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Understanding the Cost of Proposed Overtime Regulations

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Ever since President Barack Obama on March 13, 2014, signed a memorandum directing the U.S. Department of Labor (DOL) to update the Fair Labor Standards Act (FLSA) overtime regulations, it has perhaps been the most talked about issue in employment law. This is understandable, given the tremendous scope of the FLSA, which applies to virtually all employers in both the public and private sectors. According to DOL, the primary objectives for the update are to (1) ensure workers are paid fair pay for a fair day's work; (2) modernize and simplify the regulations; and (3) ensure the FLSA's intended protections are fully implemented. The last time DOL made changes to the overtime regulations was in 2004. The proposed regulations govern the rules on who can be properly classified as exempt from overtime laws; they were published in the Federal Register on July 6, 2015.

Exemptions

The proposed regulations seek to revise what are commonly referred to as the "white-collar exemptions." Under these exemptions, certain types of "exempt" employees are generally not entitled to overtime if they satisfy three tests: (1) they are paid on a "salary basis"; (2) they satisfy the applicable "duties" test; and (3) they are paid the prescribed minimum salary level.

On the other hand, "nonexempt" employees are those who are entitled to overtime at time-and-one-half their "regular rate" for all hours worked over 40 in a workweek. A workweek is any designated seven-consecutive-day period established by the employer. Revisions to the white-collar exemptions which govern which employees may be properly classified as exempt will have a significant impact on employers not only on a fiscal but operational level.

For example, most employers do not require exempt employees to track daily hours, and they are usually provided with flexible scheduling provided they are performing their duties satisfactorily. The expectation is that an exempt employee will work as many hours as necessary to perform the job. In busy weeks, this means more hours. In less busy weeks, the employee is usually permitted to leave early without necessarily needing to obtain prior approval. Regardless of whether the employee worked a busy or less busy week, the exempt employee is guaranteed a pre-determined weekly (or less frequent) set amount of compensation which cannot be reduced except for very limited permissible reasons. This guaranteed compensation is the "salary basis" requirement.

To the contrary, non-exempt employees are only entitled to compensation when they perform actual work. Thus, if a non-exempt employee leaves work early, she is not required to be paid. During weeks a non-exempt employee is permitted to work over 40 hours, she is required to be paid the overtime premium. For this reason, employers normally require such employees to receive prior supervisory approval before working overtime to control labor costs. Thus, the classification of employees as exempt or non-exempt is directly tied to an employer's labor costs. In addition, the classification decision affects operational considerations because of issues such as scheduling and availability.

As the term "white-collar" implies, these overtime exemptions were intended to only apply to employees higher up in the organization chart such as managers, professionals and administrative employees who exercise independent judgment and discretion over matters of significance. There are a number of discrete exemptions within the broader category of white-collar exemptions such as the executive, administrative and professional exemptions. Depending on which exemption is being utilized, employees must perform certain "duties" to be properly classified as exempt. This is the "duties" test referred to above.

The public comment period closed on Sept. 4, 2015, and approximately 250,000 comments were received. Despite numerous requests from various organizations and several members of Congress to extend the public comment period, DOL declined to do so. On March 14, 2016, the proposed regulations took the final step before implementation when they were sent to the Office of Management and Budget (OMB). OMB can hold the proposed regulations for a maximum period of 90 days, although there is no minimum period. It is expected that there will be a 60-day grace period after OMB releases the proposed regulations before they become effective.

Salary Level

DOL did not propose changes to the salary basis test, and none are expected. The primary thrust of the proposed regulations is to significantly increase the minimum salary level for the applicable exemptions. Under the FLSA's current regulations, executive, administrative and professional employees must earn at least $455 a week ($23,660 per year) to be exempt. (An exception applies to doctors, lawyers and teachers.) According to the Bureau of Labor Statistics, the poverty line in 2015 was approximately $24,250 per year, only slightly above the current minimum salary level.

