Thompson Technology: A Case Study in Controlling Labor Costs

Scenario D: Moving Employees to a PEO

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CASE ABSTRACT

Thompson Technology provides software solutions to the financial industry. From its founding in 1988 through the 1990s, the company experienced significant financial success, growing rapidly from a small startup to a publicly traded organization with approximately 800 employees. The recent economic recession and increased regulation of the financial industry, however, have caused Thompson to experience significant decreases in revenue for the first time. This case focuses on the organization’s attempts to control labor costs by decreasing expenses.

The case begins with an overview of the organization and is divided into five scenarios. Each scenario includes separate questions (and debriefs) for undergraduate and graduate students to answer. This document contains only Scenario D: Moving Employees to a PEO. The scenarios are as follows:

- Scenario A: Restructuring After a Hiring Freeze
- Scenario B: Flexible Scheduling
- Scenario C: Hot-Desking
- Scenario D: Moving Employees to a PEO
- Scenario E: Downsizing and the HR Department

Teaching note
In order to create a student workbook, please make one copy of pages 2 through 10 for each student.
ABOUT THOMPSON TECHNOLOGY

Alan Thompson, founder of Thompson Technology, was always an idea man. Whenever something new came down the road, he jumped on it, took it apart, transformed what was there and created something different. He also embraced technology. Thompson was fascinated by its constant evolution, and he understood its creative possibilities well before the rest of us caught on.

Thompson didn’t start his career in technology. As a teenager, Thompson worked at the local bank where his father was the branch manager. Banking helped pay his way through college, and although he never liked working there, Thompson admitted that it was the beginning of his career success.

Technology captured Thompson’s imagination. He said his real career path started in the cluttered techno cave he carved out of a cramped space in his parent’s garage. He set up his first computer on a makeshift table squeezed between the lawn mower and the garden tools. It was there where he tinkered with programming and computer code. He designed simple accounting software at first, but he didn’t stop there. Each new innovation made his software better and faster. When he realized his systems were far better than anything available in the banking industry at the time, he knew he was onto something. In 1988, he left banking and launched Thompson Technology. By the mid-1990s Thompson Technology was a major player in the design and maintenance of specialty software for the financial industry; Thompson products were at work behind the scenes at most major financial institutions across the U.S. and Canada.
The early years of Thompson Technology were characterized by innovation and growth, and it was soon known as a great place to work. When the company grew and prospered, employees did too, with generous compensation and benefits that rewarded creativity and employee engagement. When 1999 turned to 2000, Thompson Technology greeted the new century with enthusiasm; it seemed that there wasn't a dark cloud on the horizon.

Thompson Technology made its first public stock offering in 2006. By then, the company had 800 employees and new headquarters in Denver, Colo. As majority shareholder, Alan Thompson maintained control of the company, but he turned the day-to-day management of the organization over to Howard Kessler, Thompson’s new CEO. Kessler came to the company with a strong background in international finance, and Thompson believed Kessler was the ideal choice to expand the company beyond North America.

Thompson Technology began to change with Kessler at the helm. He hired Jack Albright as the new chief operations officer (COO), and Elizabeth Schiff became the new chief financial officer (CFO). Scott Montgomery remained as Thompson’s chief human resource officer (CHRO). Besides new management, other things were different as well; now there were shareholders to satisfy.

In addition, the company underwent a major reorganization in 2008 that realigned departments and reassigned a number of employees. Some employees saw the reorganization as an opportunity for growth and new energy, but not everyone was happy.

It wasn’t just Thompson Technology that was changing. In 2008, the U.S. economy went into a severe recession, and the U.S. Congress responded with increased regulation and stricter scrutiny of the nation’s banks. As the financial industry adapted to the new banking practices, demand for Thompson Technology software dropped precipitously. Sales plummeted, and Thompson Technology’s culture of easy profits and sky-is-the-limit employee perks morphed into a new era of cost containment and belt tightening. Every department was affected, but employees were hardest hit when a financial analysis showed that labor costs were not sustainable. The year ended with the implementation of a companywide hiring freeze to curtail labor costs and, it was hoped, squelch the need for more drastic measures.

The hiring freeze was successful in reducing the number of employees. By late 2010, business in the finance industry had evened out, but Thompson was still not on easy street; increased competition in the marketplace caused sales to remain flat. Thompson’s stock price was falling. To address those issues, upper management held an intensive three-day strategic planning retreat off-site. The retreat included Kessler, Schiff, Albright, Montgomery and all the functional area directors. Before the retreat, the management teams spent many hours cloistered behind closed doors analyzing the various departments’ strengths and weaknesses and assessing budgetary and revenue forecasts. Kessler mandated that everyone come to the retreat prepared to make some difficult decisions regarding Thompson’s long-term future.
Managers armed themselves with statistical data to defend the viability of their departments.

