323.

The common-law agency test requires consideration of the "hiring party's *right to control* the manner and means by which the product is accomplished." Id. at 324 (emphasis added). The *Darden* court delineated relevant factors to be considered under this common-law "right to control" test: the skill required; the source of tools and instrumentalities; the location of the work; the duration of the relationship between the parties; the hiring party's right, or lack thereof, to assign additional projects to the hired party; the hired party's discretion over when and how long to work; the method of payment; the hired party's role in hiring and paying assistants; whether the work is part of the hiring party's business; whether the hiring party is in business; whether employee benefits are provided; and the tax treatment of the hired party. Id. at 323-324 (citing *Community for Creative Non-Violence v. Reid*, 490 U.S. 730, 751-752 (1989) (footnotes omitted). The Supreme Court concluded that employee status is determined on a case-by-case basis, assessing all factors, with no one factor being determinative. Id.[2]

Darden addressed the issue of whether an individual is an "employee" or an "independent contractor" and announced that when the term "employee" is not expressly defined by statue or when the statutory definition is inadequate (or, in the words of the *Darden* court, when the definition "explains nothing"), the common-law "right to control" test will apply to determine "employee" status. Therefore, *Darden*'s impact reaches far beyond ERISA.

The *Darden* court specifically rejected the economic realities test, which considers the economic dependency of the individual on the employer in the ERISA context. In fact, the Supreme Court distinguished ERISA from the Fair Labor Standards Act (FLSA), noting that although ERISA and the FLSA similarly define "employee," the term "employ" is defined differently in the two statutes. The FLSA defines "employ" more broadly, to mean "suffer or permit to work." Because ERISA lacks a similar provision, the *Darden* court reasoned

1 Florida's employee leasing company statute was enacted in 1991, but such a statute was rare.

2 The *Darden* court did not address whether Darden satisfied the common-law test, but instead remanded the case to the lower court to determine if Darden qualified as an "employee" under common-law agency principles.

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that the "economic realities" test used under the FLSA was not the intended standard under ERISA. Id. at 326. This fact will become significant as FLSA decisions are considered later in this feature.

Absent *Darden* and its application of common-law agency principles to employment laws, the term "employee" may have been susceptible to overbroad interpretations of federal statutes. For example, the Americans with Disabilities Act (ADA) and the Age Discrimination in Employment Act (ADEA) also define "employee" as "an individual employed by an employer…"[3] and, like ERISA, they too were enacted for broad remedial purposes.[4] Accordingly, subsequent lower courts have not surprisingly applied the *Darden* analysis to Equal Employment Opportunity (EEO) laws, reasoning that the traditional agency principles define who qualifies as an "employee" for anti-discrimination purposes.[5] The "right to control" test has been used to determine an individual's relationship to an employer under the ADEA, Title VII, the ADA, and ERISA. As such, employers have some comfort that the federal EEO statutes should be consistently applied.[6]

Significantly, in a subsequent U.S. Supreme Court case, *Clackamas Gastroenterology Associates, P.C. v. Wells*, 583 U.S. 440, 123 S.Ct. 1673 (2003) (number eight in this feature), the court relied heavily on *Darden* in determining whether shareholder physicians in a professional corporation were "employees" under the ADA. Rejecting labels as a way to classify individuals as employees or owners, the U.S. Supreme Court reiterated its *Darden* holding and focused the analysis on the common-law element of control as "the principal guidepost." Id. at 1679.

While *Darden* did not directly answer the question of whether a PEO's worksite employees are "employees" of the PEO under the myriad of employment laws, it did provide a definition of "employee:" An individual is an "employee" of an organization when that entity has the "right to control" the individual's work.

THE SIGNIFICANCE

Importantly, in the PEO arena, *Darden*'s analysis is generally helpful to PEOs, as it is the rare PEO that is going to exercise a sufficient right of control over worksite employees to be deemed a common-law employer. Indeed, courts in various situations have found, by and large, that PEOs are not common-law employers of their worksite employees. This is significant, not only for employment law liability, but also in common-law negligence cases.[7]

Darden and related cases were the primary basis for some of the original concepts used in the leasing industry. Some will remember the old "fire and lease back" concept or older contracts that were far more aggressive in asserting "the right of direction and control" by the leasing company. It was through this assertion of common-law employer status that companies maintained their authority to directly perform employer responsibilities related to health coverage, benefits, taxes, and workers' compensation when there was no specific statutory authority for the industry.