The proposed regulations seek comments on whether to raise the minimum salary level to the 40th percentile of weekly earnings for full-time salaried workers. At the time the proposed regulations were submitted for public comments, DOL projected that in 2016, the 40th percentile salary level would be approximately $970 per week ($50,440 per year),[1] more than double the current salary level requirement. Although it is unlikely the final regulations would impose a salary greater than the 40th percentile mark, it is more realistic the final number may not be as high as $50,440 per year.

In addition, DOL proposed automatic updates to the minimum salary level to ensure it remains a "meaningful" test. The department has proposed two different methodologies for updating the standard salary level. One method would keep the minimum salary level at the 40th percentile of earnings for full-time salaried workers. The other method would adjust the minimum salary level based on changes in inflation, as measured by the Consumer Price Index for all urban consumers.

In explaining the proposed changes, DOL stated it would clarify the overtime requirements for approximately 11 million workers who earn below the proposed salary threshold and make almost five million additional white-collar workers eligible for overtime. DOL estimated that the average annualized direct employer costs would total between $239.6 and $255.3 million per year, depending on the updating methodology used. In addition to the direct costs, DOL stated that the proposed regulations would transfer income from employers to employees in the form of higher earnings estimated to be between $1.18 and $1.27 billion, also depending on the annual increase methodology used.

Practical Concerns

Not surprisingly, the proposed regulations have been met with fierce opposition from numerous business advocates for a variety of reasons. For example, the U.S. Chamber of Commerce submitted comprehensive comments identifying a number of serious legal concerns:

- that the proposed regulations will exclude millions contrary to the intent of Congress because the salary level test was intended to only screen out "obviously" non-exempt employees, not to establish salary levels for exempt employees who clearly met the duties test.
- that the automatic increase violates the Administrative Procedure Act. Not surprisingly, DOL and the Chamber differ on the issue of whether Congress provided DOL with the authority to establish annual increases. If Congress did not, doing so through notice and comment rulemaking would not be appropriate. DOL further argues that annual indexing would promote government efficiency by removing the need to continually revisit the salary level through "resource-intensive notice and comment rulemaking." The Chamber, however, believes that DOL is "missing the point" in that rulemaking is intended to be "resource-intensive" and Congress wanted DOL to "continually revisit" the whitecollar regulations as opposed to putting them on "auto-pilot." In other words, because Congress did not authorize annual increases, it intended DOL to revisit the white collar regulations from time to time.
- that DOL's economic analysis is fundamentally flawed and grossly underestimates the costs of the rulemaking.

On the practical side, the Wage and Hour Defense Institute, which is comprised of approximately 22 law firms across the country representing management in wage and hour matters, have collectively identified several recurring issues with their clients across the country during compliance preparation audits. (The author is a member or the institute.) These include collective bargaining implications, strong resistance from exempt employees who may need to be reclassified, and intelligently budgeting for unknown future increases while at the same time bracing for an almost inevitable surge in litigation which will follow the regulations' release.[2]

When preparing for the new regulations, employers need to consider a number of practical and operational concerns. Although the proposed regulations identify two different methodologies for annual increases, there has been little discussion about how to budget for the uncertainty of the annual increases no matter which methodology is adopted.

To start, the proposed regulations were developed using data from 2013, while the final thresholds will likely be based on figures from the first quarter of 2016. According to Welch Consulting, based on the end-year figures for 2015, the standard salary level calculated at the 40th percentile would be $972 per week ($50,544 per year). However, an even more challenging issue is predicting and budgeting for what the increase will be each following year, considering the hollowing-out effect of employees below the bottom 40th percentile who will be reclassified as non-exempt. The more employers reclassify these employees as nonexempt, the higher the 40th percentile will subsequently become each year, because the percentile method takes into account only salaried employees, not hourly employees, and the lowest-paid salaried employees will be the ones who will be reclassified as hourly.

