Employer for Hire: Analyzing Professional Employer Organizations in the Context of Philippine Contracting Laws and the Protection of Workers' Rights

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I. INTRODUCTION

Outsourcing is a well-accepted management prerogative in the Philippines, tempered only by the prohibition against enlisting labor-only contractors,[1] the exercise of good faith, and the demonstration of due consideration to the rights of workers.[2]

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1. Digital Telecommunications Philippines, Inc. v. Digitel Employees Union (DEU), G.R. No. 184903-04, 683 SCRA 466, 478 (2012) (citing Aliviado v. Procter & Gamble Phils., Inc., G.R. No. 160506, 650 SCRA 400, 412-14 (2011)).
2. Santiago v. CF Sharp Crew Management, Inc., G.R. No. 162419, 527 SCRA 165, 179 (2007) (citing San Miguel Corporation v. Ubaldo, G.R. No. 92859, 218 SCRA 293, 301 (1993)).

In many Philippine Supreme Court cases, issues arising from outsourcing of business functions, more often than not, cannot be resolved without discussing and determining the existence of employer-employee relationship and the inclusion of a third party, i.e., the contractor, and thus, compounds the discourse.[3] Such issues are exacerbated when the parties are not on the same level of understanding about their role in the relationship. For instance, two of them may agree on who has the ultimate responsibility to the workers as the employer, but the third party may disagree with their assessment and assert their own claim against the other.

What happens then if all three parties in the outsourcing arrangement know and agree on which entity is exercising control as the employer, but internally decide that the other entity should appear as the employer on paper? Is the entity appearing on record as the employer, or what is known as a professional employer organization (PEO),[4] a contractor under Philippine labor laws? If so, how does this tripartite relationship among the business, employees, and PEO work with due consideration to the rights of workers?

II. OBJECTIVES AND SCOPE OF THE STUDY

This Article seeks to determine the applicability of Philippine labor laws in general, and Philippine contracting regulations in particular, to PEOs. The Author will briefly discuss the history of PEOs and how the industry has evolved over the years before looking at why enterprises engage PEOs. Afterwards, the Author will talk about how other jurisdictions, especially the United States (U.S.), classify PEOs before moving into PEOs in the Philippine context.

The Author will then review Philippine laws, regulations, and jurisprudence on employer-employee relations and contracting arrangements. Finally, the Author will present her conclusions on the application of Philippine labor-contracting rules to PEOs and offer recommendations on how the regulations can be calibrated to allow the operations of PEOs while ensuring the protection of the rights of workers.

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3. *See, e.g.*, Daguinod v. Southgate Foods, Inc., G.R. No. 227795, 894 SCRA 172, 186-87 (2019).

4. Ted J. Chiappari & Angelo A. Paparelli, Professional Employer Organizations and Uncharted Immigration Risks, at 1, *available at* https://www.seyfarth.com/a/web/1627/Professional%2520Employer%2520Organizations%2520and%2520Uncharted%2520Immigration%2520Risks.pdf (last accessed Apr. 30, 2022) [https://perma.cc/PGW3-SWPH].

III. DISCUSSION

A. Professional Employer Organizations

1. What are PEOs and Where Did They Come From?

PEOs, also known as labor market intermediaries (LMI), are part of a larger umbrella of firms that act as "middlemen"[5] between employers and employees.[6] One form of LMIs provides job matching services wherein the intermediary recruits workers and arranges for their employment with the employer-client.[7] Another form is what is traditionally known as a temporary help agency, which provides workers to employer-clients to perform specific jobs within a short period of time.[8] The last form are PEOs,[9] which will be the focus of this Article.[10]

PEOs have been around for some time, especially in other jurisdictions, such as the U.S., where they are described as "businesses that provide comprehensive human resources services"[11] and are known

5. Harris Freeman & George Gonos, *Taming the Employment Sharks: The Case for Regulating Profit-Driven Labor Market Intermediaries in High Mobility Labor Markets*, 13 EM. RTS. & EMP. POL'Y J. 101, 108 (2009).

6. *Id.* at 106.

7. *Id.* (citing CHRIS BENNER, ET AL., STAIRCASES OR TREADMILLS? LABOR MARKET INTERMEDIARIES AND ECONOMIC OPPORTUNITY IN A CHANGING ECONOMY 10-11 (2007)).

8. Freeman & Gonos, *supra* note 5, at 107.

9. *Id.* at 108 (citing Matthew Dey, et al., *Manufacturers' Outsourcing to Staffing Services*, 65 INDUS. & LAB. RELATIONS REV. 533, 535 (2012)).

10. The Author submits that the other forms of LMIs can be covered by existing Philippine regulations already — matching or recruitment of employees can be regulated by Philippine recruitment and placement laws; temporary help agency, in its most traditional sense, is a form of labor-only contracting prohibited under Philippine laws, which concept will be discussed in the next part of the Article.

11. Office of Program Policy Analysis and Government Accountability, Review of Professional Employer Organizations and Workers' Compensation (OPPAGA Report 21-04, Mar. 2021), at 1, *available at* https://oppaga.fl.gov/Documents/Reports/21-04.pdf (last accessed Apr. 30, 2022) [https://perma.cc/G3D4-BXAH].

by other names, such as payrolling firms, employer of record, and employment leasing.[12]

PEO is the latest variant of the many arrangements that were geared towards the outsourcing of employees.[13] One article shares that the precursors of PEO got their head start in the 1970s in response to the passage of the Employee Retirement Income Security Act (ERISA)[14] that prohibited a discriminatory practice among employers, in which, "far more generous pension contributions [were offered] to officers and key employees (and deducting the contributions as a business expense), while offering much less generous contributions to their rank-and-file employees."[15] The ERISA required employers to accord similar pension coverage to their employees, whether rank-and-file or high-ranking,[16] but the law had a loophole wherein only those employees working for the same employer were covered by the non-discrimination policy.[17] To do away with the non-discrimination policy under ERISA, the precursors of PEOs exploited this loophole by pooling the officers and key employees receiving high compensation and the rank-and-file employees who were getting low compensation into separate structures.[18] This

12. Freeman & Gonos, *supra* note 5, at 106 (citing David West, PEOs and Payrolling: A History of Problems and a Future Without Benefits (The Center for a Changing Workforce Report, Dec. 2001), at 6, *available at* https://web.archive.org/web/20160313050047/https://cfcw.org/PEO.pdf & Peggie R. Smith, et al., *Contingent Workers: Lesson 5: Proceedings of the 2001 Annual Meeting of the Association of American Law School Section on Labor Relations and Employment Law*, 5 EM. RTS. & EMP. POL'Y J. 661, 665-69 (2001)).

13. Natalya Shnitser, *"Professional" Employers and the Transformation of Workplace Benefits*, 39 YALE J. ON REG. BULL. 99, 108 (2021) (citing Britton Lombardi & Yukako Ono, *Professional Employer Organizations: What Are They, Who Uses Them and Why Should We Care?*, 32 ECON. PERSPECTIVES 2, 2 (2008)).

14. *See generally* Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. §§ 1001-1461 (2018) (U.S.).

15. Shnitser, *supra* note 13, at 108.

16. Katherine Sanford Goodner & Ursula Ramsey, *Certified Professional Organizations and Tax Liability Shifting: Assessing the First Two Years of the IRS Certification Program*, 16 BERKELEY BUS. L.J. 571, 576 (2019) (citing Sheldon S. Cohen, *Employee Leasing: Industry in a Time of Change*, 20 FORUM 657, 670 (1985)).

17. Goodner & Ramsey, *supra* note 16, at 576 (citing Nancy F. Hanshaw, et al., *Save Time, Money, and Taxes — Lease Your Employees*, 67 MGMT. ACCT. RES. 30 (1986)).

