Andrew Taylor has a lot on his plate. As the director of finance and operations at an Internet start-up company, he's busy getting the firm and its four employees off the ground. He has little, if any, time to tend to payroll, benefits and other human resource functions.

So he turned to a "professional employer organization"- a PEO - to lend a hand to the company, BeBusy.com, launched in New York last September. PEOs manage and administer HR services for small and midsize firms by forming "co-employer" relationships with them.

"There are 1,001 things to do," Taylor says. "It seemed to me a PEO would have some advantages. No.1 is time savings."

Taylor considered hiring separate vendors to handle the company's payroll and health insurance needs but concluded that a single point of contact would avoid confusion. "It tends to be a little more expensive than doing it in-house, but if you put a value on time, it's probably less expensive," he says.

Tending the Bottom Line

The fundamental appeal of PEOs, the ability to provide employers a complete array of outsourced HR services and expertise, hasn't changed since the industry began in the early 1980s. That basic strength, plus expansion of PEOs' core small-business market, has fueled annual revenue growth rates of 25 percent to 30 percent - a pace industry experts say won't let up any time soon.

"Business owners are overwhelmed with the complexities of employment and regulation," says Dale Hageman, president of Accord Human Resources, a PEO based in Oklahoma City that manages 8,500 employees. Entrepreneurs generally are consumed with keeping their businesses afloat, so most are glad to transfer time-consuming HR tasks and headaches to someone else.

"Most people didn't go into business to deal with minutiae," says Steven A. Tessler, president of New York operations for EPIX Holdings Corp., based in Tampa, Fla., and Woodbridge, N.J. EPIX is the nation's largest privately held PEO, serving more than 43,000 worksite employees.

Another advantage for small-business owners is the ability, through PEOs, to offer better benefits at discount rates. That's because PEOs can negotiate lower rates with health, workers' compensation and other insurers by pooling clients' employees into large groups.

"That helps attract and retain new talent," especially in the current tight labor market, says Lou Basso, president of the Alcott Group, a Farmingdale, N.Y.-based PEO that manages nearly 4,000 employees.

Depending on their size, PEOs offer a variety of services. All provide the basics: payroll processing, payroll tax payments and health insurance. Most offer 401(k) retirement plans, workers' compensation insurance, risk management and regulatory-compliance monitoring. Full-service PEOs sell an even broader range of services, including high-end benefits, such as adoption assistance, usually found only at the largest corporations.

The services demanded by clients are changing, executives say. More government regulations
mean more compliance monitoring. A tight labor market means more help with recruitment. As a general rule, PEOs leave hiring decisions to employers, but they often give advice and screen candidates.

Some firms let clients choose from a menu of services and charge accordingly; others have an "all or nothing" approach. For example, clients of Accord Human Resources must order payroll processing and taxes, workers' compensation insurance and an on-site HR supervisor, but health insurance and retirement plans are optional.

Today 1,500 to 1,800 PEOs oversee 2 million to 3 million American workers who earn $18 billion in annual wages and benefits, according to the National Association of Professional Employer Organizations (NAPEO) in Alexandria, Va. Industry revenues exceed $21.6 billion.

"The fundamentals have not changed," says NAPEO executive vice president Milan P. Yager. Small firms face increasing pressure to be competitive - all the more reason for them to focus on "the business of business" and hire PEOs, Yager says.

That was Christine Pepin's reasoning when she hired Administaff Inc., a nationwide PEO based in Kingwood, Texas. She had had an employee working two to three days per week on HR. Now that person is devoted solely to sales, marketing and the bottom line.

"The whole HR function is so time-consuming, and that's just to do an OK job," says Pepin, president of Performance Software Services Inc., a 20-person software consulting firm in Melbourne, Fla. Administaff helped by adding a 401(k) benefit and handling special needs such as immigration visas, she says.

"It's allowed us to have big-company capabilities," Pepin says. It's "absolutely" worth the cost.

PEOs generally charge clients 4 percent to 8 percent of payroll, says Yager. Multiple sites, frequent payrolls and high-cost areas push rates to the high end of that range.

Not every employer has been happy with what they got for their money. Susan L. Burleigh, SPHR, says her former employer, an Indianapolis HR staffing and consulting firm called Providyn, was happy with its hometown PEO until the PEO was sold in late 1997 to a larger firm.

"Service went drastically the wrong way. They weren't consistently accurate with payroll. There were problem health insurance claims," Burleigh recalls. Paychecks didn't get deposited on time. Medical claims were wrongfully denied. Burleigh, then Providyn's HR manager, and the company's controller spent hours untangling the problems. Providyn fired the PEO in mid-1998 and brought all HR in-house.

"I would have to think long and hard before considering another PEO service," Burleigh says.

**Liability Confusion**

Perhaps the biggest point of confusion about PEOs is their legal status. As co-employers, they contract to perform certain services and to assume and share certain liabilities. For example, PEOs are usually solely liable for the payment of wages and payroll taxes.
While some business owners fear losing control through a co-employment relationship, a PEO's role is limited to the HR side of the business. Owners still control the workplace and its products or services.

But sorting out who's responsible for what with HR functions can be perplexing. Currently, 17 states require licensing, recognition or registration of PEOs to hold them liable for state unemployment taxes and workers' compensation insurance. The industry has its own groups that accredit PEOs and certify their employees. But the main push is to pass federal legislation to clarify exactly what PEOs are and what they do.

"There are still a number of unanswered issues because we don't have status in federal law. There's very little guidance about co-employment, so a lot of it falls to the contract," says Hageman of Accord Human Resources.

