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OVERTIME

The Labor Department released its long-awaited changes to the Fair Labor Standard Act's overtime regulations on May 18, 2016. The new rule effectively doubles the minimum salary level necessary for employees to be eligible for the most common ''white collar'' exemptions to the FLSA's overtime rules. In this BNA Insights article, Thomas P. Gies and Andrew W. Bagley of Crowell & Moring examine steps employers must take to assure compliance with the new rule, which is scheduled to take effect on Dec. 1, 2016.

Labor Department Revises FLSA Overtime Eligibility Regulations: Implications for Employer Compliance Programs

BY THOMAS P. GIES AND ANDREW W. BAGLEY

The U.S. Department of Labor has released its long-awaited changes to the Fair Labor Standard Act's overtime regulations. DOL's final rule, issued on May 18, 2016, effectively doubles the minimum salary level necessary for employees to be eligible for the most common ''white collar'' exemptions to the FLSA's overtime rules (95 DLR AA-1, 5/17/16). The new regulations, scheduled to take effect on Dec. 1, 2016, present significant financial, legal and operational issues for most U.S. employers.

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Highlights of the New Regulations

The DOL has set the new minimum salary threshold at $47,476 per year ($913 per week) for individuals classified as exempt under the Executive, Administrative and Professional (EAP) ''white collar'' exemptions governed by Part 541 of DOL's FLSA regulations. This means that, subject to a few exceptions, any employee earning a salary below this figure will be automatically entitled to overtime for all hours worked in excess of 40 in a workweek.

The new minimum salary is indexed to rise every three years to a level equivalent to the 40th percentile of weekly earnings for full-time, salaried workers in the nation's lowest income region. Current data generated by the Bureau of Labor Statistics identifies the South as this region. The first indexed increase is scheduled for Jan. 1, 2020, and DOL expects the minimum salary to reach $51,168 per year at that time. Future increases in the minimum salary level will be published in the Federal Register 150 days before their effective date.

For the first time, employers will be allowed to count bonuses, incentives and commissions toward the re-

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quired threshold, up to a maximum of 10 percent of that figure, so long as these payments are made at least on a quarterly basis.

The DOL also raised the ''highly compensated employee'' (HCE) salary threshold to $134,004 per year (from $100,000), which is based on the 90th percentile of all salaried, full-time workers. This figure will also be adjusted every three years to maintain the 90th percentile position. DOL expects this threshold to reach $147,524 per year in the January 2020 adjustment. For the HCE figure, employers may continue to count non-discretionary bonuses, incentive payments and commissions in determining whether employees have satisfied the HCE threshold, including a year-end lump sum adjustment, so long as the employee's guaranteed base salary is at least equivalent to the standard minimum salary level (i.e., $47,476 per year as of Dec. 1, 2016).

When the DOL issued its Notice of Proposed Rulemaking on June 30, 2015, it invited comments about the ''job duties'' element of the EAP overtime exemptions (125 DLR AA-1, 6/30/15). In a decision that relieved many in the employer community, DOL opted to leave these tests unchanged. The final rule makes no change in the exemption eligibility criteria for some of the other ''white collar'' exemptions, including outside sales employees, teachers, doctors and lawyers.

The final rule updates the special ''base rate'' for employees in the motion picture industry to $1,397 per week, and provides a special phase-in period for employers that provide services to certain Medicaid recipients. The final rule rejected calls by various employers for special rules for part-time employees and for non-profit employers.

The Dec. 1, 2016, effective date is another welcome feature of the final rule. There was considerable concern that DOL might provide employers with only 60 days to achieve full compliance with the new minimum salary requirements, a deadline that would be extremely aggressive for most employers.

Implementation of the Final Rule: Raise Salaries or Reclassify Affected Employees?

The obvious first step toward compliance is the identification of positions that will be affected by the new minimum salary requirements. In preparing this list, companies should not only consider employees' base salaries but also decide how best to address non-discretionary bonuses and other forms of incentive pay that may be included in determining whether the new threshold is satisfied.

