Federal Sick Leave Health and Welfare Benefit Changes Bring Enhanced Compliance Challenges for Federal Service Contractors

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Introduction

The federal paid sick leave obligations that went into effect at the beginning of this year pursuant to FAR 52.222-62 and the recent introduction of new health and welfare (H&W) fringe benefits levels under the Service Contract Act (SCA, also known as the Service Contract Labor Standards statute), including a separate rate for contracts subject to the paid sick leave rules, present a number of compliance challenges for federal service contractors. This white paper explores three key challenges that federal service contractors need to closely manage, including: (1) the application of differing H&W rates to service contracts and individual service employees; (2) the differing standards for incorporation of the federal sick leave obligations and the new SCA fringe benefits levels; and (3) the impact of the new sick leave H&W level on potential price adjustments under the FAR price adjustment clause. This white paper discusses these challenges as well as strategies for managing these SCA compliance issues.

Federal Sick Leave Executive Order and FAR Rules

In September 2015, the Obama administration issued Executive Order (EO) 13706, Establishing Paid Sick Leave for Federal Contractors, requiring federal contractors to offer paid sick leave to employees. *See* 80 Fed. Reg. 54,697 (Sept. 10, 2015). In particular, the EO required executive departments and agencies to ensure that certain contracts, "contract-like instruments," and solicitations include a clause requiring contractors to provide employees with at least one hour of paid sick for every 30 hours worked. In addition, the EO prescribed that contractors were not to set a limit on the total accrual of paid sick leave at less than 56 hours per year. It further directed the Department of Labor (DoL) and the Federal Acquisition Regulatory (FAR) Council to issue implementing regulations.

As directed, the FAR Council published an interim rule, which became effective on January 1, 2017, in the Federal Register to implement the EO. *See* 81 Fed. Reg. 91,627 (Dec. 16, 2016). The interim rule established a new FAR clause, FAR 52.222-62, that directs contractors to permit employees engaged in performing work on or in connection with a covered contract to earn not less than one hour of paid sick leave for every 30 hours worked, as prescribed by the EO. The FAR Council's interim rule is substantially similar to DoL's final rule, which DoL published in the Federal Register in September 2016 and went into effect in November 2016. *See* 81 Fed. Reg. 67,598 (Sept. 30, 2016).

FAR 52.222-62 applies to contracts awarded under solicitations issued after January 1, 2017 covered by the SCA or the Davis-Bacon Act (DBA, also known as the Wage Rate Requirements (Construction) statute) and that require performance in whole or in part within the United States. It also applies to employees performing on or in connection with such contracts whose wages are governed by the SCA, the DBA, or the Fair Labor Standards Act (FLSA), including employees who qualify for an exemption from the FLSA's minimum wage and overtime provisions. Importantly, FAR 52.222-62 also states that the

requirements of the rule are in addition to the contractor's obligations under the SCA and the DBA, and the contractor may not receive credit toward its prevailing wage or fringe benefit obligations under those statutes for any paid sick leave provided in satisfaction of the rule's requirements.

Use of Federal Sick Leave as a "Bona Fide" Fringe Benefit Under the SCA

Prior to the issuance of the sick leave EO, many service contractors provided sick leave as a means to partially satisfy SCA H&W fringe requirements. As long as the sick leave program set up by the contractor satisfied the requirements of a "bona fide" fringe benefit or was approved by DoL, there was little doubt that sick leave could be used to offset the SCA H&W fringe. However, with the issuance of the sick leave EO and resulting FAR rules, all that would quickly change. Because sick leave would now be required by federal law, sick leave could no longer be used to satisfy the H&W obligations thus raising contractor concerns and forcing these contractors to revise their plan for satisfying SCA H&W requirements. *See* 29 C.F.R. 4.171(c).

Shortly thereafter, however, and much to the delight of federal service contactors, DoL foreshadowed in a Q&A posted on DoL's website that future SCA WD H&W rate revisions would take into account the impact on contractors of having to provide federal sick leave under the EO. This was welcome news for contractors that had used sick leave to satisfy the H&W requirement and that initially feared they would need to provide sick leave, and then also provide another fringe benefit in order to satisfy the H&W shortfall created by removing sick leave from the SCA H&W fringe calculation.