However, sole common-law employer status for a leasing company proved problematic given the continued authority and day-to-day operational control of the client. More significantly, a major problem was that common-law employer status carried with it potential responsibility and liabilities beyond the control of the PEO.

Darden and other cases that rely on the "right to control" test for determining employer liability have resulted in both benefits and challenges for the PEO industry.[8] The obvious advantages of not being held responsible as a common-law employer are numerous. However, the industry has also faced obstacles, especially in the employee benefits arena, when a court has applied the control test. For example, the Department of Labor and courts apply the common-law right to control test when determining whether a PEO has a valid ERISA plan. Oftentimes, when this test is applied to the facts of a PEO-worksite employee arrangement, the worksite employees have been found not to be employees of the PEO for purposes of ERISA preemption.

It is no coincidence that most contracts between PEOs and their clients contain language recognizing that the client must maintain sufficient direction and control over the worksite employees to enable the client to properly run its business. Additionally, NAPEO's Model Act includes language that while a PEO's service contract must contain language that the PEO "assume[s] responsibility for hiring, firing, and recruiting workers," this is "in addition to the customer's responsibility for hiring, firing, and recruiting workers." *Proposed Small Business Efficiency Act*, H.R. 4985 and S. 2913. Presently, most courts will deem the client a common-law employer rather than the PEO if a choice between the two is required. However, for liability purposes, a court can also find the PEO as an additional common-law employer. This has resulted in an effort by NAPEO at both the state and federal levels to develop statutory certainty about the role and responsibility of PEOs rather than relying upon common-law status.●

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3 42 U.S.C. § 12111(4); 29 U.S.C. § 630(f).

4 The purposes for enactment of the ADA are set forth at 42 U.S.C §12101(b) and the purposes for enactment of the ADEA are set forth at 29 U.S.C. §621 (b).

5 See e.g., *Speen v. Crown Clothing Corp.*, 102 F. 3d 625 (1st Cir. 1997) (in light of *Darden*, applying the common-law agency test to define "employee" in ADEA cases); *Barnhart v. N.Y. Life Ins. Co.*, 141 F.3d 1310 (9th Cir 1998) (finding that *Darden*'s common-law definition of employer applies to the ADEA); *Wilde v. County of Kandiyohi*, 15 F.3d 103 (8th Cir 1994) (applying *Darden* to Title VII case); *Birchem v. Knights of Columbus*, 116 F.3d 310 (8th Cir. 1997) (relying on *Darden*'s control test to determine whether the ADA was applicable).

6 The Equal Employment Opportunity Commission (EEOC) has also applied the *Darden* analysis to Title VII, the ADEA, and the ADA in a 1997 Compliance Manual, "Enforcement Guidance: Application of EEO Laws to Contingent Workers Placed by Temporary Employment Agencies and Other Staffing Firms," Number 915.002 (December 3, 1997).

7 See *Vasquez v. United Enterprises of Southwest Fla., Inc., d/b/a Fidelity United*, 811 So.2d 759 (Fla. 3d DCA 2002) (employee leasing company that did not supervise client's employees or control their day-to-day activities was not vicariously liable for worksite employee's negligence); *Boston Old Colony Ins. Co. v. Tiner Assoc., Inc.*, 288 F.3d 222 (5th Cir. 2002) (company that "leased" employees was not vicariously liable for the negligence of its client's employees because the employees were under the control of the client at the time of the negligent action).

8 A classic example is *Astrowsky v. First Portland Mortgage*, 70 FEP Cases 195 (D.Me 1995), wherein the court found that a PEO or leasing company did not exercise sufficient control over the employee and that no meaningful employment relationship existed between the PEO and worksite employee; as such, the PEO was not liable under the ADEA and Title VII. Here, although the PEO "won" the case, this decision, however, has been problematic to legislators, lobbyists, and potential clients.

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