For each identified position, employers should make an informed decision whether to raise the affected employees' compensation up to the new threshold or to reclassify them as non-exempt (i.e., overtime eligible). In making these decisions, employers must be mindful that the minimum salary has become a moving target, as a result of the periodic indexing feature of the final rule.

This process inevitably requires an analysis of the budget and other financial implications of the choice between salary increases or reclassification. Some employers may find it difficult to perform the financial analysis with optimal precision. Most companies do not require salaried exempt employees to keep time records and may thus be unaware of the number of hours actually worked by employees who are affected by the final rule. This lack of accurate information may inhibit the ability of employers to accurately quantify actual overtime costs and thus prevent the development of a reliable projection of the total direct and indirect cost of a reclassification strategy. This exercise may be particularly challenging for employers in industries where affected employees work remotely or travel as part of their jobs. Because the regulations make no changes to the existing rules governing the definition of what constitutes compensable ''work,'' many employers will be challenged to understand the full financial implications of reclassifying affected employees.

Employers should also be mindful of the hidden cost of paying overtime to employees who will be reclassified as overtime-eligible. The traditional FLSA rules for paying overtime are not altered by the final rule. In many situations, employers may be inclined to simply change the compensation structure for affected employees from an annual or weekly salary to an hourly rate. In that scenario, the employees will become eligible for overtime pay for all hours worked over 40 in a workweek, measured at one and one-half times the employees' ''regular rate.'' Employers should be aware that various types of compensation received by non-exempt employees must be included in calculating the ''regular rate'' at which overtime must be paid. Examples include payments such as shift differentials, and various types of non-discretionary bonuses and other forms of incentive compensation.

Controlling Payroll Costs: Available Options

Many employers will be focused on controlling the costs associated with the final rule. To that end, employers should consider the various options available in a reclassification strategy. Some companies may decide to adopt the straightforward solution summarized above, of simply converting salaries to hourly rates. But other options to the conventional hourly rate approach are available. When properly designed and administered, employers may compensate non-exempt employees in other ways, including piece-rate compensation plans and day-rate arrangements. Many employers will consider converting certain classifications of employees to a ''salaried non-exempt'' compensation system. These arrangements can be configured so that overtime is paid at 0.5 times the regular rate, as opposed to the conventional 1.5 calculation method.

Depending on the industry, some employers may consider a fluctuating workweek arrangement. DOL

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regulations permit such compensation systems. 29 C.F.R. § 778.114. When properly administered, such arrangements permit employers to save on overtime costs, because employees paid under a permissible fluctuating workweek method receive only half time (rather than one and a half) their regular rate for overtime hours worked. There are several requirements of lawful fluctuating workweek pay systems, and employers should fully understand them as part of making a feasibility study of this alternative.

Training and Policy Review

For employees who are reclassified, employers must manage compliance with the full range of the FLSA's recordkeeping and overtime payment rules. This effort should include necessary training to ensure that formerly exempt employees understand what it means to be a non-exempt employee. This includes learning what constitutes ''work time'' under the FLSA and how to record it. Compliance training should include discussion of the treatment of meal and rest breaks under both federal and state law, as well as providing a general understanding of the new expectations that come with overtime eligibility. Similarly, supervisors and senior leaders of business units with a significant number of reclassified employees must be trained on the new expectations of their non-exempt subordinates, from the tracking of work time to the pre-authorization of overtime work to the prevention of off-the-clock work.

A robust compliance plan should include a thoughtful communications strategy. Many employers will want to consider preparing written materials, including talking points for managers and senior leaders, written FAQs, and other initiatives sponsored by Human Resources leaders to facilitate implementation of changes necessary to comply with the regulations.

