Special Issues in Agreements Involving Human Resources

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Introduction

The trend towards outsourcing will continue to grow as market pressures force corporations to be more tightly focused on core business functions, gaining competitive advantage and reducing costs. Outsourcing is an attractive alternative in good times and bad times. Shifting back end administrative and business functions to an external provider in good times, may be a means for quicker time to market and focusing resources on core business activities to grow the business. In bad times, outsourcing is a means for streamlining the enterprise by eliminating functions, which create a drag on capital and/or do not provide any competitive advantage.

In the current economic environment, concerns over, shrinking margins, liquidity and the need to reduce operating cost structures is accelerating a trend towards shifting certain back office administrative functions to outside suppliers. This trend is seen as a major paradigm shift within enterprises, which have realigned their internal corporate infrastructure to focus on more strategic areas of their core business.

Although the human resources (HR) function is viewed as critical within corporations, increasingly, small, medium and even large corporations are moving to outsource this service.[1] The case for outsourcing has three basic rationales. First the regulatory compliance obligations imposed under ERISA, COBRA and IRS regulations, have become extremely burdensome and expensive for companies. Consequently, avoiding major legal problems and financial liability requires substantial investment in resources and capital in an area outside of the core business of most companies. This makes outsourcing a viable option even if it does not necessarily result in a cost savings in the near term. Second, the need to upgrade HR systems and invest in new technology is increasingly difficult when companies are hard pressed to invest in functions aligned with the core competency of the enterprise. HR outsourcing service providers are better positioned to invest in new technologies and software more likely to conform to "best practices" for delivery of the service. Third, for companies with global operations, employee self-service can substantially reduce costs and improve employee satisfaction with the service. However, this requires integration of all processes- HRIS, payroll and benefits administration- across the entire HR operation including its global ones.[2]

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[1] GM has outsourced its some of its HR processes to EDS, and BPO has become a $3 billion business for EDS.

[2] Firm Builder.Com, "HR Outsourcing as a Best Practice", Jan 28, 2002

Because of the business exigencies driving the shift towards HR outsourcing, the industry is expected to grow to $37.7 Billion in 2003.[3]

Currently HR outsourcing services fall primarily within three categories: Professional Employer Organization (PEO), Business Processing Outsourcing (BPO) and Application Service Providers (ASPs).[4]

PEOs assume and take full responsibility for the human resources administration, including the legal liability for the company's workers. It becomes in essence a co-employer with final say over, hiring, firing, and compensation decisions. The PEO becomes a partner, in the non-legal sense, with ownership of the HR function while the company retains responsibility over all business matters.

BPO refers to all business processes and not just HR. Typically this involves transferring the entire function to a service provider and is differentiated from PEOs because it usually involves introducing new technologies and processes to bear in the HR service. Because of the complexity of HR systems in large corporations, shifting to BPO may be more expensive in the short term. However, long term it can result in benefits because large HR outsource providers will invest in systems and technology viewed as prohibitively expensive within a firm where this function lies outside of its core business. The BPO services market is growing rapidly with analyst projecting revenues of $128 billion this year and growth to $234 billion by 2005.[5]

Finally, ASPs host software on the web and rent it to users. The most commonly known of these packages is "People Soft". The latter application and other packages are used to manage payroll, benefits, head count and other HR processes.

Each of the HR outsourcing services described has advantages and disadvantages for particular enterprises depending, on the number of employees, affordability of the service, type of business and the degree to which an enterprise desires to retain control of this function in-house.

This paper will briefly cover the legal aspects of HR outsourcing and will discuss some of the most common contract issues faced in outsourcing relationships, essential items that ought to be considered by the parties and key provisions within outsourcing service agreements.