Employees were on edge, and rumors were rampant because of the uncertainty about the future and the changes that might occur as a result of the retreat. The biggest worry was that the organization would downsize U.S. operations and move jobs offshore, even though Thompson took pride that its products were built and serviced entirely in the U.S. When managers returned from the retreat and remained tight-lipped about the results, employee tension increased as everyone waited for an announcement. Finally, on a Wednesday afternoon, Kessler sent the following e-mail to the staff:

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All Staff:

As you are aware, senior managers spent several days in important strategic planning discussions regarding the future of Thompson Technology. It is important that we continue to meet the needs of our shareholders, our customers and our employees as we move through these difficult times. Keeping those needs in mind, we recognize that some changes are necessary at Thompson Technology. For information sharing and discussion of our strategic initiatives, all employees are asked to meet with their area directors on Friday morning at 9:00. Further information will be shared at that time.

As always, thank you for the good work you do and for the outstanding service you provide to Thompson customers. Thompson employees are the foundation of our success.

Howard Kessler
CEO
Thompson Technology
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The rumor mill was instantly at full speed as heads popped up from cubicles and employees clumped together in speculation. Staff meetings were common at Thompson, but there had never been anything like this before.

“What does it mean?”

“This must be a major announcement. Why else would all departments meet at the exact same time?”

“Have we been bought out?”

“Are we shutting down?”

“I didn’t think things were this bad!”

Productivity plummeted. Except for a lot of talk, the employees accomplished nothing from the time they received Kessler’s e-mail to 9:00 Friday morning.
9:00 Friday Morning

Employees met with their area directors as scheduled. Some arrived early, but in contrast to the usual staff meetings, nobody arrived late. Coffee service at staff meetings had been discontinued months ago as a cost-cutting effort, so when coffee and pastries were set out for the morning meetings, it only raised anxiety levels. Speculation continued as employees filled coffee cups and forked pastries onto paper plates. At exactly 9 a.m., everyone dispersed to their designated meeting areas. In conference rooms across the company, chairs were full, speculation ceased and employees waited.

Of course, things are never as bad as rumors suggest. In most areas, relief could be seen in employees’ faces as directors reiterated the organization’s commitment to employees, but the directors left no doubt that the future would be different. Managers had agreed that further cost-cutting measures would have to be taken. Employees were told to expect changes in working conditions as the company tried to cut labor costs by 10 percent. In addition, efforts would be made to increase sales revenue by exploring new markets. But for now, at least, the company was ready to move forward with no plans to lay off employees.
SCENARIO D: MOVING EMPLOYEES TO A PEO

Players:
Scott Montgomery, CHRO
Jack Albright, COO
Pete Zumwalt, engineering staff
Niles Jorgensen, engineering staff

Shortly After the Strategic Planning Retreat
CHRO Scott Montgomery grabbed his smartphone and scanned his e-mail as he headed out the door for his appointment with Mayfield, a professional employer organization (PEO). As part of the plan to save on labor costs, the strategic planning team decided to move some of Thompson’s regular employees to contingent worker status. The change would enable the company to save on taxes and administrative costs while retaining the knowledge and skills the workers bring to the organization. The transfer would start with the engineering and design department and then be implemented gradually across other areas of the organization where flexible staffing is appropriate.

Unknown to anyone outside the strategic planning team, Montgomery had already met with representatives from Mayfield several times. Today’s meeting would determine the terms of their agreement. The transition would mean terminating Thompson’s entire engineering and design department. The terminated employees would be removed from Thompson’s payroll and then be re-employed by Mayfield and leased back to Thompson. Thompson would pay Mayfield a set fee per employee, and Mayfield would manage all the administrative costs associated with their employment, including taxes, benefits and compensation. Thompson would realize significant savings.

Montgomery knew that many companies had successfully transferred employees to PEOs, but the idea made him uncomfortable. On paper, it looked great, but there were risks involved, and he was unsure how the employees would accept the change. He shared his concerns at the retreat and argued strongly against the plan. “After all,” he reminded everyone, “Alan Thompson based this company on innovation and creativity. That’s who we are! How can we be cutting-edge with no engineering or design team of our own? Do you really think you’ll get that kind of innovation out of contract workers?”

