COMMENTS ON THE
WORKER ECONOMIC OPPORTUNITY ACT
(PUB. L. NO. 106-202)

The following comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation.

The comments were prepared by individual members of the Committee on Employee Benefits of the Section of Taxation (the “Committee”). Principal responsibility was exercised by Kurt L.P. Lawson. Substantive contributions were made by John E. Aguirre, George R. Ince, Jr., Arthur S. Meyers, Charles F. Plenge, Joseph E. Ronan, Jr., Susan D. Serota, Norma M. Sharara, and Steven H. Sholk. The comments were reviewed by Pamela Baker, former Chair of the Committee, Diane J. Fuchs, Chair of the Committee, Kyle N. Brown, Vice-Chair of the Committee, Dick Harter, of the Section’s Committee on Government Submissions, and Elaine Church, Council Director for the Committee.

Although many of the members of the Section of Taxation who participated in the preparation of these comments have clients affected by the legal principles addressed by these comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

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INTRODUCTION

This document was prepared in response to a request for comments on whether there is any conflict between the requirements of the Worker Economic Opportunity Act (“WEOA”) and the requirements of the Internal Revenue Code (the “Code”) or prevalent employer practices regarding stock option, stock appreciation right, and employee stock purchase plans.

COMMENTS

I. BACKGROUND

WEOA was signed into law by the President on May 18, 2000, as Pub. L. No. 106-202. WEOA amends Section 7(e) of the Fair Labor Standards Act of 1938 (“FLSA”), to provide that, if certain requirements are met, grants or rights provided pursuant to a stock option, stock appreciation right, or bona fide employee stock purchase plan will be excluded from the “regular rate” of pay used to calculate a nonexempt employee’s minimum rate of pay for overtime work. The WEOA exclusion does not cover restricted stock.

WEOA effectively reverses a conclusion reached by the Wage & Hour Division of the Department of Labor (“DOL”) in a February 12, 1999 opinion letter. That letter concluded that a particular one-time stock option plan did not qualify for any of the existing “regular rate” exclusions. The opinion letter did not explain the reasons for this conclusion, but DOL officials later explained that (i) the plan did not qualify for the exclusions for gifts, discretionary bonuses, and payments under a bona fide profit-sharing plan in part because it required employees to remain employed with the company for a period of time after the date of grant, and therefore violated a requirement for those exclusions that benefits not be conditioned on the performance of future services, and (ii) the plan did not qualify for the exclusions for payments under a bona fide thrift or savings plan in part because it provided that the company would exercise, on behalf of an employee, any options that the employee failed to exercise before their expiration date (using a cashless exercise effectively to cash them out), and therefore violated a requirement for those exclusions that participation be voluntary.1

The DOL has noted that the opinion letter dealt with a particular stock option plan and suggested that many stock option, stock appreciation right, and employee stock purchase plans that do not have the same features as that plan might qualify for one or more of the existing “regular rate” exclusions. While this is true, because those exclusions are both narrow and vague most employers will prefer to rely on the new exclusion added by WEOA.

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II. REQUIREMENTS FOR NEW EXCLUSION

A number of requirements must be met for the new WEOA exclusion to apply. The legislative history explains that “in order to reach a consensus, the new exclusion had to be tailored to comport with the existing framework of the FLSA. The result is a series of requirements that stock option, SAR and ESPP programs must meet for the proceeds of those plans to fit within the newly created exemption.”

A. Requirements for Particular Types of Plans

1. Requirements for stock option and SAR plans

For grants and rights made under a stock option or stock appreciation right (“SAR”) plan to qualify for the WEOA exclusion, (i) there must be at least a six-month period between the date of grant and the date on which that right is first exercisable, and (ii) the exercise price must be at least 85 percent of the market value of the underlying stock at the time of grant.

The six-month holding period is waived in cases involving an employee’s death, disability, retirement, or a change in corporate ownership or in other circumstances permitted by regulations. The legislative history explains that “[t]he term change in ownership is intended to include events commonly considered changes in ownership under general practice for options and SARs”, and encourages the DOL “to consider and evaluate other changes in employees’ status or circumstances” that will qualify for a waiver. Whether the six-month holding period is met is determined on an option-by-option, SAR-by-SAR basis. In addition, if exercisability is tied to an event such as an IPO, whether the six-month holding period is met is determined (retroactively) based on when the event actually occurs.