18. Shnitser, *supra* note 13, at 108 (citing Goodner & Ramsey, *supra* note 16, at 576-77).

resulted in the employers establishing two separate pension plans that could qualify under ERISA.[19]

Years later, while policy developments were passed to ban this practice,[20] the predecessors of PEOs had already grown into firms that provide more crucial services and benefits to their clients.[21] PEOs, then still more commonly known as employee leasing firms, adapted and started offering other services that dealt with the human resources (HR) compliance and payroll management of businesses, which many found crucial to their operations.[22]

PEOs, in their current iteration, offer services that have to do with HR, including "preparing and distributing payroll checks; depositing wages directly to bank accounts; maintaining payroll data; filing local, state, and federal government paperwork; and tracking vacation and sick leave[s]."[23] The U.S. Office of Program Policy Analysis and Government Accountability (OPPAGA) places PEO services into four categories:

(1) state, local, and federal law compliance;[24]

(2) human resources;[25]

(3) payroll administration, technology, and tax administration;[26] and

(4) workers' compensation and risk management.[27]

Rarely, some PEOs also offer human capital-enhancing services to client firms, such as management training and employee relation counselling.[28]

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19. Goodner & Ramsey, *supra* note 16, at 576 (citing Cohen, *supra* note 16, at 658).

20. *See, e.g.*, Internal Revenue Code of 1986 [INTERNAL REVENUE CODE], 26 U.S.C. § 414 (m) (1986) (U.S.).

21. *Id.*

22. Shnitser, *supra* note 13, at 109-10. The OPPAGA also offers its take on the history of PEOs. *See also* Office of Program Policy Analysis and Government Accountability, *supra* note 11, at 1.

23. Lombardi & Ono, *supra* note 13, at 3.

24. Office of Program Policy Analysis and Government Accountability, *supra* note 11, at 25.

25. *Id.*

26. *Id.*

27. *Id.* at 26.

28. Brian S. Klaas, et al., *Professional Employer Organizations and Their Impact on Client Satisfaction With Human Resource Outcomes: A Field Study of Human Resource Outsourcing in Small and Medium Enterprises*, 31 J. MGMT. 234, 235-37 (2005).

What sets PEOs apart from other forms of LMIs is that they "place workers that have been recruited by the client firm, or who are already in employment with the client firm, on their own payroll";[29] thus, the term "employer of record"[30] came to be, wherein the PEOs are presented as employers on paper.[31] The term "employee leasing" has a similar meaning: "on paper, [the employees] work for the PEO and are leased back to the client firm[,]"[32] but there is no actual leasing taking place as the client firm is the entity that searches for and hires the employees in the first place.[33]

Operationally, the method of employee pooling utilized by the precursors of PEOs have been adopted by modern-day PEOs by "group[ing] its client firms' workers on the PEO's own payroll and processed tasks at the same time."[34] Notably, however, there are firms that provide payroll processing and handling of other administrative tasks in relation to HR without holding themselves as employers of record.[35] They are, however, excluded from the discussion in this Article.

PEOs operate and provide the foregoing services under a co-employment arrangement with their client firms.[36] The PEO industry allows client firms to maintain "direct supervision of the employees so that they may focus on the core mission of the business"[37] by handing over the management of HR functions to the PEO which "becomes the outsourced HR department" for

29. Freeman & Gonos, *supra* note 5, at 106.

30. *Id.*

31. Lombardi & Ono, *supra* note 13, at 2-3.

32. *Id.* at 2.

33. *See* Freeman & Gonos, *supra* note 5, at 106.

34. Lombardi & Ono, *supra* note 13, at 3.

35. *See* Ellen Rosen, *The Perils of Hiring Out the Company's Paperwork*, N.Y. TIMES, Apr. 14, 2005, *available at* https://www.nytimes.com/2005/04/14/business/the-perils-of-hiring-out-the-companys-paperwork.html (last accessed Apr. 30, 2022) [https://perma.cc/VUX8-7VZH].

36. Office of Program Policy Analysis and Government Accountability, *supra* note 11, at 10.

37. *Id.* at 1.

the client firm.[38] In turn, the PEOs receive the HR-related costs of the client firm plus administrative service fees.[39]

PEOs are particularly attractive to small and medium enterprises (SMEs).[40] Due to restrictions brought by limited resources, some SMEs may not find it beneficial to employ HR professionals who can handle their HR compliance on a regular basis.[41] In the same vein, the intricacies of HR tasks may be beyond the competence of employees who are already in the payroll of the SMEs, and may even "become a significant drain on managerial time and resources."[42] In addition to streamlining operations and reducing costs, some SMEs engage PEOs to enhance their expertise.[43] In contrast, bigger entities with more resources are in a better position to hire an entire department of HR specialists in line with the concept of economies of scale.[44]

The National Association of Professional Employer Organizations (NAPEO),[45] founded in the mid-1980s[46] to advocate for the PEO

38. Brian S. Klaas, et al., *Trust and the Role of Professional Employer Organizations: Managing HR in Small and Medium Enterprises*, 14 J. MANAGERIAL ISSUES 31, 32 (2002) [hereinafter Klaas, *Trust and the Role of Professional Employer Organizations*].

39. Lombardi & Ono, *supra* note 13, at 3.

40. *See* Klaas, *Trust and the Role of Professional Employer Organizations*, *supra* note 38, at 32.

41. *Id.* (citing Carolyn Hirschman, *For PEOs, Business Is Booming*, HR MAG., June 1, 2000, *available at* https://www.shrm.org/hr-today/news/hr-magazine/pages/0200hirschman.aspx (last accessed Apr. 30, 2022) [https://perma.cc/9RS2-CN7P]).

42. *See* Klaas, *Trust and the Role of Professional Employer Organizations*, *supra* note 38, at 31.

43. Ingri Runar Edvardsson & Guðmundur Kristján Óskarsson, *Outsourcing of Human Resources: The Case of Small- and Medium-Sized Enterprises*, 1 MERITS 5, 9 (2021).

44. Klaas, *Trust and the Role of Professional Employer Organizations*, *supra* note 38, at 32 (citing Hirschman, *supra* note 41).

45. National Association of Professional Employer Organizations, About NAPEO, *available at* https://www.napeo.org/about-napeo (last accessed Apr. 30, 2022) [https://perma.cc/97Z7-4M4N].

46. Goodner & Ramsey, *supra* note 16, at 577 (citing National Association of Professional Employer Organizations, *supra* note 45). *See also* Dan Sadowsky, *The PEO Advantage: Less Hassle, Better Benefits*, ATLANTA BUS. CHRON., Aug. 24, 1988, *available at* https://www.bizjournals.com/atlanta/stories/1998/08/24/focus4.html (last accessed Apr. 30, 2022) [https://perma.cc/J9WR-UGGH] & National Association of Professional Employer Organizations, Board

industry,[47] conducted a survey and found that, in 2020, 487 PEOs in the U.S. serviced about 173,000 client firms.[48] While many businesses find PEOs appealing and create positive impacts to the client firms' culture, especially to SMEs,[49] it brought about issues on the status of the relationship between the client firm, the PEO, and the employees. In particular, it blurred the line on who is considered the employer of such employees.[50] Such confusion caused more issues as client firms exploited the situation to try to decrease, if not eliminate, their obligations as an employer.[51] In response, the U.S. federal government and several state governments implemented laws to address these issues.[52] This Article presents four examples of these U.S. laws below (three state-level regulations and one federal-level regulation).

2. Examples of U.S. Laws Regulating PEOs

North Carolina has adopted a law that regulates the PEO industry within the state.[53] Notably, the law was made part and parcel of the state's General

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of Directors, *available at* https://www.napeo.org/docs/default-source/board/napeo-2020-2021-board-of-directors-nom-first-cut.pdf (last accessed Apr. 30, 2022) [https://perma.cc/E9TY-5AQM].