All Agency Memorandum 225

On July 25, 2017, DoL issued All Agency Memorandum Number 225 (AAM 225), which increased the rate of the prevailing H&W fringe benefits under the SCA from $4.27 to $4.41 per hour. Notably, and as promised by DoL in its Q&A, AAM 225 also included a second SCA H&W fringe benefits for employees performing under contracts covered by the paid sick leave rules. That health and welfare rate is $4.13 for each hour performing work on a contract covered by EO 13706. This second, alternative rate essentially subtracts the minimum annual cost of required sick leave from the prevailing H&W rate because employer contributions made to satisfy the employer's obligations under EO 13706 may not be credited toward the contractor's obligations under the SCA.[1] The new rates went into effect on August

[1] Under separate rules, non-exempt employees working on SCA and DBA covered contracts or in support of those contracts for at least 20% of their workweeks must be paid a minimum wage of $10.20 an hour. A worker accruing the minimum of 56 hours of sick leave per year at the $10.20 minimum wage will accrue sick leave worth $571.20 per year. When $571.20 is divided by 2080 hours per year, the result is 27.5 cents per hour, which almost exactly equals the 28 cent difference between the new $4.41 and $4.13 H&W rates.

DoL's singular calculated amount for sick leave of $0.28 of course does not cover all federal sick leave costs for contractors since anyone that makes over the SCA minimum wage and gets 56 hours will run at a higher sick leave cost. For instance, someone making $20.00 per hour that gets 56 hours will result in the contractor having to absorb more cost than what the lower fringe accounts for.

1, 2017. Therefore, contractors can expect to see the new H&W fringe benefit rates in solicitations issued or contracts awarded on or after August 1, 2017. [2]

So what does issuance of these two alternative H&W fringe rates mean for service contractors performing under SCA covered contracts? Allowing credit of a predefined amount for sick leave against the SCA H&W fringe is certainly a good thing for federal service contractors, but at what price? Well, let's just say we expect many challenges will await those trying to apply the sick leave obligations and new alternative H&W fringe rates. Although certainly not exclusive, we have identified below three areas for service contractors to carefully consider when applying the sick leave obligations and new alternative SCA H&W rates.

Application of Differing H&W Rates to Contracts and Service Employees

On the one hand, DoL's issuance of AAM 225 with alternative H&W rates is beneficial to contractors in that it allows contractors subject to the sick leave rule to provide H&W fringe benefits at a lower rate to SCA covered personnel. However, it also will inevitably complicate the process for determining the appropriate H&W rate to pay SCA covered employees. Couple this with the fact that, for most SCA covered contracts, the SCA H&W rate applies on an individual "per-hour" basis to service employees, thus necessitating an individualized calculation in order to determine if an employee has received at least the minimum required H&W fringe benefits. As a result, calculation of individual SCA H&W fringe benefits will become an even more cumbersome process.

For example, it is plausible that a single contractor may simultaneously have contracts subject the old $4.27 H&W rate, the new $4.41 H&W rate, and the new $4.13 sick leave H&W rate. And if the contractor also has contracts where the contracting agency has failed to diligently incorporate SCA WD revisions, it is possible for the contractor to have contracts with even older H&W rates, adding to the administrative challenges already inherent with contractor administration of the SCA. For contractors that cross-utilize employees on multiple SCA covered contacts, this challenge becomes even more acute. In such a scenario, it is plausible for a contractor to have an employee that is subject to three different SCA H&W rates depending on which contract that employees performs work under on a given day. The more H&W calculations a contractor must undertake for an individual service employee (or group of employees), the greater the risk for errors that could result in significant compliance issues for a service contractor.

Compliance Strategy: Given these challenges, we recommend that contractors try to limit, when possible, employee cross-utilization on multiple SCA covered contracts. Although there may be times when this is not possible for business or other reasons, the administrative and recordkeeping burdens as well as compliance risk increase significantly when a service employee is subject to multiple H&W rates under different SCA covered contracts. In addition, it is critical for contractors to engage appropriate

[2] AAM 225 also sets new SCA health and welfare fringe benefits levels for Hawaii to reflect the state law that requires most employers to provide health insurance coverage for their employees: $1.63 per hour for employees covered by EO 13706 and $1.91 per hour for all other employees.

resources (whether internal or external) to prepare detailed, documented SCA H&W calculations that can withstand future audit by the DoL.

