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STOCK OPTIONS AND OVERTIME PAY CALCULATIONS UNDER THE FAIR LABOR STANDARDS ACT

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Abstract. The Fair Labor Standards Act requires that covered workers be paid 1-1/2 their regular rate of pay for hours worked in excess of 40 in a single work week. Where cash wages are involved, the calculation is reasonably clear but, where workers receive stock options or related items of value, it may be less so. To clarify the issue, legislation has been introduced both in the House and the Senate. This report looks at calculation of the regular rate and at legislative efforts to render that calculation clearer.

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Summary

For covered employees, overtime pay for hours worked in excess of 40 in a single week is calculated, under the Fair Labor Standards Act (FLSA), upon the basis of 1½ times a worker's *regular rate* of pay. Where the worker receives a straight cash wage, the calculation is relatively simple. But, compensation may also include non-cash benefits such as gifts, bona fide profit sharing, etc., and Section 7(e) of the Act explains how such elements are to be treated for regular rate calculation. How stock options and related items of value are to be treated may be less clear.

On February 12, 1999, in response to a specific inquiry, the Wage and Hour Division of the Department of Labor dispatched an *opinion letter* explaining that, under the circumstances set forth in the inquiry, the value of stock options would not be exempt from inclusion in the FLSA regular rate calculation. The letter was precise and limited to a single case, but it provoked concerns in the employer community. Would the denial of exemption apply more broadly and, if so, might employers be subject to suit for back wages earned through overtime work?

The issue was taken up by the Labor Policy Association (LPA), an industry-oriented interest group based in Washington, D.C. There followed a series of conferences and exchanges of letters and, ultimately, a hearing before the House Subcommittee on Workforce Protections (March 2, 2000). After negotiations between the interested parties, legislation was introduced both in the House and Senate on March 29: H.R. 4109 (Ballenger), and S. 2323 (McConnell). On April 5, Representative Cunningham introduced H.R. 4182.

On April 12, having by-passed the hearings process in the Senate, S. 2323 won Senate approval, 95 to 0 with 5 not voting. On May 3, the measure was called up in the House and passed by a vote of 421 to 0 with 13 not voting. The measure was signed by President Clinton (P.L. 106-202) on May 18, 2000.

The immediate issue under the pending legislation is relatively narrow: the treatment of stock options for regular rate calculations. If the treatment of stock options (and related instruments) for regular rate purposes is not clarified, industry spokesmen have indicated, the granting of such options to hourly-paid workers is likely to cease — or, at least, to be severely diminished. The exemption created under the pending legislation would remove one impediment to the continuation of such arrangements.

Contents

Stock Options and Overtime Pay Calculation Under the Fair Labor Standards Act

The Fair Labor Standards Act of 1938 (FLSA), as amended, is the basic federal statute dealing with minimum wages, overtime pay, and related issues. It requires that covered workers, employed for more than 40 hours in a single week, be paid at a rate of 1½ times their *regular rate* of pay. Since not all compensation is in cash, exceptions are made in the statute under Section 7(e) for various types of non-cash benefits (i.e., gifts, bona fide profit sharing plans, bona fide thrift or savings plans, etc.) that need not be included in the regular rate calculation.

How stock options and related non-cash compensation are to be treated for regular rate purposes may not be entirely clear. In early 1999, the Department of Labor (DOL) issued an *opinion letter* suggesting that stock options might, under certain circumstances, be included as part of the regular rate calculation.[1] By implication, the opinion letter also raised the specter of potential retroactive liability for employers who had made stock options available to their employees. The result was a measure of concern among employers and a call for clarification.

On March 2, 2000, the House Subcommittee on Workforce Protections conducted a hearing on the general issue of stock options and overtime pay calculation. Subsequently, on March 29, Senator Mitch McConnell (R-KY) introduced legislation to amend the FLSA to provide a clearer definition of regular rate where stock options are concerned (S. 2323). Parallel legislation (H.R. 4109) was introduced in the House by Representative Cass Ballenger (R-NC).[2] On April 12, without a hearing on the proposed legislation, S. 2323 was passed by the Senate: 95 yeas with 5 not voting. On May 3, the bill was called up in the House and approved by a vote of 421 to 0 with 13 not voting. It was signed by President Clinton on May 18, 2000 (P.L. 106-202).