47. National Association of Professional Employer Organizations, *supra* note 45.

48. Laurie Bassi & Dan McMurrer, The PEO Industry Footprint 2021 (NAPEO White Paper Series, May 2021), at 1, *available at* https://www.napeo.org/docs/default-source/white-papers/2021-peo-industry-footprint.pdf (last accessed Apr. 30, 2022) [https://perma.cc/9EVN-BPKY].

49. *See generally* Brian S. Klaas, *Professional Employer Organizations and Their Role in Small and Medium Enterprises: The Impact of HR Outsourcing*, 28 ENTREPRENEURSHIP THEORY PRAC. 43 (2003).

50. Lombardi & Ono, *supra* note 13, at 3 (citing Peter F. Drucker, *They're Not Employees, They're People*, HARV. BUS. REV., Feb. 2002, *available at* https://hbr.org/2002/02/theyre-not-employees-theyre-people (last accessed Apr. 30, 2022) [https://perma.cc/Z2KZ-R8DC] & Daniel W. Greening, et al., *A Qualitative Study of Managerial Challenges Facing Small Business Geographic Expansion*, 11 J. BUS. VENTURING 233, 242 (1996)).

51. *Id.* (citing Susan N. Houseman, *The Benefits Implications of Recent Trends in Flexible Staff Arrangements*, *in* BENEFITS FOR THE WORKPLACE OF THE FUTURE 101 (Olivia S. Mitchell, et al. eds., 2001)).

52. Lombardi & Ono, *supra* note 13, at 3.

53. North Carolina Professional Employer Organization Act, N.C. GEN. STAT. § 58-89A (2005) (U.S.).

Statutes' chapter on insurance.[54] The North Carolina Professional Employer Organization Act provides that a PEO involves an

> arrangement by which employees of a [PEO] are assigned to work at a client company and in which employment responsibilities are in fact shared by the [PEO] and the client company in accordance with [the contract requirements under] G.S. 58-89A-100, the employee's assignment is intended to be of a long-term or continuing nature, rather than temporary or seasonal in nature.[55]

To be clear, the law expressly excludes from the definition of PEO, services that provide temporary employees,[56] independent contractors,[57] personnel placement services,[58] managed services,[59] or payroll services that do not involve employee staffing or leasing.[60] These exclusions hark back to the delineation of the three types of LMIs referenced earlier.[61]

PEOs that fall under the definition of North Carolina's law are required to secure a license from the state's Department of Insurance.[62] The licensed PEO shall enter into a PEO agreement with a client firm, which agreement should provide "[f]or the allocation and sharing between the client company and the [PEO] of the responsibilities of employers with respect to the assigned employees, including hiring, firing, and disciplining of employees."[63]

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54. *Id.*

55. *Id.* § 58-89A-5 (16).

56. *Id.* § 58-89A-5 (17). This arrangement involves the hiring by an entity of its own employees and assigning them to a client to beef up a client's personnel in special situations, including employee absence. *Id.*

57. *Id.* § 58-89A-5 (16).

58. North Carolina Professional Employer Organization Act, § 58-89A-5 (13). These include services providing assistance to individuals seeking employment and placing them in the workforce complement of companies that seek employees. *Id.*

59. *Id.* § 58-89A-5 (10).These include supplying staff and managing a specific portion of a company's workforce or a specific facility within a company on an ongoing basis. The employees supplied to a client firm are the employees of the organization managing them and supplying them to client firms. *Id.*

60. *Id.* § 58-89A-5 (16).

61. Freeman & Gonos, *supra* note 5, at 106-08.

62. North Carolina Professional Employer Organization Act, § 58-89A-35 (a).

63. *Id.* § 58-89A-5 (11) (a).

Specifically, the law requires the PEO agreement to contain the following provisions:

> (1) Unless otherwise expressly agreed by a professional employer organization and a client company in a PEO agreement, the client company retains the exclusive right of direction and control over the assigned employees as is necessary to conduct the client company's business and without which the client company would be unable to conduct its business, to discharge any fiduciary responsibility that it may have, or to comply with any applicable licensure, regulatory, or statutory requirement of the client company or an assigned employee. The PEO agreement shall provide that employment responsibilities not allocated to the licensee by the PEO agreement or this section remain with the client company.
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> (2) That the licensee assumes responsibility for the payment of wages to the assigned employees as agreed [upon] in the PEO agreement.
>
> (3) That the licensee assumes responsibility for the payment of payroll taxes and collection of taxes from payroll on assigned employees.
>
> (4) That the licensee shall have a right to hire, discipline, and terminate an assigned employee as may be necessary to fulfill the licensee's responsibilities under this Chapter and [the] PEO agreement. The client company shall have a right to hire, discipline, and terminate an assigned employee.
>
> (5) That the licensee retains a right of direction and control over the adoption of employment policies and the management of workers' compensation claims, claim filings, and related procedures in accordance with applicable federal laws and the laws of [North Carolina].
>
> (6) That responsibility to obtain workers' compensation coverage for assigned employees, from an entity authorized to do business in [North Carolina] and otherwise in compliance with all applicable requirements, shall be specifically allocated in the PEO agreement to either the client company or the licensee. If the responsibility is allocated to the licensee under any such agreement, that agreement shall require that the licensee maintain and provide to the client company, at the termination of the agreement if requested by the client company, records regarding the loss experience related to workers' compensation insurance provided to assigned employees pursuant to the agreement.[64]

While the agreement is executed between the PEO and the client firm, the employees covered by such agreement have a right to be informed of the

64. *Id.* § 58-89A-100. The PEO has the statutory obligation to collect and pay on time the employees' insurance premiums, benefit and welfare plans, as well as other withholding taxes. *Id.* § 58-89A-130.

contents thereof,[65] thereby allowing the employees to have adequate knowledge of who has the responsibility to comply and meet employer-related obligations under the law.

In Louisiana, the law regulating PEOs is more explicit in describing the relationship among the PEO, the client firm, and the employees, calling it a co-employment relationship.[66] Under such relationship, 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."[67] The PEO service agreement must satisfy the following requirements:

> (1) The agreement shall be in writing and executed by both the PEO and the client.
>
> (2) The agreement shall have an initial term of at least one year or, in the absence of an initial term of one year, the agreement shall clearly indicate that the intent is for the agreement to be ongoing rather than temporary.
>
> (3) The agreement shall provide that the client retains control over its business enterprise and exercises direction and control over the covered employees as to the manner and method of work done in furtherance of the client's business, but that authority and responsibility as to other employment matters, including but not limited to hiring, firing, discipline, and compensation are allocated to and shall be between the PEO and the client.
>
> (4) The agreement shall specifically provide for and allocate responsibility between the PEO and the client company with regard to the procurement and maintenance of workers' compensation insurance covering their liability for workers' compensation benefits and group health insurance to or with respect to the employees covered by the professional services agreement.
>
> (5) The agreement shall state specifically that the agreement is executed between the parties subject to the provisions of [the chapter on PEOs in the Louisiana Laws Revised Statutes].[68]

65. *See id.* § 58-89A-95 (b).

66. LA. REV. STAT. § 23:1761 (2021) (U.S.).

67. *Id.* § 23:1761 (3).

68. *Id.* § 23:1768.

Similar to North Carolina, Louisiana requires PEOs to register,[69] and explicitly excludes temporary employment arrangements, independent contractors, and staffing services from the definition of a PEO.[70]

Meanwhile, South Dakota placed its regulations on PEOs under its taxation laws.[71] Specifically, the State imposes tax on the gross receipts of PEOs, which it defines as a firm that

> (1) [e]nters into a contractual agreement with a client company to create a co-employment relationship for the provision of payroll, benefits, and other human resources functions;
>
> (2) [c]overs at least [75%] of the client company's full-time or full-time equivalent employees domiciled in South Dakota; and
>
> (3) [m]aintains separate books and records of account for each client company.[72]

Likewise, on the federal level, PEOs are treated as the sole employer of workers rendering services to client firms for purposes of compliance with employment-related federal tax obligations,[73] but only if they apply to become a certified PEO.[74] The certification comes with certain obligations, including submitting to an independent audit and filing of a security bond.[75]

While the certification is not mandatory and businesses can still engage PEOs that do not participate in the certification program, the certification offers certain benefits such as establishing credibility and attracting more client firms.[76] While the employment taxes are shouldered by the PEO, client firms that engage a certified PEO can obtain federal tax credits related to the

69. *Id.* § 23:1764 (A).