Differing Standards for Incorporation and Associated Challenges

While AAM 225 states that the new H&W rate for sick leave covered contracts goes into effect on August 1, 2017, it is critically important for contractors to recognize that a contract first must be covered by the new sick leave obligations (that is, contain FAR 52.222-62) before contractors can start paying employees at the new lower H&W rate. In addition, for both non-sick leave covered and sick leave covered contracts, the new rates, although effective August 1, 2017, do not change H&W fringe benefit payment requirements until they are incorporated into a contract by the contracting agency. This last point is an oft-overlooked principle espoused by DoL that requires careful attention by service contractors.

One additional subtle, yet important wrinkle that mirrors challenges we've seen associated with application of the federal minimum wage rule is that the standards used for incorporation of new WD revisions under the SCA and incorporation of the sick leave requirements into SCA covered contracts differ in many key, significant ways. Under the SCA regulations, the contracting agency must insert a new SCA WD whenever the term of an existing contract is extended, pursuant to an option clause or otherwise. *See* 29 C.F.R. 4.143(b). This contract extension is considered a "new contract" thus requiring insertion of a new or revised SCA WD as provided under DoL regulations.

Federal sick leave incorporation principles, however, differ significantly. The FAR Council's interim rule applies to solicitations issued on or after January 1, 2017, and resultant contracts. However, the sick leave rules also apply to certain "new contracts" that were originally entered into prior to January 1, 2017. More specifically, under 29 C.F.R. 13.2, a contract that is entered into prior to January 1, 2017 will constitute a *new contract* if, through bilateral negotiation, on or after January 1, 2017: (1) The contract is renewed; (2) The contract is extended, unless the extension is made pursuant to a term in the contract as of December 31, 2016 providing for a short-term limited extension; or (3) The contract is amended pursuant to a modification that is outside the scope of the contract. Contracting officers also are "strongly encourage[d]" to include the clause in existing indefinite-delivery indefinite-quantity contracts if the remaining ordering period extends at least six months and the amount of remaining work or number of orders expected is substantial. Importantly, though, the unilateral exercise of a contract option by the Government, which is how most options are exercised, does not trigger a requirement for the contracting agency to incorporate the federal sick leave obligations. *See* FAR 22.2104(c). This final point diverges from the SCA WD revision incorporation principles for a "new contract" under the SCA.

Because of this distinction, it is plausible that federal service contractors could be performing service contracts awarded under a solicitation issued prior to January 1, 2017 for many years under unilaterally exercised contract option periods that are not subject to the federal sick leave obligations. For example, let's assume a contractor receives a contact award in February 2017 under a solicitation that was issued in October 2016 (and not otherwise qualifying as a "new contract" for sick leave under 29 C.F.R. 13.2) and the contract contains four option years. Under the incorporation standards for sick leave, the sick leave obligations would not apply to this contract for the base period of performance or during the

option years of performance unless any of the sick leave "new contract" triggers (described above) are present.

Of course, the contracting agency will be required to incorporate new or revised SCA WDs with the two alternative H&W rates, but those option exercises should not include incorporation of the sick leave clause, and the non-sick leave H&W rate would be the operative SCA H&W rate.

As a result, the contractor could be performing under this contract well into 2020 without having the sick leave rules apply to this contract. At the same time, by 2020 that same contractor likely will have sick leave obligations applying to nearly all its other service contracts. This inevitable inconsistent application of the sick leave obligations across SCA covered contracts will likely result in another administrative and recordkeeping nightmare.

In addition, we expect agency contacting officers also struggle with managing these differing incorporation standards. Indeed, we've found that navigating the DoL SCA regulations and FAR rules regarding incorporation of new or revised WDs (or collective bargaining agreements) presents challenges in and of itself without adding this new sick leave incorporation wrinkle. Our advice to contractors is to be vigilant and ensure that contracting officers are acting in compliance with the standards for SCA WD revision incorporation and sick leave incorporation standards.

