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PAY OR PLAY IN CALIFORNIA?

On October 5, 2003, embattled Governor Gray Davis signed a sweeping health care reform bill, S.B. 2 (Burton) that imposes new obligations on medium and large employers to provide health insurance benefits for their workers. Under the so-called "pay or play" legislation, covered employers are required to provide health insurance benefits to employees (the "play" alternative) or to pay a fee to be used for the purchase of state-provided health insurance coverage (the "pay" alternative). Specifically, medium-sized employers (20 to 199 employees) must provide health insurance coverage to employees and pay at least 80% of the premium for that coverage. Large employers (over 200 employees) must provide coverage for both employees and dependents and pay at least 80% of the premium for both employee and dependent coverage. Alternatively, employers covered by the legislation could pay an as yet undetermined fee into a state pool that would be used to provide healthcare coverage to eligible employees under a state-administered system.

Two important points for employers: (1) SB 2 is unlikely to survive the inevitable legal challenges based on ERISA pre-emption and (2) the earliest possible effective date is January 1, 2006.

Effective Dates

Large employers must comply with SB 2's requirements on or before January 1, 2006. Medium employers must comply on or before January 1, 2007, except that medium-sized employers employing between 20 and 49 employees do not have to comply unless a tax credit of 20% of those employers' net costs is enacted by the California Legislature prior to January 1, 2007.

The "Pay" Alternative

SB 2 creates the State Health Purchasing Program to be managed by the Managed Risk Medical Insurance Board (the "Board"). The Board is given fiduciary responsibility and authority for the administration of the program, "including sole and exclusive fiduciary responsibility over the assets of the fund."

The Board will fulfill its fiduciary responsibility for arranging coverage for employees and eligible dependents by establish-

ing and maintaining a purchasing pool. The purchasing pool or fund is created through employer fees and eligible employee contributions. The Board shall negotiate contracts, exempt from the competitive bidding process, with healthcare service plans and insurers to provide such coverage.

The amount of the fee for large- and medium-sized employers will be set by the Board after it determines the total amount necessary to pay for health coverage. This amount shall include costs associated with the administration of the fund, including its enforcement through the Employment Development Department (EDD). Fees for large employers will be based upon the number of eligible employees and dependents in its workforce. Fees for medium employers use only the number of eligible employees in the workforce.

Failure to pay the fee will subject employers to a penalty of 200% of the amount of any fee that would have otherwise been paid by the employer plus interest on all amounts due including any penalties.

Eligible employees (or "enrollees," defined as an individual who works at least 100 hours per month for any individual employer and has worked for that employer for three months) may be required to pay up to 20% of the fee. (An employer may elect to pay more than 80% of the fee.) This fee will be collected by the employer and paid with the employer fee. For enrollees who are making less than 200% of the federal poverty guidelines for a family of three, the enrollee contribution shall not exceed 5% of wages. In addition to these enrollee contributions, the Board shall also establish levels for co-pay, co-insurance, and deductible expenses.

The "Play" Alternative

An employer obtains a credit against its fee by providing proof to EDD that the employer provides health insurance coverage for its employees. For employer-provided healthcare coverage to suffice, that coverage must meet the minimum requirements under the Knox-Keene Health Care Services Plan (California Health and Safety Code § 1340, et seq.) The key requirements include:

- ◆ Employer responsibility for all costs associated with the coverage;

- ◆ Employee contributions of up to 20% of the costs of coverage, unless the wages of an employee are less than 200% of federal poverty guidelines, in which case the employee contribution can be no greater than 5% of wages;
- ◆ If an employer provides multiple health insurance coverage options, only one of those options must meet the minimum requirements;
- ◆ Employee out-of-pocket expenses, i.e., co-pays, deductibles, and co-insurance, may not exceed levels established by the Board for state-provided coverage;
- ◆ Medium employers may impose more than a 20% contribution on employees for dependent coverage;
- ◆ Prescription drug coverage must be provided that meets the minimum requirements established for state-provided coverage.

SB 2 makes it unlawful for an employer to designate an employee as an independent contractor or temporary employee, reduce an employee's hours of work, or terminate and rehire an employee if a purpose of that action is to avoid the employer's obligations under the legislation. A penalty of 200% of the amount of any fee may be imposed for this violation.

Anticipated Legal Challenge: ERISA Preemption

Section 514 of the federal Employee Retirement Income Security Act ("ERISA") provides that ERISA shall supersede "any and all State laws insofar as they may now or hereafter relate to any employee benefit plan." On its face, it would seem that SB 2 is preempted. In fact, the United States Supreme Court has noted that "a state law might produce such acute, albeit indirect, economic effects, by intent or otherwise, as to force an ERISA plan to adopt a certain scheme of substantive coverage or effectively restrict its choice of insurers, and that such a state law might indeed be shown to be preempted under [section] 514." See *New York State Conf. of Blue Cross & Blue Shield v. Travelers*, 514 U.S. 645 (1995). SB 2 appears vulnerable under this standard.

While states may regulate insurance companies without violating ERISA preemption provisions, in order to survive a preemption challenge such laws must (1) be specifically directed toward entities engaged in insurance, and (2) substantially affect the risk pooling arrangement between insurer and the insured. See *Kentucky Association of Health Plans, Inc. v. Miller*, 123 S.Ct. 1471 (2003). Arguably, SB 2 fails on both counts. It remains to be seen how SB 2 will fair when challenged on the basis of ERISA preemption. Certainly, such a challenge is inevitable. Opponents of the legislation, including the California Chamber of Commerce, have indicated that a challenge based upon ERISA preemption is likely.

Anticipated Legal Challenge: Violation of California Constitution

A second basis for challenging SB 2 is the requirement in the California State Constitution that any new tax increase be approved by a two-thirds majority of the state legislature. Opponents of SB 2 contend that it imposes a new tax on employers. Because the legislation was not passed with a two-thirds majority, it could be vulnerable to a challenge on this ground as well.

Conclusion

Proponents of SB 2 have hailed it as a historic victory for California's working poor. Opponents counter that it will impose an economic burden of nearly \$6 billion dollars on California employers that will have a stifling effect on California's job market and economy. While opinions may vary, one thing is for certain: the fate of SB 2 will be resolved in the courts in the coming months.

If you have any questions about the application of the new California "pay or play" legislation, please contact the Seyfarth Shaw LLP employee benefits group attorney with whom you work or any employee benefits group attorney listed on the website at www.seyfarth.com.

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