70. *Id.* §§ 23:1762 (A) (2)-(4) & 23:1762 (A) (1). Labor organizations, as defined by the National Labor Relations Act, are also excluded.

71. *See generally* S.D. CODIFIED LAWS § 10-45-96 (2021). The law excludes temporary agency services and similar arrangements from the coverage. *Id.* § 10-45-98.

72. *Id.* § 10-45-97.

73. INTERNAL REVENUE CODE, 26 U.S.C. § 3511 (a) (1) (2019) (U.S.).

74. *Id.* § 7705 (a) & (b).

75. *Id.* § 7705 (b).

76. Lorraine Lee & Ursula Ramsey, *Certified Professional Employer Organizations: The First Four Years*, J. ACCOUNTANCY, July 1, 2021, *available at* https://www.journalofaccountancy.com/issues/2021/jul/certified-professional-employer-organizations.html (last accessed Apr. 30, 2022) [https://perma.cc/7A6F-KK4H].

employees.[77] Given the express responsibility imposed on the certified PEOs, the certification also affords protection to the client firms. Usually, under the PEO agreement, client firms would be required to provide in advance the amount equal to the tax on the wages of the employees subject to the PEO arrangement.[78] In case the certified PEO winds down without remitting the employment taxes, or worse, takes the money for its own use in breach of the service agreement, the client firms are protected from any inquiry from the tax authorities.[79]

3. PEOs in the Philippine Context

Unfortunately, there is a dearth of publications and studies on the PEO industry in the Philippines.[80] One prominent PEO operating in the Philippines claims that around 175,000 SMEs[81] have used PEOs as of

77. INTERNAL REVENUE CODE, 26 U.S.C. § 3511 (d) (1) (A) (U.S.).

78. Goodner & Ramsey, *supra* note 16, at 586.

79. *Id.* at 585-86 (citing INTERNAL REVENUE CODE, 26 U.S.C. §§ 3511 & 3551 (a), (c), & (d) (2018) (U.S.)).

80. It is worth noting, however, that the Philippine Standard Industrial Classification recognizes employers on record for "matters relating to payroll, taxes, and other fiscal and human resource issues, but they are not responsible for direction and supervision of employees." Philippine Statistics Authority, 2019 Updates to the 2009 Philippine Standard Industrial Classification, *available at* https://psa.gov.ph/classification/psic2019/?q=psic/class/7830 (last accessed Apr. 30, 2022) [https://perma.cc/B4NP-RT9W].

81. Micro and small domestic market enterprises are those with paid-in equity capital of less than U.S. $200,000 and are reserved for Filipinos. Prior to the amendment, these enterprises were referred to as small and medium-sized domestic enterprises. Meanwhile, the Magna Carta for Small Enterprises, as amended, provides a definition of SMEs for the purpose of availing the benefits under the law. In particular, SMEs are defined as

> [a]ny business activity or enterprise engaged in industry, agribusiness and/or services, whether single proprietorship, cooperative, partnership[,] or corporation whose total assets, inclusive of those arising from loans[,] but exclusive of the land on which the particular business entity's office, plant[,] and equipment are situated, must have value falling under the following categories:
>
> Micro: less than [₱]1,500,001
>
> Small: [₱]1,500,001 - [₱]15,000,000

2020.[82] Without any source cited, however, this claim remains unsubstantiated.

It is not a secret that there are firms providing PEO services in the Philippines,[83] like the one mentioned above, but their presence is somehow not massive enough to warrant the passage of measures by lawmakers.

To understand how PEOs in the Philippines operate, this Article discusses an example of a service agreement (HR Service Agreement) between a PEO and its client.[84] For confidentiality reasons, the Author will not be providing the HR Service Agreement in full and will not be disclosing the identities of the PEO and the client who executed the Agreement. It is important to note, however, that the client in this case is a foreign company — that has no business presence or operations in the Philippines — which wanted to hire Filipino employees who would be working remotely for the client's foreign customers.

> Medium: [₱]15,000,001 - [₱]60,000,000
>
> The above definitions shall be subject to review and adjustment by the [Small and Medium Enterprise Development Council] *motu proprio* or upon recommendation of sectoral organization(s) taking into account inflation and other economic indicators. The Council may use as variables the number of employees, equity capital[,] and assets size.

An Act to Promote, Develop and Assist Small and Medium Scale Enterprises Through the Creation of a Small and Medium Enterprise Development (SMED) Council, and the Rationalization of Government Assistance Programs and Agencies Concerned with the Development of Small and Medium Enterprises, and for Other Purposes [Magna Carta for Small Enterprises], Republic Act No. 6977, § 3 (1991) (as amended) & An Act to Promote Foreign Investments, Prescribe the Procedures for Registering Enterprises Doing Business in the Philippines, and for Other Purposes [Foreign Investments Act of 1991], Republic Act No. 7042, § 8 (b) (2) (1991) (as amended).

82. KMC, Professional Employer Organization (PEO) in the Philippines, *available at* https://kmc.solutions/professional-employer-organization-peo-in-the-philippines (last accessed Apr. 30, 2022) [https://perma.cc/5FCV-HPA3].

83. *Id.*

84. For the sake of transparency, the Author was able to obtain a copy of such HR Service Agreement from a foreign corporate client with no business presence or operations in the Philippines, but wished to engage a PEO incorporated in the Philippines. The client asked the Author to review the agreement. HR Service Agreement (on file with Author).

Under the HR Service Agreement, the PEO would provide orientation, management, and employee payroll processing for the client firm,[85] which are similar to the services offered by PEOs in the U.S. Further, the PEO's main obligation is to handle and control exclusively the HR management of the employees, while the client firm would provide all management directives related to the work product or output expected of the employees.[86] While the PEO and the client firm have the HR Service Agreement binding them, the PEO and the employees would be entering into an employment contract.[87] In addition to the employment contract, the employees would be subject to the employment manual and HR policies of the PEO.[88]

The HR Service Agreement also highlights that the client firm cannot perform any act involving the employees and their status in the organization without the consent, or in opposition to the advice, of the PEO.[89] In other words, if the client firm has an issue with the employee to a degree that, if the client firm had full control and supervision over the employees, the client firm would have already exercised its disciplinary rights over the employees, the PEO must first be notified of the client firm's assessment, and the PEO's advice on the next steps should be sought and followed by the client firm.

Further, the HR Service Agreement provides that the salaries and other statutory benefits due to the employees should be shouldered by the client firm.[90] The obligation extends to the payment of a separation package for the employees in the event of termination due to authorized causes,[91] including the pre-termination of the HR Service Agreement by either the PEO or the

85. *Id.* Other than providing employer of record services, the PEO, under the HR Service Agreement, could be requested to provide recruitment services. This part of the HR Service Agreement will not be discussed in this Article.

86. HR Service Agreement, *supra* note 84.

87. The employment contract between the PEO and the employees of the Author's client was not provided to her; thus, no review of the employment contract mentioned in the HR Service Agreement was conducted.