“Come on, Scott, you’re being overdramatic,” replied Jack Albright. “We’ll have the same team as before. Nothing will change. Someone else will write their paychecks, and we’ll save money. The engineering staff should be independent contractors anyway. As independents, they would have the opportunity to work on outside projects whenever they want. It’s a win-win for everyone.”
Several Months After the Conversion of the Engineering and Design Department

Montgomery’s concerns may have been unfounded; there was little outward change in the engineering department. The staff was the same, with the exception of two employees who said they were independent enough that they weren’t going to hang around for any more of Thompson’s cost cutting. The rest stayed. There was grumbling at first, but then everyone went back to work and things now look much the same as before. The only visible change is the new ID badge the engineers have to wear. The badges now have the Mayfield and Thompson designations on them, but they work exactly the same as the old ones. The engineering staff still has admission to the front door, just as before. They sit at the same desks, have the same e-mail addresses and phone numbers, and work the same hours. The department is functioning like it always had.

Montgomery was relieved that things were going well, and senior managers were impressed with the cost savings. Unfortunately, Montgomery wasn’t always privy to the conversations taking place among the engineers. If he could hear them, he would have overheard the following discussion between two engineers as they ate Thompson-provided cake to celebrate the birthday of one of the other PEO engineers.

“How ya doing, Niles?” Pete Zumwalt asked, his mouth full of chocolate fudge.

“I’m doing okay, I guess. You know how it is,” answered Niles Jorgensen. “At least we’ve still got jobs.”

“Yeah,” said Pete, “but it’s sure not what they told us.”

“Not even close!” said Niles. “Sure my paycheck is the same as before and I do the same work, but I feel like a second-class citizen now, and our benefits package isn’t the same at all!”

“I know what you mean. I don’t think we’ll ever see a stock option again,” said Pete. “And all that stuff they told us about opportunities for other projects we could do as independents. Who has time for that? We have to be here every single day, the same hours as before!”

“I really don’t care about stock options or independent work. I’ve got health insurance problems,” replied Niles.

“Oh, I’m sorry Niles, I haven’t asked. How’s your wife doing?”

“Not good, Pete,” said Niles. “You know she was diagnosed with breast cancer just before we were converted to Mayfield. We had just started a treatment plan through Thompson’s insurance, and then we had to shift over to that lousy HMO we get from Mayfield. She had to change doctors and go to a different clinic farther away. It’s not the same at all, Pete, and she’s not doing well. I don’t think she can handle all this change.”
“I’m so sorry, Niles. I thought she was doing better than that,” said Pete.

“Well, things are pretty tough right now. I try not to take the stress home, but you know how that goes. I’ve got to leave early again today to take her in for another treatment. I really feel let down by Thompson, but I don’t think there is anything we can do about it. I’ve got to have a job, and I guess some insurance is better than none,” said Niles.

“Yeah, me too,” said Pete. “But I’m not sure there isn’t something we can do. I talked to my wife’s cousin last week. We were at another family wedding. You know, my wife’s got a zillion relatives. Anyway, this cousin of hers is a lawyer, and I was telling him about all this independent contractor stuff. He said it didn’t sound like independent contractor status to him.”

“Well, they’ve been telling us we’re independents. If we’re not independents, then what are we?” asked Niles.

“I don’t know,” said Pete, tossing his paper plate into the wastebasket. “But I’ve got to run. I have a committee meeting this afternoon. Can you believe it? They’ve got me on a hiring committee. I’m supposed to help hire staff, but they tell me I’m not really an employee. That doesn’t make sense to me. I just don’t trust Thompson anymore, and I think we need to find out where we stand. Say, if I make an appointment with this lawyer/cousin guy, do you want to come along?”

“Yes,” said Niles. “I really need to talk to somebody. This just doesn’t feel right to me at all.”

“I’ll give him a call and set it up,” said Pete.
Montgomery was never convinced that transferring the engineering and design employees to a PEO was a good idea. He tried hard to convince the management team that it was a risky maneuver, but he couldn’t get them away from the idea that it would save money on employment costs. Now that things have settled down, he wants to ensure that these employees are properly managed. He has scheduled a meeting with your team later this afternoon, and he asked you to respond to the following questions:

1. How does the use of leased employees change HR functions at Thompson?
2. What management practices should be changed to ensure that the engineering and design employees are not considered regular Thompson employees?
SCENARIO D: QUESTIONS FOR GRADUATE STUDENT TEAMS

Montgomery was never convinced that transferring the engineering and design employees to a PEO was a good idea. He tried hard to convince the management team that it was a risky maneuver, but he couldn’t get them away from the idea that it would save money on employment costs. He is concerned about Thompson’s liability for misclassification of employees, and he wants to minimize the risk as much as possible, starting with the agreement between Thompson and Mayfield. He has scheduled a meeting this afternoon with your team, and he has asked you to provide him with the following information:

1. What kind of agreement should Thompson have in place with the PEO for transferring regular employees to contract labor?