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[3]Inc. Com, "Buyer's Guide to Outsourcing", Reprinted with Permission 9© 2000 Buyer.com Inc.
[4] "E-Services" is considered another category covering Web-Based services. However this is essentially performed by BPOs and ASPs, which utilize dedicated software and technology platforms for HR services.
[5] Larry Greenemeier, "Business_Porcess Outsourcing Grows", Information Week Jan. 14, 2002

Discussion

"To Be or not to Be…" William Shakespeare, "Hamlet"

I. Does an Employment Relationship Exist?

As previously discussed, companies facing pressure to reduce costs or address the personnel shortages due to corporate down sizing have several different outsourcing alternatives available to them to delegate back-end administrative functions. Typically, the first alternative firms look to before looking outside, is to retain control of the function in-house and reduce employment related costs (taxes, benefits, headcount), by using contingent staff or (temporary workers) or persons classified as "independent contractors" (IC) to perform the work. Though this may be an appealing solution for many firms, given the legal and economic benefits, improper classification of someone as an IC, consultant or temporary worker, who is later deemed an "employee" carries serious financial risks.

Friction has developed between the growing use of contract workers in lieu of full time employees and, the public policy aims of providing workers with protections under federal labor laws to take the Employment Retirement Income Security Act ("ERISA") and state law employee remedial measures. In addition to the tax risk of an IRS audit, the risks are higher today that workers will bring claims for social security, workman's compensation or other actions challenging the misclassification, so that they may participate in lucrative benefit programs provided by the employer.

The case that brought these issues to the fore was *Vizcaino v. Microsoft Corporation* ("Microsoft I") and its progeny of cases. In Microsoft I, plaintiffs, employees designated as temporary workers or "free lancers", brought an action against the corporation to recover savings benefits under ERISA and for stock option benefits offered through a stock purchase plan, that were available to regular employees.[6] The Court framed the legal and public policy issues in the opinion's opening statement:

> *"Large corporations have increasingly adopted the practice of hiring temporary employees or independent contractors as a means of avoiding payment of employee benefits, and thereby increasing their profits. This practice has understandably led to a number of problems, legal and otherwise. One of the legal issues that sometimes arises is exemplified in this lawsuit. The named plaintiffs, who were classified by Microsoft as independent contractors seek to strip that label of its protective covering to obtain for themselves certain benefits that the company provided to all of its regular or permanent employees."*[7]

The problems for Microsoft arose as a result of an IRS tax audit for tax years 1989 and 1990. The IRS examined the company's employment records to determine if it was in compliance with tax laws. Applying the common-law principles defining the employer-

[6] The ERISA claim was subject to Federal law but the stock purchase plan was a contract matter decided under Washington state law.
[7] *Microsoft*, 97 F.3d at 1189

employee relationship, the IRS concluded Mircosoft's "freelancers" were not independent contractors but employees for withholding and tax purposes.
In reaching this conclusion, the IRS applied the test set out under the common law of agency, which requires, in determining if a hired party is an "employee", consideration of the hiring party's right to control the manner and means by which the product is accomplished. [8] The IRS applies a 20 factor "control test" to "assess all of the incidents of the relationship" with no one factor being determinative of the employment relationship of the parties.[9] The US Supreme Court reached asimilion conclusion in Nationwide Mutual Insurance Company vs. Darden party not to adopt the IRS factors and, instead applied a twelve factors that it considered. In assessing the relationship of the parties the court decided for determining whether an individual qualifies as a "common law employee".

Microsoft, on first impression, appeared to have taken the appropriate measures to avoid stumbling into an employer-employee relationship- the workers were told they were freelancers and signed various agreements classifying them as independent contractors, that included provisions that the workers would be responsible for paying their own taxes and benefits. However, after having taken these steps with respect to the form of the relationship, the court found that Microsoft had fully integrated these workers into its workforce, placing them alongside regular employees, sharing the same supervisors, performing identical functions and working the same core hours. Because Microsoft required them to work on site, they were given admittance keys, office equipment and supplies of the company.