Finally, there is an employee relation dynamic that should not be underestimated. Because of these differing incorporation standards, contractors will be in the unenviable position of having to explain to service employees why certain service employees receive federal sick leave, but others do not even though they are all working under SCA covered contracts. Although the FAR and sick leave rules provide legitimate answers and a legal basis for application of different standards to seemingly similar contracts, service contractors will surely face questions from service employees where (entirely permissible) fringe benefit discrepancies exist between contracts.

Compliance Strategy: Contractors should confirm whether contracting officers have properly incorporated the federal sick leave rules into their contracts and what SCA WDs apply before assuming applicability or making any adjustments to H&W rates. Relatedly, it is important to keep thorough records of any amendments made to contracts to assess the impact of such amendments. Clear communication with employees to explain the basis for any differing treatment will also be key.

Price Adjustment Clause Impacts and Reduction of H&W Benefits Challenges

During performance of SCA covered contacts, many service contractors are concerned not just with baseline compliance with the SCA (meaning payment of wages and fringe benefits, including H&W, that meet the minimums required in the WD), but also with avoiding situations where they provide H&W fringe benefits (or wages) that exceed the SCA WD minimum on non-cost type contracts that contain the FAR Price Adjustment clause, FAR 52.222-43. If a contractor provides wages or H&W fringe benefits that exceed the SCA minimums, contracting agencies can use that fact as a basis for denying recovery of future wage or H&W fringe benefit increases in revised WDs applied to the contract during option periods.

For instance, if a contractor provides $4.75 in H&W fringe benefits under a SCA covered contract where the H&W rate is $4.27 per hour and the new H&W rate of $4.41 is incorporated into an option exercise, the contracting agency can (and generally will) deny recovery of the $0.14 increase in fringe rate because the contractor was already paying over the new fringe rate. *See* FAR 52.222-43. One can argue whether this is fair to the contractor and harmful to service employees since it disincentives contractors to provide rich fringe benefits that exceed WD minimums, but this is the current practice amongst agency contracting officers.

Furthermore, we expect this issue will become even more acute with the issuance of the new sick leave H&W fringe rate – a fringe rate ($4.13) that is lower than the 2016 H&W fringe rate of $4.27. This dynamic may result in situations where service contractors reduce H&W benefits for their employees in order to not exceed the H&W fringe rate and to avoid creating the price adjustment clause recovery issue described above.

To illustrate, let's take a contractor that traditionally has not used sick leave to offset the H&W fringe requirements and currently provides $4.27 in H&W benefits to its employees through a combination of health benefits, life insurance, and vested 401(k) match payments. If that contractor is awarded a follow-on contract that is subject to the sick leave requirements, and therefore the new H&W fringe rate of $4.13 per hour would apply, this contractor would need to reduce the amount of H&W provided or else risk not being able to fully recover for future H&W price adjustments when new SCA WD revisions are incorporated into the contract. To alleviate this issue, the contractor could be forced to inform its SCA employees that they will receive a reduction of $0.14 in H&W fringe benefits (to account for the difference between the $4.27 H&W rate and $4.13 sick leave H&W rate) because of the impact of the application of the sick leave rule. Of course, these same employees also will enjoy the benefit of receiving the sick leave benefit going forward but, as any contractor knows, taking away or reducing a benefit from a service employee is a tricky proposition.

Compliance Strategy: Contractors should be careful to identify the level of H&W fringe benefits (or wages) they must provide to meet the SCA WD minimum on non-cost type contracts that contain FAR 52.222-43 and be aware that exceeding the minimum may have negative repercussions in the future, as described above. In addition, contractors should be prepared to explain to employees the reasons for any change in H&W rates or benefits they receive to minimize complaints and misunderstandings.

Conclusion

The federal sick leave rules and new H&W fringe benefits level present a number of compliance challenges and risks for the unwary. Contractors should consider relying on the expertise and experience of third-party experts and legal counsel to navigate the challenges associated with incorporation and interplay of these new requirements.

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