2. Although the engineering employees were told they were independents and they were calling themselves independents, are they truly independent contractors or co-employees of Mayfield and Thompson? What risks are associated with the change in employee classification, and how can Thompson minimize and protect itself from those risks?
SCENARIO D: QUESTIONS FOR UNDERGRADUATE STUDENT TEAMS

1. How does the use of leased employees change HR functions at Thompson?

- **Staffing.** The PEO will now manage the recruitment and selection of leased employees. Thompson will give job descriptions and specifications to the PEO so it can provide employees who meet the job requirements. In addition, the PEO will handle the I-9 paperwork for all new hires. It should be made clear to all employees involved that they are employees of the PEO, not Thompson, even though they work on Thompson’s job site and to Thompson’s specifications.

- **HR development.** This area will likely be shared by Thompson and the PEO. The PEO will manage general employee training, such as safety training and sexual harassment. Thompson will handle training specific to working at the company. The PEO will be responsible for employee development and all career management efforts. Thompson and the PEO will probably both participate in the employees’ performance appraisal.

- **Compensation and benefits.** The PEO will handle compensation for the leased employees; paychecks will be issued by the PEO. Thompson will pay a flat fee to the PEO for the leased employees. In the contract negotiated between Thompson and the PEO, Thompson may influence the amount of compensation paid to leased employees, but all benefits are at the discretion of the PEO, just like benefits are at the discretion of the employer for any regular employee.

- **Safety.** The PEO will manage general safety training and Occupational Safety and Health Administration (OSHA) reporting for leased employees. Thompson will conduct any safety training that is necessary and specific to working at Thompson.

- **Labor relations.** Thompson and the PEO will document information as needed regarding the employees’ work. Both agencies should participate, as appropriate, in disciplinary or termination issues involving a leased employee.

Montgomery should expect to periodically review the PEO arrangement to ensure that Thompson continues to receive the anticipated benefits. As the process moves forward, agreements and responsibilities may need to be revised to ensure that objectives are met.

2. What management practices should be changed to ensure that the engineering and design employees are not considered regular Thompson employees?

Montgomery must offer management training for the supervisors of the PEO employees. The supervisors must understand that these workers are no longer Thompson employees, and they cannot be managed in the same manner as regular Thompson employees. This may be a difficult transition for some supervisors, but it is extremely important that they make the necessary transition. If they continue to manage contract workers as regular employees, their actions will blur the
independent classification of these workers, and Thompson may be at risk for benefit and tax requirements for these employees.

Some typical employment practices that Thompson must not do for contract workers are as follows (SHRM, n.d.):

- Do not complete an I-9.
- Do not provide an employee handbook.
- Do not enroll independent contractors in any company-sponsored benefits plans.
- Do not pay independent contractors for company holidays.
- Do not invite or permit attendance at company parties or special events.
- Do not issue business cards, employee ID badges or facility keys.
- Do not require full-time work or set work hours for independent contractors.
- Do not conduct performance evaluations for independent contractors.
- In addition, Thompson should restrict participation in projects and meetings for contract workers and limit their role in hiring and termination decisions.

The conversation between Pete and Niles indicates that little has changed in Thompson’s management practices since the employees were transitioned to the PEO. Contract employees should not participate in staff birthday parties or serve on hiring committees. The conversation also indicates that these employees are required to work the same hours as before and that nothing has changed with employee phone numbers, e-mail addresses or general working conditions. These practices put Thompson at risk for losing the independent status of these workers. HR must implement training and update policies immediately.

REFERENCES


SCENARIO D: QUESTIONS FOR GRADUATE STUDENT TEAMS

1. What kind of agreement should Thompson have in place with the PEO for transferring regular employees to contract labor?

When regular employees are transferred to a PEO and leased back to the employer, the employer must ensure that the agreement with the PEO clearly spells out the expectations and responsibilities of both agencies. The major change for Thompson is that the engineers will no longer be Thompson employees; they will be employees of Mayfield, the PEO.

Montgomery should carefully research PEOs in his area to ensure that whatever provider he chooses abides by state regulations. Many states require PEOs to be licensed and registered with the state, and many states also require bonding and insurance. After that is determined, Montgomery should be ready to negotiate the specific details of the agreement.