An Issue Emerges

Early in 1999, inquiry was made to the Wage and Hour Division of the Department of Labor with respect to a particular case in which stock options were to be offered to employees. Could they, legitimately, be omitted from the calculation of

[1] As a supplement to regulations developed through the rulemaking process, DOL periodically issues "opinion letters" designed to help fit statutory requirements to specific workplace situations. Thus, one has, in sequence: the statute, the implementing regulation, and "opinion letters." The latter normally deal with individual cases.

[2] See also H.R. 4182 (Cunningham), introduced on April 5, 2000.

a worker's regular rate of pay? In an *opinion letter* of February 12, 1999, DOL reviewed the particular circumstances set forth in the inquiry and stated: "No, the proposed stock option plan does not qualify for any of the exclusions from the regular rate as defined in Section 7(e)(1) of the FLSA."[3] The advisory letter then responded to questions concerning stock option plans and the regular rate: i.e., questions dealing with calculation of value, terms of the option, when it must be exercised, etc. And, the letter closed by noting that "[t]his opinion is based exclusively on the facts and circumstances" set forth in the inquiry. "Existence of any other factual or historical background not contained in your request might require a different conclusion than the one expressed herein."[4]

Industry Reaction

When the opinion letter of February 12 came to the attention of the Labor Policy Association (LPA), an industry-oriented interest group based in Washington, D.C., it provoked various concerns. Following consultation with member firms, LPA president Jeffrey McGuiness wrote to Secretary of Labor Alexis Herman asserting that "this new DOL policy will make it very difficult for companies to offer stock options to non-exempt employees" — that is, those employees not exempt from the overtime pay provisions of the FLSA. McGuiness stated the problem as follows:

> Under the ruling, employers must undertake an excessively complicated series of calculations to pay overtime on the profit earned by the hourly employees. For example, if a company were to give options to 10,000 non-exempt employees, all of whom worked some overtime, the company would have to do the following:
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> - determine the exercise date for each share of stock exercised by each employee;
> - determine the profit each employee made on the stock as of the exercise date;
> - determine the overtime hours worked by each employee during the weeks the employee held the options;
> - calculate the additional overtime owed to each employee; and
> - cut a check for the additional overtime.
>
> Because employees can exercise options at any time during the life of the program, many of which allow employees to hold options for up to ten years, the overtime calculations will become excessively cumbersome.[5]

Some days later, Representative William C. Goodling (R-Pa.), Chairman of the Committee on Education and the Workforce, wrote to Secretary Herman to protest that "[c]onfusing and overly-complicated wage and hour regulations already discourage many employers from fully motivating and rewarding their employees for

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[3] Section 7(e) of the FLSA defines "regular rate" for overtime pay calculation purposes and discusses the types of non-cash income that the regular rate shall not be deemed to include.

[4] Opinion Letter from Daniel F. Sweeney, Office of Enforcement Policy, Wage and Hour Division, U.S. Department of Labor. February 12, 1999.

[5] Jeffrey C. McGuiness to Alexis Herman, January 11, 2000.

hard work. The Department's interpretation on stock option plans," he added, "further compounds the problem."[6]

Other exchanges followed. While it was argued that stock options for hourly-paid workers constituted a win-win situation, it was also noted that following that policy could subject employers to "unanticipated overtime expenses."[7] Unless the ambiguities raised by the opinion letter were clarified, it was suggested, employers would likely cease offering their hourly-paid employees stock options. DOL responded that it had "not ruled that stock option plans must always be reflected in overtime payments. Nor," affirmed Wage and Hour Administrator T. Michael Kerr, "have we ruled that stock option plans cannot be structured to meet the requirements of Section 7(e) of the Act ...."[8]

At that point, DOL sought to develop "a better understanding of how the law does or should apply to the broad variety of stock option plans" and undertook "extensive discussions with a broad range of groups ... to identify the factors relevant to whether a stock option plan should or should not be included in the regular rate."[9] Meanwhile, interest groups similarly began to organize. The Employment Policy Foundation, educational arm of the LPA, suggested that the DOL position on stock options could penalize millions of workers.[10] The Coalition To Promote Employee Stock Ownership (organized in January 2000 in response to the DOL opinion letter) urged Congress "to develop legislation that allows companies to continue to offer stock options and other equity participation programs to non-exempt (hourly) workers."[11] Meanwhile, Secretary Herman acknowledged that "the workplace is constantly changing, and that to maintain the spirit of the law, sometimes the letter of the law must change." She affirmed: "If all interested parties work together in a

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[6] William C. Goodling to Alexis Herman, January 27, 2000. The letter was co-signed by three subcommittee chairmen from the Committee on Education and the Workforce.