88. HR Service Agreement, *supra* note 84.

89. *Id.*

90. *Id.*

91. *See* A Decree Instituting a Labor Code, Thereby Revising and Consolidating Labor and Social Laws to Afford Protection to Labor, Promote Employment and Human Resources Development, and Ensure Industrial Peace Based on Social Justice [LABOR CODE], Presidential Decree No. 442, art. 298 (1974) (as amended).

client firm.[92] Nevertheless, the PEO would be made to appear as the employer of the client firm's employees for purposes of tax withholding and payments of statutory contributions to the Social Security System, Home Development Mutual Fund, and Philippine Health Insurance Corporation.[93]

In a word, the HR Service Agreement is replete with provisions overstressing the importance of the client firm following the instructions of the PEO on matters involving the employment of the workers, while delineating carefully the obligations of each party to the employees.[94]

Another thing that stands out in the HR Service Agreement is the non-solicitation clause that imposes a penalty on the client firm should it decide to incorporate its business in the Philippines and request the employees to be transferred to the established company.[95] Thus, while the PEO is merely the employer on paper, the PEO is maintaining that the workers, even if actually recruited and hired by the client firm, should be treated as the PEO's employees for purposes of implementing the non-solicitation clause. This particular provision is connected with the concept of doing business under Philippine laws.

The implementing rules and regulations of the Foreign Investments Act of 1991,[96] as amended, provide that *doing business* in the Philippines covers

> soliciting orders, service contracts, opening offices, whether liaison offices or branches; appointing representatives or distributors, operating under full control of the foreign corporation, domiciled in the Philippines or who[,] in any calendar year[,] stay[s] in the country for a period or periods totaling [180] days or more; participating in the management, supervision or control of any domestic business, firm, entity[,] or corporation in the Philippines; and any other act or acts that imply a continuity of commercial dealings or arrangements, and contemplate to that extent the performance of acts or works, or the exercise of some of the functions normally incident to and in

92. HR Service Agreement, *supra* note 84.

93. *Id.*

94. *See id.*

95. HR Service Agreement, *supra* note 84.

96. National Economic and Development Authority, Rules and Regulations Implementing the Foreign Investments Act of 1991, Republic Act No. 7042 (1996).

> progressive prosecution of commercial gain or of the purpose and object of the business organization.[97]

The foreign corporate client that wanted to engage the PEO and execute the HR Service Agreement does not do business in the Philippines under any of the aforementioned activities, but wanted to utilize the excellent labor market in the Philippines. Would the situation have been different if the foreign corporate client did business in the Philippines as defined above?

Doing business in the Philippines requires that the business is duly registered with the relevant regulators.[98] For foreign investors, they have a choice of corporate vehicles through which their business is conducted.[99] These vehicles include a domestic corporation or subsidiary, the incorporation, management, and formation of which is governed by the

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97. *Id.* rule I, § 1 (f). The same provision expressly excludes the following activities from the coverage of doing business:

> (1) Mere investment as a shareholder by a foreign entity in domestic corporations duly registered to do business, and/or the exercise of rights as such investor;
> (2) Having a nominee director or officer to represent its interests in such corporation;
> (3) Appointing a representative or distributor domiciled in the Philippines which transacts business in the representative's or distributor's own name and account;
> (4) The publication of a general advertisement through any print or broadcast media;
> (5) Maintaining a stock of goods in the Philippines solely for the purpose of having the same processed by another entity in the Philippines;
> (6) Consignment by a foreign entity of equipment with a local company to be used in the processing of products for export;
> (7) Collecting information in the Philippines; and
> (8) Performing services auxiliary to an existing isolated contract of sale which are not on a continuing basis, such as installing in the Philippines machinery it has manufactured or exported to the Philippines, servicing the same, training domestic workers to operate it, and similar incidental services.

Id. See generally Securities and Exchange Commission, Office of the General Counsel, SEC-OGC Opinion No. 17-03, Series of 2017 (Apr. 4, 2017) (SEC makes a review of the jurisprudence regarding doing business in the Philippines).

98. *See* An Act Providing for the Revised Corporation Code of the Philippines [REV. CORP. CODE], Republic Act No. 11232, § 140 (2019).

99. *See id.*

Revised Corporation Code,[100] or a foreign corporation, which is formed, organized, and existing under foreign laws, but should be registered with the Philippine Securities and Exchange Commission for it to have a right to transact business in the Philippines.[101] Foreign corporations licensed to do business in the Philippines can be in the form of a branch office or a representative office, among others.[102]

Thus, if the foreign corporate client in this scenario commences doing business in the Philippines, it would have to establish a presence in the Philippines,[103] which physical presence would directly assume the employer obligations provided in the HR Service Agreement and in Philippine labor laws. Does this mean then that the engagement of PEOs should be limited to foreign companies that do not conduct business in the Philippines? In the first place, do Philippine laws currently account for such scenario? Do Philippine laws regulate PEOs? To answer these questions, a review of relevant Philippine laws is presented.

B. Philippine Laws on Contracting Arrangements

1. Contracting Laws and Regulations

Contracting[104] is an arrangement where a principal (employer) agrees to outsource or to "farm out to a contractor the performance or completion of a specific job or work within a definite or predetermined period, regardless of whether such job or work is to be performed or completed within or outside the premises of the principal."[105] Contracting of activities to third parties is part of the business management prerogative of an enterprise.[106]

100. REV. CORP. CODE.

101. *Id.* § 140.

102. Rules and Regulations Implementing the Foreign Investments Act of 1991, § 1 (c).

103. *See id.*

104. In this Article, the term "contracting" includes subcontracting, and the term "contractor" includes subcontractor.

105. Department of Labor and Employment, Rules and Regulations Implementing Articles 106 to 109 of the Labor Code, as Amended, Department Order No. 174, Series of 2017 [DOLE D.O. No. 174, s. 2017], § 3 (c) (Mar. 16, 2017).

106. Universal Robina Corp., v. Alfredo Jumao-as, et al., G.R. No. 212580, Dec. 2, 2020, at 6, *available at* https://sc.judiciary.gov.ph/19150 (last accessed Apr. 30, 2022).

In a contracting arrangement, there are three parties involved whose relationship are governed by two main contracts.[107] The parties are the principal who is the direct employer, the contractor who has the capacity to accomplish the job, and the contractor's employee who is "hired to perform or complete a job or work farmed out by the principal"[108] to the contractor. The three parties form a trilateral relationship,[109] where there is an agreement between the principal and contractor to do a specific job, work, or service, and an employment contract between the contractor and its workers.[110]

The prevailing regulation on contracting, Department of Labor and Employment (DOLE) Department Order No. 174, series of 2017 (DOLE D.O. No. 174-17),[111] requires the execution of two contracts: (1) an employment contract between the contractor and its employees; and (2) a service agreement between the principal and the contractor.[112] DOLE D.O. No. 174-17 also requires the inclusion of certain provisions in these contracts. For instance, the employment contract should contain the provisions on

107. Department of Labor and Employment, Rules and Regulations Implementing Articles 106 to 109 of the Labor Code, as Amended, Department Order No. 18-A, Series of 2011 [DOLE D.O. No. 18-A, s. 2011], § 3 (m) (Nov. 18, 2011).

108. DOLE D.O. No. 174, s. 2017, § 3 (e).

109. Fuji Television Network, Inc. v. Espiritu, G.R. No. 204944-45, 744 SCRA 31, 75 (2014) (citing DOLE D.O. No. 18-A, s. 2011, §§ 3 (m) & 5).

110. DOLE D.O. No. 18-A, s. 2011, § 3 (m). (DOLE D.O. No. 174, s. 2017 has superseded DOLE D.O No. 18-A, s. 2011, but the Author submits that the provision on trilateral relationship in a contracting arrangement in the superseded issuance is still instructive).

111. DOLE D.O. No. 174, s. 2017. *See*, *e.g.*, Department of Labor and Employment, Guidelines Governing the Employment of Workers in the Construction Industry, Department Order No. 19, Series of 1993 [DOLE D.O. No. 19, s. 1993] (Apr. 1, 1993) (lays down the contracting rules applicable in the construction industry) & Department of Labor and Employment, Revised Guidelines Governing the Employment and Working Conditions of Security Guards and Other Private Security Personnel in the Private Security Industry, Department Order No. 150, Series of 2016 [DOLE D.O. No. 150, s. 2016] (Feb. 9, 2016) (discusses the contracting rules governing security guards and the private security industry). The Article will not be discussing both labor issuances.