Compliance will also likely require making changes to relevant policies and practices. Employers can continue to maintain policies that require prior management approval of overtime, so long as they are mindful of the legal obligation to pay for all hours actually worked (based on either actual or constructive knowledge) by non-exempt employees. Some employers may consider other measures to control or limit additional overtime costs, including imposing strict limits on hours that may be worked. In considering such options, employers should be aware that explicit ''no overtime'' rules can increase the chances of class and collective action litigation. Problematic fact patterns in this area include situations in which employees plausibly claim that management is aware that they are unable to perform all of their assigned duties within a 40-hour workweek, and cases in which there are allegations of ''time shaving'' by supervisors who must approve employee time records.

Finally, considerable effort may be required to ensure that relevant timekeeping systems are modified to allow for full compliance. This effort should include appropriate review of regular rate calculations and various aspects of properly tracking hours worked, including matters such as ''on call'' and travel time.

Other Financial Considerations

Companies should be mindful of the larger impact of compliance with the final rule. A decision to increase salaries for affected employees, in order to keep them exempt from overtime, presents obvious and direct wage compression issues. Similar issues may result from reclassification of affected employees. Depending on hours worked and the particular compensation design chosen by the employer, total compensation for reclassified employees (with overtime) may end up exceeding the pay provided to employees on the next rung of many job ladders.

Budget projections for the next several years should reflect expected increased overtime costs for reclassified employees. The budgeting process should also address the likely upward pressure on wages as lower earners move up to meet the exemption threshold.

Transition Matters

Several states have laws requiring advance notice to employees of changes to the type or level of compensation. Employers should be mindful of all such legal requirements.

Companies should ensure that all aspects of their timekeeping and payroll systems are redesigned and fully tested well in advance of the compliance date. For many employers, the effective date of the final rule will come in the middle of a bi-weekly or monthly payroll period for salaried exempt employees. This will require careful consideration of the mechanics of converting affected employees to a different payroll system.

Specific Compliance Issues

Many employers will confront significant operational challenges in maintaining compliance with the final rule. Employers concerned about increased payroll costs and lower profits should set realistic expectations for their business units. Many companies will consider developing programs to determine whether business leaders and supervisors can realistically manage to a 40-hour schedule. Operational needs may require employers to consider alternative ideas to maintaining adequate staffing, including hiring of part-time workers or outsourcing solutions.

Employers should consider the regulations as an opportunity to reassess their compliance with the ''job duties'' tests applicable to the EAP white collar exemptions. Despite DOL's decision not to alter the job duties test, employers should expect that legal challenges to employee classification decisions will continue. Claims are most likely to be filed on behalf of employees who spend a significant portion of their time performing non-exempt tasks. As a prevention strategy, some employers will benefit from conducting targeted audits of job titles. Entry-level white collar positions in functions including accounting, marketing and procurement may be appropriate candidates for review. Actual job duties performed by first-level supervisor positions may also be reviewed. Some of these positions may be challenging to defend under current case law interpreting the FLSA's white collar exemptions. In other situations, job duties may have changed since some of these positions were last evaluated. Companies should consider conducting audits of job duties by counsel in a manner that utilizes the attorney client privilege.

Employers in all industries, including educational institutions and many non-profit organizations, should also consider what might be called the ''soft costs'' of compliance. Many employees may consider that conversion to non-exempt status is a sort of demotion. Employees may bristle against newly-imposed rules calling for closer supervision of their activities and resent having to work in a ''time clock punch'' environment. The wage compression phenomenon mentioned above is likely to present additional challenges to companies trying to avoid deterioration in employee morale. In some industries, employers may have to respond to increased employee turnover.

As mentioned above, the final rule permits employers to include certain non-discretionary bonuses in meeting the new minimum salary thresholds, assuming the bonuses are paid out on a quarterly or more frequent basis. Employers should adopt thoughtful approaches to this issue, including the adoption of appropriate mechanisms for paying the bonus and determining appropriate ''true up'' payments at the end of the bonus period. Employers will also want to consider the best way to handle the payment of such bonuses to individuals who leave the organization during the middle of a bonus period.