[7] James A. Klein, president, Association of Private Pension and Welfare Plans, to Alexis Herman, January 24, 2000. Under date of January 31, 2000, Representative Cunningham had circulated a "Dear Colleague" letter advising the Members of the issue and urging a legislative solution. On February 15, 2000, together with other Members, he took up the issue in a letter to Secretary Herman. See Bureau of National Affairs, *Daily Labor Report*, February 17, 2000: A12-A13. (Hereafter cited as *DLR*.)

[8] T. Michael Kerr to Representative Cass Ballenger, Chairman, Subcommittee on Workforce Protections, February 28, 2000.

[9] *Ibid*.

[10] News Release, Employment Policy Foundation, March 2, 2000.

[11] News Release, Coalition To Promote Employee Stock Ownership, March 2, 2000. The Coalition is identified as "composed of more than 100 companies and trade associations dedicated to working with Congress, the Administration and other groups to preserve the ability of non-exempt employees to receive the benefits of equity participation in their companies."

constructive way, we can arrive at a solution that will benefit both employees and their employers."[12]

A Hearing in the House

On March 2, a hearing on the stock option issue was conducted by the Subcommittee on Workforce Protections with Representative Ballenger as chairman. The hearing dealt only with the concept of stock options for hourly-paid workers; no legislative language had yet been presented. Several industry spokespersons were among the witnesses. Randall MacDonald, Vice President of GTE and a member of the Board of Directors of the LPA, outlined how stock option plans work and pointed to certain "legal liabilities" in the wake of the opinion letter.

> Even if the Department of Labor decides not to enforce the policy outlines in the advisory opinion, the Fair Labor Standards Act provides a private right of action. Courts often view advisory opinion letters as indicative of how the Wage and Hour Division, which is the expert agency with regard to federal wage and hour matters, interprets the law and the regulations it enforces .... Consequently, courts could still consider the letter as primary guidance in interpreting the FLSA. This means that employers who have tried to narrow the gap and give similar benefits to exempt and nonexempt employees could find themselves the subject of huge class-action lawsuits based on this policy.[13]

Under questioning by the Subcommittee, Administrator Kerr acknowledged the need to resolve the current conflict promptly and expressed a willingness to cooperate with the Subcommittee in developing an appropriate amendment to the FLSA.[14]

Crafting a Legislative Solution

Through the next two weeks, negotiations continued between DOL and congressional staff, "complicated by differences over how to define the types of programs that would be covered by a new statutory exemption." By some estimates, "between 7 million and 10 million nonmanagement workers receive *some form* of stock options." But, DOL found that there "is not a lot of information" about the

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[12] News Release, U.S. Department of Labor, "Statement of Alexis M. Herman on Stock Options and the FLSA," March 2, 2000. During the early weeks of 2000, the role of *opinion letters* had surfaced on two fronts: the stock option case, discussed here, and OSHA coverage of employees who work from their homes — each, controversial. On February 15, 2000, Representative David McIntosh (R-IN), chairman, Government Reform Subcommittee on National Economic Growth, Natural Resources and Regulatory Affairs, conducted a hearing on the use of opinion letters. See Bureau of National Affairs, *DLR*, February 16, 2000: AA1-AA2, E1-E2.

[13] Statement of J. Randall MacDonald before the House Subcommittee on Workforce Protections, March 2, 2000.