Even after the IRS determined that plaintiffs were "common law employees", Microsoft attempted to use a temporary agency to "house" these workers as employees of the agency, so that it could continue to use them in the same manner previously described. On review in *Vizcaino v. U.S. Dist. Court for Western District of Washington*, 173 F.3d 713 (9th Cir. 1999) ("Microsoft III"), the Court in striking down the District Court's modification of the class of plaintiffs, which it deemed a contravention of its order on remand, rejected the lower court's assertion that the eligibility for benefits of these temporary agency workers turned on whether they were employees of the Company or the agency. The District Court's view precluded the possibility that the agency and Microsoft could jointly employ the plaintiff. The Court held that at common law it was possible for the plaintiff's to be employees of both the temporary agency and of the recipient of their services (Microsoft), if, based on a determination using the *Darden* factors, an employee-employer relationship existed. In essence the agency and Microsoft were joint employers and the triangular relationship that Microsoft created was not viewed as precluding or as being mutually exclusive of a two- party relationship that existed between the company and the temporary workers.[10]

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[8] In *Nationwide Mutual Insurance Company v. Darden*, 503 U.S. 318 (1992), the US Supreme Court affirmed the use of this test to determine the "employee" status of a hired party.
[9] See Rev. Rule 87-41, 1987 –1 Cum Bull. 296, 2980299 and Restatement (Second) of Agency § 220 (2) (1958)
[10] id. §226 "A person may be a servant of two masters not joint employers, at one time as to one act if the service does not involve abandonment of the service to the other."

So what are the lessons gleaned from the *Microsoft* cases?

- Review the language in the company's benefit plans to ensure "covered employees" is properly defined within the plan and not left to statutory or judicial interpretation.
- The mere classification of workers as independent contractors is not sufficient, and behavioral, financial and the type of relationship between the hiring party and the workers must support the classification.
- Users of outsourcing services should apply the 20 IRS factors to conduct a self-assessment of the relationship between the parties.
- Consider using only ICs that are incorporated so that the relationship is between entities and not an individual and an entity.
- Ensure that the agreement reflects the 20 factors, so for example: allow the IC to determine the means and the methods for delivery, limit the agreement to the project, and ensure the contract calls for the IC to cover its expenses and benefits.
- Require that the IC submit an invoice prior to receiving any payments.
- Avoid placing IC in situations where work is subject to the direct supervision of a company employee.
- Avoid imposing administrative requirements on the IC, which are applicable to employees.
- Allow the IC to hire and delegate the work to its employees subject to the requirements of the project.

In particular, the fact that a worker is employed by a temporary agency, or similar entity is not a guarantee against misclassification under the joint employer rule applied by the Ninth Cir. Court in Microsoft III. If a misclassification does occur a firm may qualify for an IRS Section 530 "safe harbor" exception if it can show the following:

1. Reasonable basis for classification of individuals as ICs based on:
   - Reliance on a relevant court case, the advice of a qualified accountant or attorney, or IRS ruling;
   - The IRS did not reclassify the same or similar workers in a previous audit;
   - It is standard industry practice to treat the particular workers as ICs.

2. Consistently treated same or similar workers as ICs in the past.

3. Consistently filed federal tax forms 1099 on these same or similar workers.

The issues raised here are not unique to the outsourcing of HR processes and functions but are common to all instances where the outsourcing alternative used by a firm involves the hiring of individuals as consultants, independent contractors or temporary workers. Microsoft's mistakes resulted in a $97 million award to plaintiffs who had been misclassified and later found eligible to receive benefits offered to all "employees". Care and vigilance is required on the part of the recipient of the services to protect against

potential liability resulting from an inadvertent de facto employment relationships arising in the course of the service.

II. "The Deal"

Risks

Outsourcing any critical business function and especially one like HR must be carefully planned and executed to be an economic and strategic success. HR operations require trained and specialized personnel to handle complex processes and manage the compliance responsibilities created under the myriad of federal and state employment regulations. Outsourcing of this function carries the risk of losing qualified personnel and a degradation of the function. A firm can ill afford the risk of entering into a relationship with a vendor whose lack of expertise in payroll and benefit administration causes disruptions and a loss of efficiency. This may, in the worst case, demoralize the work force and expose the firm to significant legal liability. Partial success in this area can mean total failure and the loss of strategic initiative.