The contract should outline how the PEO will be compensated for services. Some PEOs charge a flat fee per employee, and others charge a fee based on a percentage of payroll. Either is acceptable. The contract should also identify each agency’s responsibilities, because the leased employees are now shared employees, with each agency maintaining some responsibility for their employment and working conditions. Those responsibilities should be clearly outlined in the contract.

The PEO should handle all HR functions for leased employees, including payroll and benefits, tax withholding, unemployment and workers’ compensation insurance, performance appraisals, and disciplinary actions. The PEO should pay the employees’ wages and employment taxes out of its own accounts, and it is responsible for reporting, collecting and depositing employment taxes with state and federal agencies. The PEO should maintain records for the functions it manages. The PEO is responsible for notifying employees that they are employees of the PEO.

Thompson must ensure EEO compliance and safety standards at the Thompson facility. Thompson should also manage any training that is specific to Thompson or to the work assigned to the leased employees. The PEO should be responsible for employee manuals, but Thompson should provide information that is company specific, such as parking, building access, communication systems, dress code, safety policies, company culture and conduct, confidentiality, and nondisclosure agreements.

There are also areas of shared responsibilities. Both the PEO and Thompson have the right to independently decide whether to hire or fire an employee. Other shared responsibilities include the right to direct and control employees. The PEO should handle matters involving HR management and compliance with employment laws, and Thompson should handle management of contract employees as it relates to the manufacture, production and delivery of its products and services (National Association of Professional Employer Organizations, 2011).
2. Although the engineering employees were told they were independents and they were calling themselves independents, are they truly independent contractors or co-employees of Mayfield and Thompson? What risks are associated with the change in employee classification, and how can Thompson minimize and protect itself from those risks?

There may be financial advantages for Thompson by moving the engineering department employees to a PEO, but there are some issues that Montgomery should be concerned about. A major risk to employers who use contingent staffing is misclassifying staff as independent contractors when they are really employees. Employee status triggers employer obligations under federal and state laws that do not apply to independent contractors. The responsibility for classifying a worker correctly falls on the employer (Bliss & Thornton, 2009). There is no clear test as to when a worker is an employee or an independent contractor, because employment conditions are variable. In a number of court cases, employees initially designated as independent contractors were later deemed employees because of the level of control the employer exercised over the workers. The more control the employer has over the work and the worker, the more likely the worker is an employee and not an independent contractor. When an employer has both independent contractors and employees working side by side doing similar work, a red flag goes up at the Internal Revenue Service (IRS) and the Department of Labor, and the classification of some workers as independents may be challenged. Misclassification can be expensive, as demonstrated in *Vizcaino v. Microsoft* (1999), when the 9th U.S. Circuit Court of Appeals decided that “temporary” employees of Microsoft were entitled to the same benefits as full-time employees. The case concluded with the distribution of $97 million to 10,000 temporary employees.

Thompson has used the term “independent” quite liberally even though the engineers don’t fall under the criteria of independent contractors. This is an area of concern because it blurs responsibility for payroll taxes. Misclassification could make Thompson responsible for unpaid federal payroll taxes, retroactively for up to three years, for affected employees if Mayfield has not properly deducted employment taxes or deposited the employment taxes with the appropriate agency.

Another concern is the loss of control over the engineering department that occurred when the engineers were shifted from Thompson employees to leased employees who are then managed under a joint employment relationship shared by Thompson and Mayfield. Besides control, Thompson loses the ability to determine the total compensation paid to the transferred employees. Thompson’s contract with the PEO should determine what the employees will be paid, but beyond salary levels, the total compensation is determined by the PEO. Thompson will no longer have the same control over the benefits the engineers receive; leased employees are usually not eligible for the same benefits offered to regular employees.

If Thompson considers carrying over its benefits plan to the leased employees, it must clearly define employee classifications and identify who is and who is not eligible for
benefits: “The eligibility conditions and exclusions should go beyond simply naming the types and groups of employees who are eligible (regular or permanent employees) and who are ineligible (e.g., temporary, part-time, seasonal employees). The language should give each person who reviews the language a clear and explicit understanding of who falls into each category” (Greetis, 2010).

To minimize risk, Montgomery should ensure that the contract between Thompson and Mayfield spells out the responsibilities of each party. Thompson should also ensure that employees are correctly classified and that the management practices of Thompson supervisors are appropriate for leased employees who are managed under a joint employment relationship. This is an area where Montgomery should seek legal counsel.

REFERENCES


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