Working Overtime To Deal with Evolving Benefits and Pay Practices

What do cafeteria plans and stock options have in common? They are both forms of compensation, and they both reflect an emerging philosophy of compensation for the "new" labor force. In the last 20 years, evolving compensation design has gone beyond the paychecks, benefits and bonuses of a generation or two ago, and increasingly in the direction of making employees think less like clock-punchers, and more like owners. Stock options do this by offering workers a financial incentive based on the companies' success. Cafeteria plans strike a similar philosophical chord by giving workers a budget and giving each employee the power to design a sensible compensation and benefits package for him or herself.

As readers of this journal can attest, cafeteria plans—which come in many different shapes and sizes—have become virtually universal. Even the federal government has decided to get into the flexible benefits business. The federal Office of Personnel Management (OPM) recently decided that all executive branch federal workers will be able to pay their health care premiums on a pre-tax basis by October 1, 2000. The OPM also said it is considering whether to offer flexible spending accounts to these workers.

Stock-based employee incentive devices also are growing to record levels. A recent study by the National Center for Employee Ownership indicates that between seven million and ten million U.S. workers receive stock options. This is on top of the employer stock that may be available under company-sponsored 401(k) plans and ESOPs. A notable aspect of the growth of stock option programs is the expansion of these programs outside the executive ranks. For example, a 1998 survey by PricewaterhouseCoopers of 389 companies granting stock options found that 34 percent of these companies made grants to employees who are non-exempt under the Fair Labor Standards Act (FLSA). Stock options also have become a staple for start-up businesses. According to another study by the National Center for Employee Ownership, over 80 percent of companies receiving venture capital financing provide stock options to non-managerial employees as well as key executives.

Overtime Pay Issues

In addition to their widespread popularity, stock options and cafeteria plans share another similarity—both types of plans recently have come under scrutiny with respect to the calculation of an employee's "regular rate of pay" under the federal overtime pay rules.

In the case of stock options, the overtime pay issue was highlighted in a Labor Department Wage and Hour Division advisory opinion letter. The Wage and Hour letter was issued in February 1999, but was not made public until the end of 1999. In the letter, the Labor Department concluded that stock option gains must be counted as compensation for purposes of overtime pay.

According to the letter, stock options do not qualify for any of the statutory exclusions from the definition of "regular rate" of pay—an option is not a gift, a discretionary bonus, a profit sharing program, or a thrift or savings program. The letter concluded that when an employee exercises an option, the extra pay represented by the stock option spread would have to be retroactively attributed to the time the employee worked from the date the option was granted to the time the option was exercised, but limited to a period of 104 weeks. This means that stock option income would have to be attributed to the employee's previous two years of work, or less if the option was exercised less than two years from the date of grant.

Needless to say, the Wage and Hour Division letter would have imposed an enormous administrative burden on stock option sponsors. This would require that the profit realized by each optionee would have to be calculated, the overtime hours by each employee determined during the option-earning period, and additional overtime determined for each employee. Doubtless, many payroll vendors would be working overtime just to calculate the adjusted overtime rates for option-covered employees.

Understandably, the Wage and Hour letter raised howls of protests, with all the major employer advocacy groups and key congressmen weighing in. A hearing was held on March 2, 2000 before the Subcommittee on Workforce Protections of the House Committee on Education and the Workforce, and what happened at that hearing was nothing short of breathtaking for any ERISA-phile who has grown accustomed to a more slow-moving Labor Department. At the hearing, the Administrator of the Wage-Hour Division recommended that federal policy is best served by amending the statute to exclude compensation from bona fide stock option programs from

the definition of "regular rate of pay." Setting a world record for quickly dealing with a high-profile legal issue, the Labor Secretary worked with a bipartisan group of Senators and Congressmen in framing corrective legislation to exclude stock option gains from the overtime pay base. The so-called Worker Economic Opportunity Act was introduced on March 29, 2000 and offers employers both prospective and retroactive relief for broad-based stock option plans.

Cafeteria Plans and Overtime

What the stock option tempest also exposes, however, is the antiquated nature of the definitions of pay in the Fair Labor Standards Act. The statute includes a broad definition of pay and a list of exceptions that make little sense in light of today's pay practices. Cafeteria plans present a perfect case in point. These plans were not invented until some forty years after the FLSA was enacted in 1938. Cafeteria plans have long suffered from uncertain treatment under the overtime pay rules, and a 1999 federal court decision added to that uncertainty.

