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Approaches To Hourly Rates Under DOL White Collar Rules

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Deborah K. Foster Stephen G. Bronars

The recent notice of proposed rulemaking from the U.S. Department of Labor's Wage and Hour Division outlines changes to the white collar exemption requirements that the DOL estimates will result in approximately 4.6 million workers becoming eligible for overtime.[1] Although the final rule can differ from the notice of proposed rulemaking[2] and likely would not become effective until sometime in 2016[3] at the earliest, it behooves employers to plan how they would react and start collecting information they will need if and when the time comes.

Although the specific salary threshold may differ between the notice of proposed rulemaking and the final rule, it is advisable to begin considering how hourly rates will be set for previously salaried employees. At first glance, this may seem like an exercise in simple arithmetic, but practically speaking, there are nuances and complications that must be addressed before even simple calculations are undertaken.

One Approach: Using the Same Hourly Rate for the Same Hours

To understand some of the complications that arise, start with the simplest situation: Sally Worker is an exempt employee (whose duties would clearly pass the duties test) earning an annual salary of $43,000 and working 42 hours per week for 50 weeks (assuming two weeks of paid vacation) each year. Her hourly pay is simply her total earnings divided by her total work hours for the year. For Sally, that means dividing her salary of $43,000 by her 2,100 annual work hours (calculated as 42 hours per week times 50 weeks per year) for an hourly rate of $20.48.

However, if Sally becomes eligible for overtime under the final rule, she must now be compensated at 1.5 times her rate for all hours over 40 in each week.[4] Applying the hourly rate of $20.48 calculated above, her total compensation for the year would be $44,032.[5] That means Sally would be paid over $1,000 more per year as a nonexempt employee than as an exempt employee for the exact same work hours.

Another Approach: Lowering the Base Hourly Rate to Counteract the Overtime Premium

Critically, the regulations do not specify how the hourly rate for previously salaried employees must be calculated; employers can set the hourly rate at a lower amount to offset the anticipated value of the overtime premium.[6] For example, to keep Sally's total annual compensation the same (at $43,000), the hourly rate must be reduced by inflating hours over 40 in a week to reflect the overtime premium. Her adjusted weekly work hours are 40 regular hours plus two overtime hours multiplied by the 1.5 overtime premium. Sally's total adjusted work hours for the year are then the 43 adjusted work hours per week multiplied by 50 work weeks per year for a total of 2,150 hours. The corresponding adjusted hourly rate is her annual salary of $43,000 divided by the adjusted annual hours of 2,150, which is $20 per hour. At that rate and at these specific hours, her annual compensation would be the same whether she is classified as exempt or nonexempt.

Of course, the rate calculation is not likely to be so straightforward for most employees. Several of the more pressing issues that employers should consider in setting hourly rates for previously exempt employees are discussed below.

How Much Overtime Will Be Worked?

A key input into the hourly rate calculation is the total (and then adjusted) weekly work hours. In our experience, most firms do not require salaried employees to track their work hours and therefore do not have accurate measures of hours worked by exempt classified employees.[7] Employers may want to find ways to collect that information immediately.

Possible solutions include requiring employees to start tracking hours now (before the regulations become effective) to provide some baseline prior to the implementation, asking the employees and/or their direct supervisors about work hours, examining alternative data sources (such as building entry and exit security swipe times, computer log-on and log-off times, etc.), or performing time and motion studies that observe workers over some period of time. The best options for an employer will depend on the nature of the work performed, the data sources readily available and the composition of its workforce. Although collecting and analyzing hours worked data is time-consuming and potentially expensive (particularly if a new time-keeping system must be implemented), it is critical to understanding the range of possible hourly rates and identifying the one that best equates employees' compensation under exempt and nonexempt classifications.

To underscore the importance of using the correct work hours in the rate calculation, recall Sally Worker, whose hourly rate of $20 is based on an assumption that she works 42 hours per week. If this assumption is inaccurate and she actually works 45 hours per week, then her total annual income with an hourly rate of $20 would be $47,500[8], which is a substantial increase from $43,000. On the other hand, if Sally actually only works 40 hours per week, her annual income would decline to $40,000.[9] Assuming Sally works the same hours before and after reclassification, inaccurate assumptions about weekly work hours that are off by just a few hours (between 40 and 45 hours) generate a difference of over $7,000, which is over 16 percent of her exempt annual salary of $43,000. For Sally Worker, this is a

meaningful difference, but this difference is greatly magnified by considering *all* similarly affected employees employed by Sally Worker's firm.

Do Overtime Hours Vary From Week to Week?

While the general approach to the hourly rate calculation is to look at total earnings and total hours on an annual basis, that calculation is more accurate when overtime is spread relatively evenly over the year. Often, however, overtime fluctuates week to week based on workload, or may be heavily concentrated in a relatively short busy season.

Returning to Sally Worker, all of the calculations above assume her work hours are consistent week to week. In the baseline scenario, she works 42 hours per week for an annual total of 2,100 hours, of which 100 (two hours per week multiplied by 50 weeks) are eligible for overtime. If her 50 workweeks instead showed 10 weeks each at 38, 40, 42, 44 and 46 hours of work, she would still have a total of 2,100 hours over 50 weeks. In this scenario, however, 120 of those hours are eligible for overtime and her annual compensation would be $43,200.[10] Allowing weekly work hours to fluctuate from 38 to 46 hours increases total pay by $200 for the exact same number of total work hours.