112. DOLE D.O. No. 174, s. 2017, § 11.

general labor standards, and the service agreement should include a provision on the issuance of a bond,[113] renewable annually.[114]

Rooted in Article 106[115] of the Philippine Labor Code, DOLE D.O. No. 174-17 provides that there are two types of contracting: (1) legitimate contracting arrangement, and (2) labor-only contracting.[116] For a contracting arrangement to be valid and legitimate, the following conditions must be met:

> (1) The contractor is engaged in a distinct and independent business and undertakes to perform the job or work on its own responsibility, according to its own manner and method;
>
> (2) The contractor has substantial capital to carry out the job farmed out by the principal on his account, manner[,] and method, investment in the form of tools, equipment, machinery[,] and supervision;
>
> (3) In performing the work farmed out, the contractor is free from the control and/or direction of the principal in all matters connected with the performance of the work except as to the result thereto; and
>
> (4) The Service Agreement ensures compliance with all the rights and benefits for all the employees of the contractor under the labor laws.[117]

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113. This refers to the bond that the principal may require from the contractor in the amount equal to the cost of labor under contract. DOLE D.O. No. 174, s. 2017, § 3 (a). The bond is to answer for the wages due to the employees in case the contractor fails to pay. LABOR CODE, art. 108.

114. DOLE D.O. No. 174, s. 2017, § 11.

115. LABOR CODE, art. 106. According to this provision —

> There is 'labor-only' contracting where the person supplying workers to an employer does not have substantial capital or investment in the form of tools, equipment, machineries, work premises, among others, and the workers recruited and placed by such person are performing activities which are directly related to the principal business of such employer. In such cases, the person or intermediary shall be considered merely as an agent of the employer who shall be responsible to the workers in the same manner and extent as if the latter were directly employed by him.

Id.

116. San Miguel Foods, Inc. v. Rivera, G.R. No. 220103, 853 SCRA 579, 591 (2018) (citing Coca-Cola Bottlers Phils., Inc. v. Agito, G.R. No. 179546, 579 SCRA 445, 458 (2009)). *See* DOLE D.O. No. 174, s. 2017, §§ 5 & 8.

117. DOLE D.O. No. 174, s. 2017, § 8. Substantial capital is defined as the paid-up capital of at least ₱5,000,000 in the case of corporations, partnerships, and

To be clear, there is a general presumption that a contractor is engaged in labor-only contracting, unless it is able to overcome that burden by proving it has met the elements listed above.[118] Contractors are required to register with DOLE, and failure to secure a registration certificate also creates a presumption that a contractor is engaged in labor-only contracting.[119] Nevertheless, the Court opined that the certification merely creates a disputable presumption that a contractor is engaged in permissible contracting.[120]

In contrast, in a labor-only contracting arrangement, there is no outsourcing of the performance or completion of a specific work or job as the contractor "merely recruits, supplies[,] or places workers to perform a job or work for a principal[.]"[121] Further, the following elements are present:

(a) i. The contractor does not have substantial capital, *or*

ii. The contractor does not have investments in the form of tools, equipment, machineries, supervision, work premises, among others; *and*

iii. The contractor's or subcontractor's employees recruited and placed are performing activities which are directly related to the main business operation of the principal; *or*

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cooperatives, and a net worth of at least ₱5,000,000 in case of a single proprietorship. *Id.* § 3 (l).

A service agreement is a "contract between the principal and contractor containing the terms and conditions governing the performance or completion of a specific job or work being farmed out for a definite or predetermined period." *Id.* § 3 (j).

118. Allied Banking Corporation v. Calumpang, G.R. No. 219435, 852 SCRA 1, 16 (2018) (citing Diamond Farms, Inc. v. Southern Philippines Federation of Labor (SPFL)-Workers Solidarity of DARBMUPCO, G.R. No. 173254, 780 SCRA 308, 337 (2016)).

119. DOLE D.O. No. 174, s. 2017, § 14 & Alaska Milk Corporation v. Paez, G.R. No. 237277, 926 SCRA 233, 244 (2019) (citing Valencia v. Classique Vinyl Products Corporation, 804 Phil. 492, 507 (2017)).

120. Manila Cordage Company – Employees Labor Union – Organized Labor Union in Line Industries and Agriculture (MCC-ELU-OLALIA) and Manco Synthetic Inc., Employee Labor Union – Organized Labor Union and Agriculture (MSI-ELU-OLALIA) v. Manila Cordage Company (MCC) and Manco Synthetic, Inc. (MSI), G.R. No. 242495, Sept. 16, 2020, at 10, *available at* https://sc.judiciary.gov.ph/19070 (last accessed Apr. 30, 2022) (citing Alilin v. Petron Corp., 735 Phil. 509 (2014)).

121. DOLE D.O. No. 174, s. 2017, § 3 (h).

(b) The contractor does not exercise the right to control over the performance of the work of the employee.[122]

The contractor in a labor-only contracting arrangement does not offer services that would be beneficial to the completion or performance of a specific work or job in accordance with the instructions of the principal. The contractor in such arrangement provides workers or recruits them for the benefit of the principal.[123] Put simply, the contractor in a labor-only contracting arrangement supplies workers, not services, to a principal, acting "as [an] agent in the recruitment, supply, or placement of workers"[124] of the principal. Admittedly, this is a very fine line distinguishing permissible contracting and labor-only contracting, which is why dissecting each element that makes up each type of contracting becomes critical, and "the totality of the facts and the surrounding circumstances of [a] case shall be considered."[125]

Why is the law belaboring the difference between permissible contracting and labor-only contracting? It is because labor-only contracting is considered a "circumvention of labor laws."[126] In labor-only contracting, the principal is considered the direct employer of the contractor's employees,[127] and it is also the same as concluding that an employer-employee relationship exists between the principal and the employees.[128]

In *San Miguel Foods, Inc. v. Rivera*,[129] the Court clarified the existence of a labor-only contracting would result in the establishment of an employer-employee relationship between the principal and the contractor's employees, such that the principal becomes directly liable to the employees with respect to the payments of their wages.[130] A labor-only contracting arrangement

122. *Id.* § 5 (emphases supplied).

123. Lingat v. Coca-Cola Bottlers Philippines Inc., G.R. No. 205688, 870 SCRA 541, 555 (2018).

124. *Id.*

125. *San Miguel Foods, Inc.*, 853 SCRA at 594.

126. Abuda v. L. Natividad Poultry Farms, G.R. No. 200712, 870 SCRA 468, 485 (2018) (citing Maraguinot, Jr. v. NLRC (Second Division), G.R. No. 120969, 284 SCRA 539, 561 (1998)).

127. DOLE D.O. No. 174, s. 2017, § 7. The same consequence applies if there is a finding of other illicit forms of employment arrangements. Section 6 of the same Department Order enumerates such other illicit forms of employment arrangements. *Id.* § 6.

128. *Allied Banking Corporation*, 852 SCRA at 17.

129. San Miguel Foods, Inc. v. Rivera, G.R. No. 220103, 853 SCRA 579 (2018).

130. *Id.* at 594.

would also make the principal and the contractor solidarily liable to the employees in case there is any violation under the Labor Code.[131]

Given the intricate connections between the elements of contracting and the existence of an employer-employee relationship, looking at cases dealing with these concepts is called for.

2. Philippine Cases on Elements of Contracting and Employer-Employee Relationship

a. Sonza v. ABS-CBN Broadcasting Corporation

In this case, Jose Y. Sonza (Sonza), a renowned radio and television host, filed for non-payment of wages and benefits under an employees' stock option plan managed by the respondent corporation.[132] Respondent, for its part, argued that Sonza had no right under the plan since he was not an employee of the company.[133]

The Court discussed that employer-employee relationship exists if these elements are present:

> (a) the selection and engagement of the employee;
>
> (b) the payment of wages;
>
> (c) the power of dismissal; and
>
> (d) the employer's power to control the employee on the means and methods by which the work is accomplished.[134]

The last element, also known as the control test, is the most important element,[135] in which, the right to exercise control is present not just on the

131. *Coca-Cola Bottlers Phils., Inc.*, 579 SCRA at 460.