Consider the case of a so-called full flex plan that involves multiple benefit choices with employer contributions expressed in terms of credit dollars. The plan may involve choices of health care benefits, disability benefits, group term life income benefits, dependent care benefits, and, in some cases, additional paid vacation days. Employees also may be entitled to take cash in lieu of benefits, although the amount of cash that may be taken never is equal to the full value of the benefits that would be selected. For many large employers, the benefits under the cafeteria plan may be self-insured or may involve a very limited element of insurance.

Wage-Hour Regulations

The Wage and Hour regulations pose a series of difficult interpretative hurdles for the full flex plan. The regulations exclude from the employee's "regular rate" of pay certain employer contributions to "life, accident or health" plans, but add a couple of important restrictions. First, the employer's contributions "must be paid irrevocably to a trustee or third person pursuant to an insurance agreement, trust or other funded arrangement." (29 C.F.R. §778.215(a)(4).) Second, the plan must not give the employee the option to receive the employer's contribution in cash instead of benefits, unless the cash payments are an "incidental part" of the plan and are "not

inconsistent with the general purposes of the plan" to provide various welfare benefits. (29 C.F.R. §778.215(a)(5).)

Many full flex plans appear not to satisfy the exception for "life, accident or health" plans. As noted, many of these plans include self-insured benefits and there appears to be no exclusion for self-insured benefits. Indeed, a Ninth Circuit case held that certain self-insured disability payments had to be included in the employee's "regular rate" of pay—and did not qualify for exclusion under the rule for "life, accident or health" plans—because the disability benefits were self-insured and not paid through a trust. (*Local 246 Utility Workers Union of America v. Southern California Edison Company,* 83 F.3d 292 (9th Cir. 1996).) Self-insured benefits are not just found in cafeteria plans, of course, so the failure to meet this requirement of the regulations exposes many large employers to risk under the overtime rules. If self-funding of benefits is a problem, what should be added to the employee's "regular rate"? Is the "premium" value of this self-insured coverage somehow included in the overtime pay calculations? If not the "premium" value of the coverage, are the actual medical payments or reimbursements included?

There are no clear answers. Also unanswered is what kind of arrangements with insurance companies qualify as "insurance" agreements under the regulations. Does an administrative-services-only (ASO) arrangement qualify? What if there is some stop loss insurance involved?

Cash Option

Even if the "third-party" aspect of the Wage-Hour regulation is met, full flex plans may fail to meet the benefit plan exception because of the cash option. The administrative guidance offers little help on the question of when a cash option is "incidental" and "consistent" with the general purposes of the plan. A number of Wage-Hour opinion letters deal with the easy case where the cash option is equal in amount to the welfare benefit contributions; these rulings all conclude that the cash amounts were not "incidental." These include opinion letters dealing with salary reduction contributions to a flexible spending account arrangement for minimum wage and overtime pay purposes, Wage-Hour Opinion No. 508 (May 7, 1981) and Wage-Hour Opinion No. 638 (June 13, 1983). Two other opinion letters deal with monthly allotments which could be taken as extra salary or used to purchase certain employee benefits—Wage-Hour Opinion No. 1602 (November 7, 1985) and Wage-Hour Opinion No. 1680 (May 31, 1988).

There is scant authority, however, where the cash option was less than 100 percent of the contribution that could be used to buy benefits. Wage-Hour Opinion No. 1028 (September 12, 1969) dealt with a vaguely described account-based welfare plan with a cash withdrawal right; the opinion held that cash withdrawals would be regarded as "incidental" as long as they were not more than 20 percent of the "employee's vested interest" in the welfare benefit account. A similar arrangement and result was described in Wage-Hour Opinion No. 155 (March 18, 1963). The plans described in these two opinion letters were pre-cafeteria plan arrangements, so it is not clear how the 20-percent limit would apply to cashable credits under a full flex plan. What is the cashable amount measured against in a full flex plan? Is the cash amount measured against the nominal value of the employer credits under a full flex plan, or is it measured against the actual employer cost of the cafeteria plan options? Also, if a full flex plan includes a flexible spending account, is the "incidental" test measured separately for the flexible spending account and the rest of the plan or is the testing combined?