Scope and Measurable Results

Contracting of the outsource service is a process which requires inputs from all of the stakeholders (HR personnel, users of the service, and the management team) and those persons within or outside of the organization with expertise in the function. Before talks are ever initiated with a vendor, the key goal is to define the scope of the service and the performance metrics, which will be applied to measure success. The use of metrics will be covered in greater detail below in respect to Service Level Agreements (SLAs).

Short or Long Term Relationship

Important to both parties in the transaction, is defining the kind of relationship, which must be established for the arrangement to succeed. If the entire HR Dept function is to be outsourced then it will be in the interest of both parties to enter into a long-term relationship that will justify the up-front costs and investments that will be required of each of them. This type of arrangement as previously mentioned is subject to the firms particular circumstances, and will probably result in selecting either the BPO or PEO alternative because of the broad scope of the outsourced service. For the buyer this type of wholesale delegation is expensive, complex and risky. If it doesn't work out, the buyers will incur significant costs and, disruption to the business in replacing the vendor or in bringing the function back in-house.

Typically, total outsourcing of a function is a major undertaking with broad implications for both the buyer and vendor. In this situation the preferred relationship is one that is more of a partnership, in the non-legal sense, where the parties view their interests as mutually benefited by the relationship.

On the other end of the continuum is the outsourcing of processes, like payroll, which is very specific and straightforward and can be executed on a short-term basis.

Normally, in the HR area, firms will retain part of the function in-house, and delegate those functions to an ASP or BPO, which require major investments in technology or software. An outside supplier whose core compency lies within function is better able to absorb the costs, based on economies of scale. This type of arrangement will generally result in an intermediate term relationship where the parties will have to develop close collaboration but will not have to incur the high costs, and investment of resources required in a long-term relationship.

Key Provisions

Approach:

Partnership arrangements require provisions that maximize the flexibility of the vendor in performing the service. Typically because such relationships are appropriate in contracts with long terms of duration, typically five to seven years, and complex service arrangements, the approach ought to be less prescriptive with respect to the scope and level of service.

In shorter-term arrangements more typical of supplier/purchaser relationships, contracts need to be more prescriptive in defining the scope of the services and the client requirements.

Generally contracts ought to build in some level of flexibility to allow for changes in: business circumstances, technology and the needs of the buyer.

Transfer of Personnel and Assets:

Outsourcing arrangements may require the transfer of assets and personnel to the vendor. Defining the terms covering the transfer of affected personnel will generally have important implications for the buyer and its employees with respect to employment or employment rights. When wholesale outsourcing of groups or functions occur, it is important for firms to take measures to preserve the general morale, of those remaining and communicate openly and honestly with those persons transferred under the outsourcing agreement. Contract terms need to address how the outsourcing of the function and subsequent transfer will affect benefits, pensions and pay of personnel moved to the service provider. Consideration should also be given to the rights, if any, the transferring firm may have to either enforce special terms affecting transferred employees or the right to retain these employees in the event of contract termination.

With respect to equipment and other assets, terms governing the use by the vendor of any equipment made available to it by the buyer should specify rights of ownership and other matters related to the transfer of equipment or other items of value.

IP Transfer

Defining the rights to intellectual property (IP) is critical in all outsourcing agreements. Typically the vendor will want to retain rights in any IP developed by it in the course of the arrangement. The thought being that it is providing a service and not being paid to develop IP. The buyer on the other hand will want all rights to IP developed based on the transfer of proprietary or confidential information to the vendor and any work product developed in performing the service. This issue will usually be resolved through negotiation.