132. Sonza v. ABS-CBN Broadcasting Corporation, G.R. No. 138051, 431 SCRA 583, 588 (2004).

133. *Id.* at 589.

134. *Id.* at 594-95 (citing De Los Santos v. National Labor Relations Commissions, 423 Phil. 1020 (2001); Traders Royal Bank v. National Labor Relations Commission, 378 Phil. 1081 (1999); Aboitiz Shipping Employees Association v. National Labor Relations Commission, G.R. No. 78711, 186 SCRA 825 (1990); & Ruga v. National Labor Relations Commission, G.R. Nos. 72654-61, 181 SCRA 266 (1990)).

135. *Id.* at 595.

end product to be achieved, but also on the manner and means used to accomplish the desired end result or product.[136]

Debunking Sonza's arguments, the Court held —

(1) The respondent's hiring of Sonza because of his peculiar skills, talent, and celebrity status not possessed by ordinary employees highlights Sonza's position as an independent contractor.[137]

(2) The copious talent fees and benefits given to Sonza were not a result of an employer-employee relationship, but of Sonza's negotiations with the respondent.[138] This is not to say that ordinary employees cannot bargain for higher wages, but Sonza, acting on his own, possessed such power to negotiate for fees higher than the salaries of ordinary employees.[139]

(3) The relationship between the two parties are governed by contractual stipulations, such that, the termination of Sonza's services would only be implemented if arising from a breach of contract, not due to grounds such as just or authorized causes under labor laws.[140]

(4) While the respondent is responsible for broadcasting Sonza's show, it did not have a say on how Sonza conducted or operated it.[141] The respondent also did not have any supervision or control over Sonza's use of his unique talent and skills.[142] Further, if there

136. Monsanto Philippines, Inc. v. National Labor Relations Commission, et al., G.R. No. 230609, Aug. 27, 2020, at 7, *available at* https://sc.judiciary.gov.ph/15650 (last accessed Apr. 30, 2022) (citing Reyes v. Glaucoma Research Foundation, Inc., G.R. No. 189255, 759 SCRA 120, 133 (2015)).

137. *Sonza*, 431 SCRA at 595. As clarified by DOLE, a contracting arrangement under Philippine labor laws excludes contractual relationships, such as in a sale or lease contract, or contracting of a job to a professional, or "individual with unique skills and talents who himself or herself performs the job or work for the principal," which is more legally known as an independent contractor. These relationships are governed by Philippine contractual laws, and not labor laws. Department of Labor and Employment, Clarifying the Applicability of Department Order No. 174, Series of 2017, Department Circular No. 01, Series of 2017 [DOLE Dept. Circ. No. 01, s. 2017], pt. V (June 9, 2017).

138. *Sonza*, 431 SCRA at 596.

139. *Id.*

140. *Id.* at 597.

141. *Id.* at 600-01.

142. *Id.*

> were rules imposed by the respondent on Sonza, these rules did not necessarily control Sonza's performance, but were geared towards achieving the result agreed by respondent and Sonza.[143]

b. San Miguel Foods, Inc. v. Rivera

In this case, the petitioner engaged the services of a contractor registered with the DOLE for an invoicing services contract.[144] After four years of engagement, the petitioner decided to cease its invoicing operations at its head office where the contractor's employees were assigned, and move it to another location.[145] Petitioner then informed the contractor of its decision and asked it to notify the employees that they would be reassigned to the new location.[146] Some of the employees refused the transfer and tendered their resignation instead, while others went ahead with the transfer.[147] Many of the employees filed a case for constructive dismissal and regularization, among others.[148] The employees' major argument was that the petitioner, the company that engaged the contractor, was their direct employer.[149] To support their argument, the employees said that the petitioner exercised control over the means and methods of doing their tasks through the various policies implemented on site.[150]

In maintaining the contractor as the employer of the complaining employees, the Court highlighted that the contractor was duly registered with DOLE as a contractor, which created a presumption, albeit a disputable one, that it is operating legitimately.[151] Further, the Court noted that the contractor had a substantial capital in the form of authorized capital stock, as provided in the contractor's Articles of Incorporation.[152] While the Court admitted that it was not evident from the facts if the contractor had investment in the form of tools, equipment, machineries, supervision, work premises, among others, this could not be taken against the contractor as it was able to substantiate that it

143. *Id.* at 603-04.

144. *San Miguel Foods, Inc.*, 853 SCRA at 582.

145. *Id.* at 583.

146. *Id.*

147. *Id.* at 584.

148. *Id.*

149. *Id.* at 586.

150. *San Miguel Foods, Inc.*, 853 SCRA at 586.

151. *Id.* at 595.

152. *Id.*

had the required capital to operate as a contractor.[153] As clarified by the Court, a contractor need not have both the substantial capital and the investment in the form of tools, equipment, machineries, supervision, and work premises — having and maintaining either is enough to comply with the law.[154]

The elements, however, that helped the Court to conclude that the contractor is the actual employer of the employees is the existence of the contractor's control over the performance of the workers' job.[155] While the principal provided guidelines and policies for the employees to follow while they were on site, the Court, citing *Royale Homes Marketing Corporation v. Alcantara*[156] and *Insular Life Assurance Co., Ltd. v. National Labor Relations Commission*,[157] reiterated that, provided the amount of control does not become an interference with the means and methods of completing designated tasks, then the guidelines implemented by the principal could not be considered as the form of control contemplated in an employer-employee relationship.[158] In this case, the contractor has the right to control the employees, not the principal.[159]

c. Daguinod v. Southgate Foods, Inc., et al. and Luces, et al. v. Coca-Cola Bottlers Phils., Inc., et al.

As mentioned, if the work performed by the contractor's employees is directly related to the main business operation of a principal, it belies a permissible contracting arrangement.[160] These particular cases discuss this element and point that there must be a reasonable connection between the specific works performed by the employee in relation to the main or usual business of the

153. *Id.* at 595-96.

154. *Id.* (citing Neri v. National Labor Relations Commission, G.R. Nos. 97008-09, 224 SCRA 717, 721 (1993)).

155. *San Miguel Foods, Inc.*, 853 SCRA at 598.

156. Royale Homes Marketing Corporation v. Alcantara, G.R. No. 195190, 731 SCRA 147 (2014).

157. Insular Life Assurance Co., Ltd. v. National Labor Relations Commission, G.R. No. 84484, 179 SCRA 459 (1989).

158. *San Miguel Foods, Inc.*, 853 SCRA at 600 (citing *Royale Homes Marketing Corporation*, 731 SCRA at 163).

159. *Id.* at 596.

160. DOLE D.O. No. 174, s. 2017, § 5.

employer.[161] In other words, the work is necessary, indispensable, and desirable to the core business of the principal.[162] The determination, however, is done on a case-to-case basis and must be based on facts, including assessing the "nature of the services rendered and its relation to the general scheme under which the business or trade is pursued in usual course."[163]

In *Daguinod*, for example, the worker, who was employed through a contractor, was tasked with receiving payments, giving change, taking food orders, and preparing food ingredients, among others, in a fast food restaurant, such as the principal in this case.[164] The worker's tasks were, without a doubt, directly related to the main business of the fast food restaurant.[165] Meanwhile, in *Luces*, the principal that contracted workers from a contractor was in the business of manufacturing, distributing, and marketing beverage products.[166] The workers were route helpers, delivery truck drivers, and forklift operators, assigned with tasks that are necessary and indispensable to the operations of the principal.[167]

IV. CONCLUSIONS AND RECOMMENDATIONS

Given the discussions above, how then should PEOs be classified from the perspective of Philippine labor laws? Is a PEO a form of labor-only contracting or of job contracting? Determining its classification is important as the obligations and rights of the parties, especially the rights of the workers, are dependent on such classification.