Welch Consulting gives as an example that if the salary test is calculated as $972 per week, and 100 percent of the employees DOL claims are newly entitled to overtime are reclassified as non-exempt, then the 2016 "40th percentile" could jump to around $1,100 per week ($57,200 annually), an increase of 13 percent.[3] Of course, how much the 40th percentile will eventually climb year to year will be determined by, among other things, employers' decisions to reclassify their lower-paid salaried employees or not. The uncertainty of how these numbers will eventually play out needs to be considered in longterm budgeting. The challenge may best be summarized by the late great Yogi Berra, to whom the following saying is attributed: "It's tough to make predictions, especially about the future."

Whether an employer decides to reclassify a position as non-exempt and how it determines the new pay rate also calls into question DOL's suggestion that the proposed regulations will result in greater earnings for millions of employees. Nothing in the FLSA requires that the employer treat the salary paid for the old, exempt position as a 40-hour base pay for the new, nonexempt, hourly position.

It is more likely that in setting the new pay rate, employers will take into account anticipated overtime and establish an hourly rate or other compensation system that will comply with minimum wage laws but be budgeted to result in paying the employee the same amount of annual compensation as the original salary. However, the reality is that most employers when budgeting may prefer to take an aggressive approach on anticipated overtime, so they come in under their labor-cost budget rather than over. If so, employees could end up receiving less compensation than their original salary.

Not only will employees earn less, but they would also lose the scheduling flexibility that most exempt employees have. Newly designated non-exempt employees will be forced to "punch a clock," i.e., track hours to comply with the FLSA's record-keeping requirements. This type of record-keeping often carries a negative perception and certainly creates additional administrative work for both employer and employee. In addition, many employers have certain fringe benefits tied to exempt status, e.g., car allowances or life insurance that the newly designated non-exempt employee may no longer be eligible for. It is easy to understand how transitioning employees to non-exempt status can result in employee morale issues that need to be strategically considered and addressed.

The employee morale issue most likely will not be contained to just employees transitioned to non-exempt status. It may also affect exempt employees already earning above the anticipated $50,440 annual threshold, because of pay compression. If employees who used to earn less than $50,440 are now given raises to go above that threshold, as DOL hopes, then employees who were already paid at that level will suddenly lose the pay differential that they used to enjoy over those employees. Although not seemingly considered by DOL, an additional cost to employers is the real potential that wage increases may need to be made to this higher-level group to prevent employee resentment.

One other huge question mark is whether the final regulations will contain changes to the duties tests for the various exemptions. Although DOL did not propose any concrete changes to the duties tests, it did ask for public comments regarding those tests, such as whether the regulations should follow California's bright-line rule that 50 percent of an employee's time must be spent on exempt duties. Doing so would serve as the basis for DOL to argue that it will have complied with the Administrative Procedure Act if it does decide to change the duty tests. Currently, the overtime regulations recognize that spending 50 percent of one's time on exempt duties is a good rule of thumb to support the exemption, but not dispositive on the issue.

Given the current level of criticism by business groups of the proposed regulations simply based on the provisions seeking to increase the standard salary level and to establish annual increases, there is no question that any changes to the duties tests will be met with a loud and swift outcry followed by lawsuits. Although there is still some uncertainty as to what the final regulations will look like, what is absolutely clear is that all employers need to immediately start, if they have not already, conducting proactive measures such as internal audits and developing appropriate communication strategies, to be able to prepare for the changes in an intelligent and meaningful way.

Endnotes

[1] See Frequently Asked Questions: Overtime NPRM available at http://www.dol.gov/whd/overtime/nprm2015/faq.htm

[2] A copy of the public comments is available at https://www.uschamber.com/sites/default/files/documents/files/u_s_chamber_-_comments_-_part_541_nprm.pdf.

[3] See Welch Consulting, "What is a White-Collar Employee? The Proposed Changes to the Salary Level Test," April 2016.

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