[14] *DLR*, March 3, 2000: AA1-AA2. Kerr is quoted as having said that "the best solution would be to address this matter legislatively."

practice.[15] On March 22, Secretary Herman appeared before the House Appropriations Subcommittee on Labor, Health and Human Services, and Education, and, as recounted in the *Daily Labor Report*, restating her commitment "to resolving the matter in a 'way that is advantageous to American workers.'"[16]

A week later, on March 29, Secretary Herman joined with a bipartisan group of House and Senate Members to announce introduction of corrective legislation: S. 2323 (McConnell) and H.R. 4109 (Ballenger). The *Daily Labor Report* noted that the legislation, the *Worker Economic Opportunity Act*, "appears to be on a fast track." It added: "Introduction of the measure was greeted with great fanfare, particularly from groups representing high tech employers, such as those in the information technology sector, that increasingly are relying on stock options to attract and retain employees."[17]

The Senate would act first. Bypassing the hearings process, S. 2323 was called up for floor consideration on April 12. Senator McConnell opened discussion of the bill by declaring that "everybody wins with this proposal." He pointed to "our 1930's vintage labor laws" and stated: "It would be a travesty for us to let old laws steal this chance for the average employee to share in his or her company's economic growth." He urged passage of the legislation so that "our 'New Deal' labor laws" will not "strangle the benefits our 'New Economy' offers to American workers." Senator McConnell placed in the *Record* an endorsement from the U.S. Chamber of Commerce for S. 2323 and noted: "... this legislation includes a broad 'safe harbor' that specifies that employers have no liability because of any stock options or similar programs that they have given to employees in the past."[18]

Various Senators spoke in support of the legislation; none in opposition. And, no questions critical of the proposal were raised. Senator Christopher Dodd (D-CT) advised that "the Clinton-Gore administration is a strong backer" of the legislation. Senator James Jeffords (R-VT) pointed out that stock option programs aid employers as "a key tool for employee recruitment, motivation and retention." Senator Mike Enzi (R-WY) envisioned "secretaries, factory workers, janitors, mailroom clerks — everybody" with stock options and argued that "the line is dimming on who is the employer and who is the employee." Senator Edward Kennedy (D-MA) spoke in support of the FLSA, noting the "fundamental role" it has played "in ensuring a fairer standard of living for all American workers" and he warned Congress "to ensure that any changes in this important law do not undermine the wage and hour protections guaranteed to workers under the act." He would support S. 2323, he said, "because it helps ensure that employers cannot misuse the act as an excuse to exclude rank and file workers from the stock option plans."

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[15] *DLR*, March 20, 2000: C1-C2. Italics added. The estimate is by the National Center for Employee Ownership.

[16] *DLR*, March 29, 2000: A1-A2.

[17] *DLR*, March 30, 2000: A12-A13.

[18] Senate debate is summarized from: *Congressional Record*, April 12, 2000, p. S2575-S2586.

Without dissenting argument, debate ended and the roll was called. S. 2323 was approved by a vote of 95 yeas with 5 members not voting.[19]

On May 3, 2000, the bill was called up in the House. Support for the proposal was bipartisan. Major Owens (D-N.Y.), rising in behalf of the bill, expressed his full concurrence "that speculative stock options should not be subject to overtime and that invoking the requirements of the law at this late date ex post facto would be unfair and unwise."[20] Representative Ballenger pointed to the bill as a means through which "to protect the stock option programs for rank and file employees." And, he affirmed: ""Allowing hard-working rank and file employees to share in the growth of their companies is good for morale, good for families, and good for the country."[21] Following a brief debate during which no dissent was offered, the House voted 421 to 0 to pass the legislation (13 not voting).[22] On May 18, 2000, the bill was signed by President Clinton (P.L. 106-202).

Substance of the "Stock Option" Amendments

In the Fair Labor Standards Act, Section 7(e) defines "regular rate" for purposes of calculating overtime pay at 1½ times a worker's "regular rate." Under it, there are seven sub-paragraphs that set forth what the regular rate "shall not be deemed to include." The proposed legislation (S. 2323 and H.R. 4109) would add to that list an eighth paragraph.[23]

The "Stock Option" Provisions

The new Section 7(e)(8) excludes "any value or income derived from employer-provided grants or rights provided pursuant to a stock option, stock appreciation right, or bona fide employee stock purchase program which is not otherwise excludable under any of paragraphs (1) through (7) if—". It then sets forth a series of qualifiers:

(A) grants are made pursuant to a program, the terms and conditions of which are communicated to participating employees either at the beginning of the employee's participation in the program or at the time of the grant;

(B) in the case of stock options and stock appreciation rights, the grant or right cannot be exercisable for a period of at least 6 months after the time of grant (except that grants or rights may become exercisable

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[19] *Congressional Record*, April 12, 2000: S2586.