In the case of an SAR, the 85-percent requirement presumably means that the appreciation in the stock must be measured from a benchmark that is no lower than 85 percent of the market value of the underlying stock at the time of grant. According to the legislative history, a reasonable valuation method must be used to determine whether the 85-percent requirement is met. In the case of a publicly traded stock, examples of reasonable methods include averaging the high and low trading prices of the stock on the grant date, and averaging the closing prices (or daily high and low trading prices) of the stock over a period of days ending with, or shortly before, the grant date. In the case of a non-publicly traded stock, any reasonable valuation that is made in good faith and based on reasonable valuation principles may be used.

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The legislative history suggests that employers granting options for less than 85 percent of the fair market value of the stock try to find another regular rate exclusion on which to rely.

2. Requirements for ESPPs

To be a bona fide employee stock purchase plan (“ESPP”), and thus for grants or rights provided under such a plan to qualify for the WEOA exclusion, a plan must (i) be a qualified ESPP, i.e., meet the requirements of Section 423(b) of the Code, OR (ii) be a plan that does all of the following: (A) allows employees, on a regular or periodic basis, to voluntarily provide funds, or to elect to authorize periodic payroll deductions, for the purchase at a future time of shares of the employer’s stock; (B) sets the purchase price of the stock as at least 85 percent of the fair market value of the stock at the time the option is granted or at the time the stock is purchased; and (C) does not permit a nonexempt employee to accrue options to purchase stock at a rate that exceeds $25,000 of the fair market value of such stock (determined either at the time the option is granted or the time the option is exercised) for each calendar year.3

B. Requirements for All Types of Plans

For grants and rights made under a stock option or SAR plan or a bona fide ESPP to qualify for the WEOA exclusion, the following additional requirements must be met.

1. Communication to participants

Participating employees must be informed of the material terms and conditions of the plan and their rights under it either at the beginning of their participation in the plan or at the time of grant.4 With respect to options, material terms and conditions include the number of options granted, the number of shares covered by each option, exercise price(s), grant date(s), vesting period(s), date(s) when the options will become exercisable, expiration date(s), conditions under which the options will be forfeited, permitted methods of exercise, any restrictions on stock acquired through the exercise of the options, and the treatment of unexercised options at the end of the exercise period. No particular method or mode of communication is required under WEOA so long as the method chosen reasonably communicates the information to employees in an understandable fashion. Electronic methods are specifically permitted by the legislative history. According to the legislative history “[t]he timing of the communication is flexible,” and the re-

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4 This requirement seems to be linked to the voluntary participation requirement discussed below. The legislative history explains that “Employers must communicate the material terms and conditions of the stock option, stock appreciation right or employee stock purchase program to employees to ensure that they have sufficient information to decide whether to participate in the program.”
quired information does not have to be given all at once or exactly on the dates mentioned in the statute.

2. Voluntary exercise

The exercise of any grant or right offered under the plan must be voluntary. According to the legislative history, voluntary means that the employee may or may not choose not to exercise his or her grants or rights at any point during the term of the stock option or SAR plan or ESPP, as long as that is in accordance with the terms of the program. The legislative history states that this requirement “does not restrict the ability of an employer to automatically exercise stock options or SARs for the employee at the expiration of the grant or right” as long as the employee has not “notified the employer that he or she does not want the employer to exercise the options or rights on his or her behalf.”

3. Performance-based grants

Additional requirements apply if grants or rights are based on performance.5

a. Grants based on future performance

Employers may condition grants based on an employee’s future performance so long as the determinations as to the existence and the amount of grant are based on the performance of either any business unit consisting of at least 10 employees or a facility (without regard to the number of employees who are working at the facility). An exception to this provision is provided, however, to permit employers to condition offers upon length of service or minimum schedule of hours or days of work. The purpose of the exception is to allow employers to differentiate between full-time and part-time employees or between employees on permanent status and those on probationary or temporary status.

b. Grants based on past performance

Employers may make determinations as to the existence and amount of grants or rights based on past performance, if such determinations are made in the sole discretion of the employer and not according to any contractual arrangement. Employers have broad discretion to make grants as rewards for the past performance of a group of employees, whether or not the group is a business unit or facility, or even for an individual employee.