The authorities not only are vague in describing the limits of the "incidental" cash test, but they also do not explain what happens if the cash option is not "incidental." A literal reading of the regulation seems to provide that the "life, accident or health" plan exclusion would be lost altogether, so that all employer contributions for these benefits—and not just the amount of the benefit that could be taken in cash form—would be included in the employee's "regular rate" of pay.

The analysis only gets murkier if a cafeteria plan offers additional vacation days as a benefit choice. The general rule is that payments made to an employee while on vacation are not included in the regular rate of pay. (29 C.F.R. §778.219(a).) So what happens if the cafeteria plan does not satisfy the exception for "life, accident or health plans"—meaning that the employer contributions would be included in the "regular rate" calculation—but the participant then spends the employer contributions on vacation days? Which of the rules wins out? Nobody knows for sure.

Given the uncertain legal standards, it is not surprising that the Labor Department has been inconsistent in its application of these rules. We are aware of one case in which the Labor Department took the position that employer contributions that could be taken in cash had to be included in the "regular rate" calculation even if the participant used them to purchase additional vacation time. We also are aware of a case in which the Labor Department took the position that

only the cash actually received by a participant under a cafeteria plan is includible in the "regular rate" of pay, and that any other cafeteria plan contributions that are paid over to a third party are not so included, even if the cash option was not "incidental." This answer was to the plan sponsor's liking, but it does not seem supported by the regulations.

Litigation

A recent federal court decision has served to focus attention on the overtime issue involving cafeteria plans, but without advancing the legal analysis very far. The case was *Madison v. Resources for Human Development, Inc.*, 39 F.Supp. 2d 542 (E.D. Pa. 1999). In *Madison*, the cafeteria plan offered health insurance, medical reimbursement accounts, life insurance, and long-term disability benefits. The employer contributed to the plan an amount equal to 7 percent of an employee's base salary, plus one hundred dollars. On top of this, employees could reduce their salary to purchase benefits. The full amount of the employer's contribution to the plan could be taken in cash in lieu of benefit. The court held that the amount of the employee contributions under the cafeteria plan—that is, the cash that could have been taken—should be included in the employee's pay for overtime purposes. The court held that the cafeteria plan did not qualify under the bona fide plan exception under Section 7(e)(4) of the FLSA. Since the cash option was unrestricted and was equal to 100 percent of the employer contributions, the court found that the cash option was not an "incidental" feature of the plan and that the cash option was not "consistent" with the general purpose of providing various welfare benefits. Perhaps, the court noted, the case might have been different if the cash opportunity was available only if the employee was covered by a spouse's plan. Nonetheless, the court noted that even if there had been some kind of restrictions on the cash opportunity that the drawing of lines would be a "nuanced and difficult" issue.

The *Madison* case serves as an open invitation to would-be plaintiffs covered by many cafeteria plans. Cafeteria plans have all varieties of cash options, and it is impossible for an employer to know if the cash option is "incidental" or "consistent" with the plan's general purpose. The potential for lawsuits raising overtime pay compliance under the FLSA is no laughing matter. Employers violating the law are not only liable for the amount of unpaid overtime wages, but also for an equal amount of liquidated damages.

The FLSA has come under strong criticism in recent years as a remnant of the Great Depression that was designed to protect unorganized workers and to create an economic incentive to enlarge companies' workforces. To many critics, the exempt and non-exempt classifications are outdated given the move to a service-oriented economy from a manufacturing-based economy. Many employers have a difficult time figuring out who is exempt and who is non-exempt, and it is no less a problem trying to calculate the employee's "regular rate of pay." The Labor Department is to be applauded for recognizing the importance of broad-based stock options in today's economy and swiftly proposing a legislative exemption for these plans.

As long as Congress is getting into the act, we think they also should consider making other modernizing changes to the FLSA. To begin with, the distinction between funded and unfunded welfare benefits should be abandoned. Recognizing the special nature of cafeteria plans also should be at the top of the list. To our way of thinking, the law should exclude from the "regular rate of pay" any amounts under a cafeteria plan that are directed to nontaxable welfare benefits. This would recognize the idea that each worker in a cafeteria plan in effect is negotiating a separate benefits package with his or her employer. Why should the overtime pay rules care about some package that the employees would have been willing to consider? Now that federal workers are getting into the cafeteria plan act, there might be a stronger incentive to straighten out the overtime pay rules as applied to these plans.

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