[20] *Congressional Record*, May 3, 2000, p. H2443.

[21] *Congressional Record*, May 3, 2000, p. H2446.

[22] *Congressional Record*, May 3, 2000, p. H2467.

[23] The proponents of the legislation have placed in the *Congressional Record* (April 12, 2000, p. S2576-S2581), a statement of legislative intent and a section-by-section analysis of the proposal.

> because of an employee's death, disability, retirement, or a change in corporate ownership, or other circumstances permitted by regulation), and the exercise price is at least 85 percent of the fair market value of the stock at the time of grant;
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> (C) exercise of any grant or right is voluntary; and
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> (D) any determinations regarding the award of, and the amount of, employer-provided grants or rights that are based on performance are—
>
> (i) made based upon meeting previously established performance criteria (which may include hours of work, efficiency, or productivity) of any business unit consisting of at least 10 employees or of a facility, except that, any determinations may be based on length of service or minimum schedule of hours or days of work; or
>
> (ii) made based upon the past performance (which may include any criteria) of one or more employees in a given period so long as the determination is in the sole discretion of the employer and not pursuant to any prior contract.

Further, the proposed legislation modifies Section 7(h). The authors explain the purpose, here, as technical, "to make clear that the amounts excluded under Section 7(e) of the bill are not counted toward an employer's minimum wage requirement under Section 6 of the Fair Labor Standards Act and that the amounts excluded under Section 7(e)(1)-(4) and new Section 7(e)(8) are not counted toward overtime pay under Section 7 of the Act."[24]

Retroactive Immunity from Liability

In order to avoid the possibility of an employee suit for back pay for overtime (based on the assumption (a) that a stock option program had been in effect, (b) that its value had not been taken into account when the worker's *regular rate* was calculated, and (c) that the Department were to enforce the thrust of the stock option opinion letter beyond the single case with which it dealt), the proposed legislation contains a clause providing retroactive immunity from such liability.

> No employer shall be liable under the Fair Labor Standards Act of 1938 for any failure to include in an employee's regular rate ... any income or value derived from employer-provided grants or rights obtained pursuant to any stock option, stock appreciation right, or employee stock purchase program if—

[24] *Congressional Record*, April 12, 2000: S2581.

(1) the grants or rights were obtained before the effective date described in Subsection (c);[25]

(2) the grants or rights were obtained within the 12-month period beginning on the effective date described in Subsection (c), so long as such program was in existence on the date of enactment of this Act and will require shareholder approval to modify such program to comply with Section 7(e)(8) ...; or

(3) such program is provided under a collective bargaining agreement that is in effect on the effective date described in Subsection (c).

Other

The Secretary of Labor is given authority to "promulgate such regulations as may be necessary to carry out the amendments" set forth in the legislation. Finally, the entire package of amendments will become effective 90 days after the date of enactment.

Comment

From the hearing of the Subcommittee on Workforce Protections and from statements of proponents of the legislation, it seems clear that, in the wake of the DOL opinion letter of February 12, 1999, clarification was deemed necessary. Whether clarification could be achieved through the rulemaking process with greater flexibility than through legislation may be less clear. Nor is it clear that the pending legislative approach is necessarily the only possible option. "The Labor Department endorsed a narrow, targeted legislative fix confined to the particular issue raised in the [opinion] letter," observed the *Daily Labor Report*, "while business groups pushed for a broad FLSA exemption that would recognize that stock ownership programs are fashioned in numerous different ways."[26] But both the Department and the authors of the pending legislation appear to have opted for legislation.

The immediate issue of the pending legislation is not whether or not employers should institute stock option programs for their employees — or whether such initiatives are wise public policy. The legislation would merely clarify the treatment of stock options for *regular rate* purposes under the FLSA. However, in the absence of such clarification, industry witnesses have argued that such stock option programs would likely be curtailed. With adoption of the legislation, an institutional impediment to these programs is removed.

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[25] Section (c) would make the amendments effective 90 days after the date of enactment.

[26] *DLR*, March 29, 2000: A2.