5 The drafters do not appear to have intended these requirements to apply to any plan with a vesting schedule based on the provision of services, although this is not as clear as it could be from the statute itself. The legislative history states that “[i]f neither the decision of whether to grant nor the decision as to the size of the grant is based on performance, the provisions of in new section 7(e)(8)(D) do not apply.”
An employer does not condition a grant on future performance merely by telling employees of the possibility of a grant before the relevant services have been performed. Whether a grant is based on future performance or prior performance depends on whether the employer has contractually bound itself to make the grant before the relevant services are provided, or reserved enough discretion to avoid being contractually bound.

C. Transition Relief

A broad transition provision governs stock option and SAR plans and ESPPs without regard to whether such plans meet the requirements specified in WEOA. Specifically, WEOA provides for a 90 day post enactment delayed effective date that is intended to give employers time to evaluate their plans and to make necessary changes that will bring their plans within the WEOA exclusion. More generous transition relief is provided for employers with plans that require shareholder consent to plan amendments, and employers with obligations under a collective agreement that conflict with the requirements of WEOA.

Furthermore, under WEOA, the pre-effective date safe harbor is intentionally broader than the new exclusion. The safe harbor comprehensively protects employers from any liability or other obligations under FLSA for failing to include any value or income derived from stock options, SARs, and ESPPs in a nonexempt employees regular rate of pay. The safe harbor extends to all grants or rights that were provided under such plans before the effective date, whether or not they meet the requirements of the new WEOA exclusion. Furthermore, any grant or right initially provided before the effective date is covered by the safe harbor even if vesting occurred later or was contingent on performance that would occur later.

III. COMMENTS ON NEW EXCLUSION

We have several comments on the new regular rate exclusion added by WEOA.

A. General

We suggest that a clarification be provided that the WEOA exclusion applies to grants and rights under arrangements covering only one or a few employees. The exclusion is limited to grants and rights under “plans” and “programs” meeting certain requirements. These terms typically refer to arrangements covering a large number of employees. We believe that there is no good policy reason to exclude, and that the drafters did not intend to exclude, arrangements covering only one or a few employees.

We suggest that the principle adopted in the legislative history regarding the six-month holding period for stock options and SARs, that compliance will be determined on a grant-by-grant basis, be broadened to cover all of the requirements of the WEOA exclusion. This is the approach taken, for example, for most of the requirements for qualified stock options (i.e., incentive stock
options and qualified employee stock purchase plans) under the Code. Otherwise, the require-
ments of WEOA will become plan qualification requirements, making the drafting of such plans
more complicated and costly, and making it difficult to offer options and SARs under the same
plan for exempt and non-exempt employees.

We suggest that, because of the very significant amount of additional detail about the require-
ments for the WEOA exclusion that is provided in the legislative history, the DOL be
encouraged to move expeditiously to issue regulations or other guidance making that information
available to employers and clarifying it where necessary.

B. Six-Month Holding Period

We suggest that an exception be added from the six-month holding period for options where the
stock acquired upon the exercise of the options will remain unvested for at least six months. It
has become common, especially among technology companies, to permit employees to exercise
stock options before they vest, and thus in many cases before the end of the six-month holding
period. Options with this feature sometimes are referred to as “reverse-vested” because it is the
stock that is acquired upon the exercise of the options rather than the options themselves that are
subject to a risk of forfeiture in these situations. With few exceptions, the stock cannot be sold
or transferred by the employee until it vests. It is not clear whether the drafters were aware of
this development.

We do not see any policy reason to exclude reverse-vested options from the WEOA exclusion
based on their failure to satisfy the six-month holding period. Presumably the drafters were con-
cerned that an option that could be exercised less than six months after it was granted would be
equivalent to cash and could be used by an employer to evade its FLSA obligations. However,
the stock that is acquired pursuant to the exercise of a reverse-vested option is still unvested and
nontransferable and could very well be forfeited by the employee, making such abuses impracti-
cal if not impossible.