Currently, PEOs' and clients' liability varies under different employment laws, says Diane Stanton, an Orlando, Fla., partner in the law firm Jackson Lewis Schnitzler & Krupman. For example, PEOs and clients share liability for payment of wages under the Fair Labor Standards Act, although "the PEO's neck is further out than the employer's," she says.

Anti-discrimination laws are a muddle. PEOs can't monitor each client's site, and most contracts hold them harmless against workplace actions they can't control, says Tessler of EPIX Holdings. Yet the Equal Employment Opportunity Commission (EEOC) can hold PEOs at least partly liable for sexual harassment and other discriminatory activity, according to the ProEmp Journal, a New York-based trade magazine on PEOs.

The EEOC adheres to a December 1997 guide for contingent workers, which doesn't mention PEOs at all, Stanton says. In practice, plaintiffs would sue both PEOs and clients for alleged discrimination, she adds.

Even PEOs' primary responsibilities - the payment of payroll taxes and sponsorship of benefit plans - are unclear, experts say. The federal legislation supported by NAPEO would amend federal tax law to codify many duties PEOs already perform, Yager says.

Under the legislation introduced last November, the Internal Revenue Service would recognize PEOs' right to collect and remit federal payroll taxes and to offer and maintain employee benefit plans. H.R. 3490 is sponsored by Reps. Rob J. Portman (R-Ohio) and Benjamin L. Cardin (D-Md.).

NAPEO backed a similar bill in 1998 that died in Congress because of White House "concerns," Yager says. "We have a piece of legislation now that everyone can live with. We're optimistic," he adds.

Room to Grow

Problems aside, PEOs are poised to continue their rapid growth, executives and analysts say. While better known now than a few years ago, they are used by just 2 percent to 3 percent of companies with 100 or fewer workers, says NAPEO's Yager.

One barrier to industry expansion is that many potential clients haven't heard of PEOs. The industry traditionally has relied on referrals for new business and hasn't done much advertising and marketing, although that is starting to change.
Some niche PEOs have emerged to serve particular industries, such as high-technology or health care. Other PEOs target clients by type or size, says Harry Feinberg, publisher of ProEmp Journal.

PEOs see plenty of new business on the horizon: high-tech startups, for example. The total number of firms with fewer than 500 employees is growing-up 7.9 percent to 5.4 million between 1990 and 1996, according to the latest figures from the U.S. Small Business Administration.

In addition, larger firms are using PEOs to handle all or part of their HR functions. In fact, PEOs' average client size is creeping up, from 11 employees in 1987 to 18 employees in 1999, according to NAPEO. ADP TotalSource, a PEO based in Coral Gables, Fla., has clients ranging in size from five to 2,000 employees.

Bigger employers have entered the PEO fold in part because their HR executives are more concerned with corporate strategy than with the mundane but necessary details of payroll and benefits, Tessler says. These companies are also more profitable for PEOs, Yager says, because benefits programs' overhead costs can be spread among more employees.

Although the number of PEOs has mushroomed over the years, Yager predicts that future growth will occur through consolidation. It's getting harder and more expensive to start new PEOs, he explained. "A PEO has to be a large regional or national player," he says.

The merger trend began about four years ago when large companies - including CNA Insurance, Paychex Inc., Fidelity Investments, ServiceMaster Co. and Wackenhut Corp. - began to buy PEOs, says Boston-based analyst John Schneller of Stephens Inc. As of late November, Bradenton, Fla.-based Staff Leasing Inc., the largest U.S. PEO at 127,000 worksite employees and $2.4 billion in 1998 revenues, was up for sale.

Payroll giant Automatic Data Processing Inc. (ADP) got into the business when it bought a small Florida PEO in 1986. Last year it zoomed to the No. 2 spot with the acquisition of Vincam Group of Miami for about $295 million in stock. It was "a natural extension" of ADP's business, says Steven Light, ADP TotalSource senior vice president of strategic initiatives. The PEO has 80,000 worksite employees.

If the Portman-Cardin legislation passes, "it opens up huge opportunities for the industry to boom," Yager says, because clients won't have to second-guess PEOs' legal status and their own liability. "In the next 20 years, I believe nearly every small business will use a PEO. We're at the infancy of our industry," he adds.

By Carolyn Hirschman, HR Magazine, February 2000
Guidelines for Selecting a PEO

1. Assess your workplace to determine human resource and risk management needs.

2. Make sure the PEO is capable of meeting your goals. Sales brochures and fancy proposals are easy to print. Meet the people who will be serving you.

3. Check the firm's financial background. Ask for banking and credit references. Ask the PEO to demonstrate that payroll taxes and insurance premiums have been paid.

4. Ask for client and professional references.

5. Check to see if the company is a member of the National Association of Professional Employer Organizations (NAPEO), the national trade association of the PEO industry. (See www.napeo.org for a list of members.)

6. Investigate the company's administrative and risk management service competence. What experience and depth does their internal staff have? Have any of the senior staff of the PEO been certified as Certified Professional Employer Specialists or other relevant professional designations?

7. Understand how the employee benefits are funded. Are they fully insured or partially self-funded? Who is the third-party administrator (TPA) or carrier? If required in your state, is their TPA or carrier licensed?

8. Understand how the employee benefits are tailored. Determine if they fill the needs of your employees.

9. Review the service agreement carefully. Are the respective parties' responsibilities and liabilities clearly laid out? What guarantees are provided? What provisions permit you or the PEO to cancel the terms of the contract?

10. If your state requires a PEO to be licensed or registered, make sure the company you are considering meets all such requirements.

Source: NAPEO