A PEO is similar to a contracting arrangement, in that, three parties are involved in the employment arrangement.[168] Both arrangements have a principal (first party), typically a corporate client that engages the services of a

161. Daguinod v. Southgate Goods, Inc., G.R. No. 227795, 894 SCRA 172, 190 (2019) & Luces, et al. v. Coca-Cola Bottlers Phils. Inc., et al., G.R. No. 213816, at 16, *available at* https://sc.judiciary.gov.ph/17661 (last accessed Apr. 30, 2022) (citing Magsalin v. National Organization of Working Men, G.R. No 148492, 403 SCRA 199, 204 (2003)).

162. *Daguinod*, 894 SCRA at 190.

163. *Luces, et al.*, G.R. No. 213816, at 16 (citing *Magsalin*, 403 SCRA at 204).

164. *Daguinod*, 894 SCRA at 191.

165. *Id.*

166. *Luces, et al.*, G.R. No. 213816, at 15.

167. *Id.*

168. DOLE D.O. No. 18-A, s. 2011, § 3 (m).

third-party services provider (second party) who employs workers (third party) to do a specific job for the benefit of the principal.[169]

At first blush, the engagement of the employees by the PEO, while lacking the right to exercise control over the means and methods with which the employees could accomplish their tasks, would place the PEO in the same category as a labor-only contractor. The PEO, however, does not provide staffing services and personnel to the principal the same way a labor-only contractor would. A PEO, as defined by various U.S. laws discussed earlier, does not involve the provision of workers to a client company and the placement and recruitment of workers.[170]

At the same time, PEOs provide services that a principal can outsource, similar to a legitimate contractor, but it cannot be classified as a form of permissible contracting because the element of control is missing. All parties to a PEO arrangement recognize that it is the client firm that can exercise the level of control needed in an employer-employee relationship. As it stands now, a PEO is neither a permissible nor a labor-only contractor.

It is therefore submitted that while there are stark similarities between a PEO and a contractor, a new species of labor intermediaries under Philippine laws should be created under which a PEO can be classified. To regulate the industry, new rules should be promulgated, providing guidelines on how PEOs can validly operate their businesses while ensuring that the rights of workers are upheld and protected at all times.

Furthermore, an example of such practice is making it appear that a worker is an independent contractor instead of an actual employee, allowing the employer to deny liability with respect to employment-related obligations or to violate an employee's security of tenure. By engaging a PEO, employers recognize that an employer-employee relationship exists and they are willing to comply with labor laws, including regulations on the wages and benefits, statutory or contractual, due to the employees. It just so happens that, most of the time, they do not have the resources or capabilities to keep up with the administrative and logistical aspects of such compliance on a regular basis. This is not to say, however, that that all employers should be given freedom to contract a PEO without restrictions. Below are some recommendations in this regard.

Going back to the questions posited in Section III on who should be allowed to engage a PEO, the Author proposes that SMEs, as they are

169. DOLE D.O. No. 174, s. 2017, § 3 (e).

170. North Carolina Professional Employer Organization Act, N.C. GEN STAT. § 58-89A-5 (13).

currently,[171] and will be, defined, should be prioritized. As the economies of scale are not working in favor of SMEs,[172] they should be given more room to exercise their management prerogative by engaging PEOs. This way, the SMEs can focus their resources on growing their business[173] and contribute more to the development of the Philippine economy. Conversely, companies that do not fall under the definition of SMEs, should be prohibited from engaging PEOs as they have the resources and the capacity to employ HR specialists and can even dedicate an entire department for it.[174]

Foreign enterprises that are not engaged in doing business in the Philippines[175] may be allowed to engage PEOs, if they employ Filipino workers under an employer-employee relationship. In doing so, the rights of the Filipino employees are well protected. If foreign enterprises are considered doing business in the Philippines as defined in Philippine laws, they should comply with the registration requirements.[176] Thereafter, their engagement of a PEO is dependent on their classification as a SME.

Borrowing from the requirements of DOLE D.O. No. 174-17, a person or entity may only engage in the business of a PEO if it is duly incorporated and registered with DOLE.[177] This provides another layer of protection for both the client firm and the employees because the registration would allow these parties to transact only with PEOs that have met the legal, technical, and financial requirements of DOLE. Again, to implement this, DOLE should come up with a new issuance setting down a certification and registration procedure, separate and distinct from the one espoused in DOLE D.O. No. 174-17.[178]

Provisions on how the PEO and the client firm should divide their obligations to the employees can also be included in the new issuance to further protect the rights of workers. In relation to this, DOLE should exercise

171. Foreign Investments Act of 1991, § 8 (b) (2).

172. Klaas, *Trust and the Role of Professional Employer Organizations*, *supra* note 38, at 107.

173. Edvardsson & Óskarsson, *supra* note 43, at 9.

174. Another purpose of this recommendation is to protect the workers' rights to form a union in larger organizations.

175. Rules and Regulations Implementing the Foreign Investments Act of 1991, § 1 (f).

176. REV. CORP. CODE, § 140.

177. DOLE D.O. No. 174, s. 2017, § 14.

178. *See id.*

its rule-making authority and limit the activities of a PEO to providing HR-related compliance and administrative support to the client firm. Control in any form that relates to the status of an employee within the organization of the employer should not be exercised by the PEO. The power to discipline, select, and hire employees, and control the means and methods by which an employee should accomplish a task[179] are powers exclusive to the client firm as the actual employer. Any act affecting the employees, such as the manner of paying wages, should be performed under the instructions of the client firm, provided it is made in accordance with Philippine laws.

DOLE can also dictate other activities that a PEO is prohibited from conducting, such as recruitment and placement activities, contracting, and other illicit forms of employment arrangements, and it can also require PEOs to secure a bond, similar to a contractor, to answer for liabilities.[180]

Accordingly, the agreements between the PEO and the client firm (the service agreement) and between the PEO and the employees (the employment agreement) should be subject to mandatory stipulations, similar to what they do in North Carolina[181] and Louisiana.[182] Below are some suggested stipulations which may be provided in the agreements:

(1) Mechanism that would allow the employees to be informed that they are under a PEO arrangement, including providing such stipulation in the employment contract;

(2) Effect of termination of service agreement to the employment of the workers, including automatic absorption of said employees into the payroll of the client firm, in order to protect the workers' security of tenure;

(3) Obligations of the client firm and the PEO, which should be in accordance with the labor standards and the new issuance that would be implemented by DOLE;

(4) Liabilities of the client firm and the PEO in case of violation of Philippine labor laws or in case of breach of the service agreement by either of them that results in the termination of such agreement; and

179. *See Sonza*, 431 SCRA at 594-95.

180. DOLE D.O. No. 174, s. 2017, § 3 (a) & LABOR CODE, art. 108.

181. North Carolina Professional Employer Organization Act, N.C. GEN. STAT. § 58-89A-100.

182. LA. REV. STAT. § 23:1768.

(5) Mechanism that would allow employees to go after a foreign-based employer that has no physical presence in the Philippines, and any assistance that the PEO may provide to the employee.

Further consultations from stakeholders are needed to fine tune the mandatory stipulations as well as regulatory issuances. To protect the rights of workers, however, the mandatory provisions should legally bind the PEO, the client firm, and the employees, irrespective of their inclusion in the contracts.

Compliance with labor laws is paramount, but in reality, not all businesses have the resources and skills to fully comply on a regular tenor. To be clear, this is in no way a condonation of people violating any law or any right. This is a proposal to acknowledge that there is a way to protect workers' rights and help businesses, especially SMEs, to grow at the same time. The significance of PEOs in the labor space is undeniable, but their role should be regulated to safeguard the rights of the parties involved.