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6 For example, under a typical arrangement if an employee exercises an option and then quits be-
fore the vesting date for the option, the employee will be required to return the stock acquired
upon the exercise of the option to the employer and receive back some or all of his or her exercise
price (but none of the appreciation on the stock).

7 The legislative history merely notes that “[f]or stock option grants that include a vesting require-
ment, typically an option will become exercisable after the vesting period ends” (emphasis
added). It is possible that the drafters actually intended to accommodate reverse-vested options:
the section-by-section analysis describes the six-month period as a “vesting (or holding) period”.
However, the rest of the discussion describes it as a restriction on exercisability rather than vest-
ing.
We suggest that exceptions be added to the existing exceptions from the six-month holding period for options and SARs that provide for accelerated exercisability when the employee is terminated without cause or the employer is involved in an corporate transaction in which it is not the surviving entity. We also suggest that exceptions be added for options and SARs that provide for accelerated exercisability upon the achievement of a bona fide performance goal or the occurrence of an IPO, where the achievement of the performance goal or the occurrence of the IPO was substantially uncertain on the grant date. Provisions allowing stock options and SARs to be exercised earlier than they otherwise would be in these situations are not uncommon. We do not see any policy reason to exclude stock options or SARs with such features, since there is little if any possibility for abuse. We realize that under WEOA such a feature will not present a problem if the acceleration event occurs at least six months after the grant date. However, that appears to mean that if the acceleration event occurs less than six months after the grant date a retroactive recalculation of non-exempt employees’ regular rates might be required, creating a significant administrative burden.

We recognize that the DOL might have the authority to add one or more of these exceptions by regulation (based on the parenthetical reference to regulations in the existing list of exceptions), but they are different enough from the existing exceptions that it is preferable to amend the statute.

C. Equal-Treatment Requirement for ESPPs

We suggest that Section 423(b)(5) of the Code be amended to provide that the equal-treatment requirement in that section is not violated if WEOA-conforming options are granted to non-exempt employees while non-conforming options are issued to exempt employees.

D. $25,000 Limit for ESPPs

The legislative history requires a “bona fide” ESPP to prohibit a nonexempt employee from accruing options to purchase stock at a rate that exceeds $25,000 of the fair market value of such stock “(determined either at the time the option is granted or the time the option is exercised)” for each calendar year. This is very similar to the rule in Section 423(b)(8) of the Code for qualified ESPPs, except that the value of stock for that purpose is always determined on the date of grant. We believe the drafters probably intended to adopt a rule allowing the value of stock to be determined on either date, whichever one results in a lower valuation. However, we believe that this point should be clarified promptly either by an amendment to the statute, regulations, or some other form of guidance.

E. Voluntariness Requirements

We suggest that the requirement that the exercise of any grant or right be “voluntary” be interpreted broadly, and that reasonable restrictions on exercisability, including those imposed under
insider trading policies or by underwriters in connection with IPOs, and employer-provided incentives to exercise such as additional compensation or low-interest or guaranteed loans (to finance payment of the exercise price), not cause a grant or right to fail to qualify for the WEOA exclusion.

More specifically, we believe that the voluntariness requirement in new Section 7(e)(8)(C) might be too broad as applied to ESPPs. As noted above, according to the legislative history “voluntary” means that the employee “may or may not choose not to exercise his or her grants or rights” at any point during the ESPP. This suggests that ESPPs might be required to allow participants to withdraw or change their elections during a purchase period. While many ESPPs have this feature, not all do, and it is not required to qualify under Section 423 of the Code. Furthermore, some ESPPs automatically switch employees from an older offering to a newer offering if the price of the stock has gone down. The voluntariness requirement that the legislative history provides as part of the definition of a “bona fide” ESPP under new Section 7(e)(8)(B) is more appropriate and makes a separate requirement unnecessary. Therefore, we suggest that the voluntariness requirement in new Section 7(e)(8)(C) not apply to ESPPs.

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8 If a participant is prohibited from withdrawing during the purchase period, the participant’s initial election to participate is treated as an “exercise” of his or her option under the ESPP.