The final rule is explicit in precluding adoption of a pro rata approach to the minimum salary for part-time salaried employees. This means that employers must comply with the FLSA's recordkeeping and timekeeping requirements, even if it is unlikely that part-time salaried employees would ever work enough hours to qualify for overtime pay.

Other Considerations

Employers with employees represented by labor unions may face additional challenges. The National Labor Relations Act (NLRA) generally requires employers to bargain in good faith before making changes in terms and conditions of employment of represented employees. Case law interpreting the NLRA broadly defines this duty. In almost all situations, employers are required to bargain about the ''effects'' of any such changes, even changes required by law. Accordingly, unionized employers should consider their obligations under the NLRA in designing their compliance programs. While there would be no duty to bargain over the decision to comply with the new minimum salary requirement for unionized employees currently classified as exempt, almost every other issue summarized in this article is subject to the duty to engage in ''effects bargaining.''

Employers should also review their employee benefit plans as part of achieving compliance. Some benefit plans may define eligibility in terms of exempt or non-exempt status. Eligibility language may need to be modified, depending on the compliance strategy chosen by the employer. Companies that are prepared to reclassify affected employees to non-exempt status should be mindful of the various obligations imposed by the Employee Retirement Income Security Act (ERISA), including the possibility of claims filed under Section 510 of ERISA, which prohibits plan sponsors from taking various actions that deny employees eligibility in ERISA-sponsored benefit plans.

Possible Challenges to the Regulations

Congressional action to stop or modify the final rule is likely. The same day DOL announced the final rule, Rep. Paul Ryan (R Wis.), the Speaker of the House, issued a statement saying that the final rule ''hurts the very people it alleges to help.'' He also stated, ''President Obama is rushing through regulations—like the overtime rule—that will cause people to lose their livelihoods. We are committed to fighting this rule and the many others that would be an absolute disaster for our economy'' (96 DLR AA-1, 5/18/16).

Congress is considering a bill entitled the ''Protecting Workplace Advancement and Opportunity Act.'' This bill, which was introduced on March 17 and is being considered both in the House and Senate, has more than 170 co-sponsors (52 DLR A-1, 3/17/16). It would require DOL to abandon the new overtime rules and to ''fully and accurately'' consider the economic impact of any new regulation on small business, nonprofits, and others who would be affected. While this bill might be enacted by Congress, it would certainly be vetoed by President Barack Obama.

Legal challenges to the final rule also seem likely. Industry groups may claim that the regulations are arbitrary and capricious within the meaning of the Administrative Procedure Act (APA). DOL's decision to implement periodic indexing of the minimum salary without invocation of the APA's ''notice and comment'' rulemaking process on each occasion may become a significant issue in such litigation. In 2004, when the minimum salary level was last adjusted, the DOL took the position that it lacked authority to require periodic indexing. Some employers and industry groups may consider a litigation strategy premised on the notion that the final rule's significant elevation of the minimum salary level is contrary to Congressional intent. We expect that any legal challenges will be filed within the next several weeks.

Concluding Comments

Employers should plan for a Dec. 1, 2016, effective date for the new rules. Appropriate efforts to achieve and maintain full compliance as of this date should be a critical objective for affected employers. Among other things, there is strong reason to believe that plaintiffs' lawyers who specialize in this area will be aggressive in filing class and collective actions against employers that are not in compliance.

Employers should begin their compliance efforts as soon as possible. Many companies will have a robust list of action items to complete in a relatively short period of time. For example, it will often take a company several months to design and implement a thoughtful and comprehensive job duties analysis of job titles that may arguably be borderline.

The final rule makes no changes to existing state and local laws governing wage and hour matters. Company compliance efforts should include devoting appropriate attention to such requirements. Finally, in part because this is an election year, employers should continue to closely monitor developments in jurisdictions in which they have operations. There is already some speculation some states may enact ''copy-cat'' increases to state law minimum salary requirements.

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