Related to this are confidentiality provisions, which provide important contractual protections with respect to each party's right's in and use of IP in the arrangement.

Services

This is will probably be set out in a schedule and negotiated based on the scope of the services and the functions or processes that will be outsourced. As stated previously, the nature of the relationship, partnership or supplier/purchaser will determine how detailed and specific this ought to be.

In any event there should be sufficient clarity and definition for the parties to be able to set mutual expectations and understand the deliverables that must be produced under the agreement.

Termination

Defining the terms for exiting an arrangement is one of the most critical issues in an outsource agreement. Generally, early termination provisions, which set out rights and applicable penalties due in such event, should be a matter of last resort except in cases, of material breach or force majeure.

Default provisions should set out escalation clauses and a reasonable cure period to ensure the parties have procedures for resolving disputes and issues related to the performance of their respective obligations.

There should also be provisions governing the management of the exit. These should include the vendor cooperation in facilitating the transfer of the service to another vendor and the return of any equipment or other items to the buyer, which were used by vendor during the contract.

Consideration should be given to other provisions, which might help to reduce the level of disruption to the buyer's operations as a result of the termination of the agreement.

Service Level Agreements

What is a Service Level Agreement (SLA)?

SLAs in an outsourcing arrangement identify the service levels or performance standards that the vendor must meet or exceed. The SLA also specifies consequences for failing to achieve the minimum service level set by the buyer.

SLAs should be applied to the key parts of the outsourced service and not necessarily to every aspect. The purpose of SLAs is to ensure the buyer has the means to control the level and the consistency of the service received from the provider.

Generally, the minimum level that ought to be set is that which is required to support the buyer's on-going business operations and HR requirements. An important rationale for outsourcing should be to improve the level and quality of the function that is being outsourced. Therefore the minimum level of service should be at least equal to the level that existed before the function was outsourced to the provider.

In the HR area metrics are difficult to establish because much of what is being measured is intangible. For example if buyer wants to determine the success of a web based application for benefits, this can only be ascertained by surveying user satisfaction. As such questionnaires and employee satisfaction surveys become essential tools for measuring the performance of the vendor.

SLAS must reflect the agreement understanding of the parties as to what constitutes a good result and with respect to measuring performance, their agreement on the mechanisms used to measure the result.

The SLA should also cover what constitutes the best and the worst-case level of service. In this regard the buyer will want to incorporate service credits, which may become applicable in the event the vendor fails to meet minimum service levels. At the same time it is also appropriate to consider incentives or bonuses, which the vendor can receive for achieving the best-case level of service.

The point of any negotiation ought to be that it is in the interest of both parties that the vendor meet or exceed the service levels set in the SLA. The buyers should not exploit the use of SLAs, to reduce costs through the application of credits or penalties, because this will only inject an unnecessary level of contention into the relationship that will under cut the development of a partnership between the parties.

SLAs should not have a distorting effect on behavior, where the vendor becomes focused only on those aspects of the service, that are measured, at the expense of other aspects, which may not be weighted as heavily in the evaluation process. The vendor's goal should be to meet, or exceed expectations in every area covered by service.

III Conclusion

The growth of outsourcing will continue rapidly, as market pressures force firms to focus and align on core business functions. Delegation of back-end administrative functions to outside vendors, frees up resources and capital for use in areas contributing to the competitive advantage and growth of the business.

From a legal and business perspective the delegation of critical functions, like HR, carries certain risks, which must be addressed in the outsourcing agreement and the SLAs. The items described in this paper while not exhaustive on the subject, attempt to provide a high level description of issues and considerations, which ought to be taken into account when negotiating outsourcing agreements.

Finally, firms need to take a cautious approach in reducing costs through reliance on independent contractors and contingent staff. Misclassification of personnel as independent contractors carries significant financial liability and requires careful attention to the terms of the agreement governing the procurement of such services.

For more information on this subject please feel free to contact Jose I. Rojas or Juan Garcia at: (305) 446-4000.