Variation in weekly hours also alters the timing of earnings to the employees. Salaried employees receive consistent earnings, even when hours fluctuate week to week; however, hourly employees' earnings fluctuate, sometimes rather widely. For example, consider Sally Worker with her 2,100 total work hours of which 100 are eligible for overtime. If those hours were evenly distributed, her weekly earnings would be $43,000 divided by 50 weeks, which equals $860. If instead she worked in an industry where virtually all overtime is concentrated in a short period (such as holiday season for the retail industry or summertime for the tourism industry), it is possible all 100 overtime hours could occur over eight consecutive weeks. In that case, her weekly earnings for 42 weeks (the majority of the year) would be only $800 per week and then increase up to $1,175 per week for the eight weeks with overtime. In setting the hourly rates, employers should be aware of the impact such fluctuations may have on employees.

In addition to altering the timing of earnings across weeks, nonexempt employees also take on risk that the same number of work hours will still be available. To the extent that hourly rates are set based on an assumption of total work hours, if fewer work hours are actually available to the employee, then the worker will have lower earnings if they are unable to work as many hours as originally anticipated.

Are There Other Earnings That Will Complicate Rate Estimates?

Overtime is to be paid at the regular rate, not just the hourly rate. Earnings such as bonuses, commissions and rate differentials (among others) that employees may earn should be included in the hourly rate calculation.

As an example, assume Sally Worker still has an hourly rate of $20 and works her 1,200 total hours (of which 100 hours receive the overtime premium), but now she also receives a $5,000 nondiscretionary bonus at the end of the year.[11] The bonus payment means that her regular rate is now different from her hourly rate. If the $5,000 is allocated across all of her work hours for the year, then the bonus amount per hour worked is $2.38. Therefore, in addition to the $5,000 bonus, Sally is also owed $119[12] in incremental overtime for the bonus earnings.[13]

One possible solution is to simply decrease the bonus amount by $119 to cover the additional overtime

premium due, but this may not be possible as nondiscretionary bonuses are often formula-based and tied to firm performance. Instead, to the extent bonus amounts are known or reasonably estimated in advance, they should also be included in the calculation to determine the base rate at which total earnings will be the same before and after reclassification.

For Sally Worker, that means reducing the base rate from $20 to $19.94. Of course, should company performance be less than projected such that the actual bonus amount is lower than expected, Sally would make *less* as a nonexempt employee than she would have as an exempt employee because all of her earnings throughout the year were paid at the reduced base rate to account for the anticipated but unpaid bonus.

Can An Employee's Individual Preferences Change Work Hours?

Economic theory predicts that employees may choose to change their behavior with the new compensation system based on individual preferences. Some may view it as an opportunity to earn more and work more hours than before. Others may place a higher value on free time and elect to work fewer hours (while earning less). Still others may desire to keep both hours and earnings the same as before. The extent to which employees can choose the quantity and allocation of work time will impact the accuracy of rates based on current hours and earnings.

What About Employees on the Margin?

For employees whose job function passes the duties test and whose total annual earnings are very close to the earnings minimum required to be classified as exempt (estimated to be $971 per week in the current proposed regulations), whether they pass the salary test may depend on things like the total hours worked and other earnings that cannot be perfectly predicted at the time employee classification decisions must be made. If employees classified as nonexempt end up exceeding the minimum threshold, firms will be paying overtime premiums that were not required. On the other hand, if an employee is classified as exempt on the assumption the minimum threshold will be met, but it isn't, the employer can be sued for misclassification. Adding to the headache, the current proposed regulations require the salary test to be adjusted on an annual basis. It is therefore possible, even likely for several occupations in several geographic areas, that employees close to that threshold exceed it in one year but fall short in a subsequent year.

Another concern arises from the fact that oftentimes employees in the same position at the same employer make somewhat different amounts, based on differences in their experience, productivity or other factors, which is not accounted for in the proposed rule. It could therefore happen that, among employees in the same job in the same location, some pass the salary test while others do not. Because of the time tracking requirements for nonexempt employees, it can be logistically challenging to ensure the right information is collected on the right employees and their pay is determined on the proper basis.

Conclusion

Although the proposed rule may change in response to comments submitted to the DOL, as a practical matter, employers should not delay thinking about measuring work hours and potential changes to their compensation structure so that they will be prepared for the final rule when it is implemented.

—By Stephen G. Bronars, Deborah K. Foster and Nathan D. Woods, Edgeworth Economics LLC

Stephen Bronars, Deborah Foster and Nathan Woods are partners in Edgeworth Economics' Washington, D.C., office.

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[1] See Notice of Proposed Rulemaking, p. 10.

[2] According to the Office of the Federal Register's "A Guide to the Rulemaking Process," the agency may proceed with a final rule "if the changes are minor, or a logical outgrowth of the issues and solutions discussed in the proposed rules."

[3] The notice of proposed rulemaking does not include an effective date for the final rule; however, footnote 1 of the notice of proposed rulemaking (p. 8) states that "the Department would likely rely on data from the first quarter of 2016" to determine the 40th percentile of weekly earnings for the final rule (if needed).

[4] For purposes of this article we focus on overtime under the Fair Labor Standards Act and do not comment on how specific state laws, including those relating to daily overtime, may further complicate this analysis.

[5] Calculated as [(40 regular hours times $20.48 per hour) plus (two overtime hours times $20.48 per hour times 1.5 overtime premium)] times 50 weeks per year equals $44,032.

[6] In fact, the DOL's own analysis of the benefits of the new regulations anticipates employer responses, including "reducing the regular rate of pay for workers working overtime" (notice of proposed rulemaking, p.173).

[7] This is the same issue that arises in many misclassification class actions where it is alleged that employers owe employees the overtime premium for all overtime hours worked, but accurate time records do not exist to track that alleged time.

[8] Calculated as (40 regular hours times $20 per hour times 50 weeks per year) plus (five overtime hours times $20 per hour times 1.5 overtime premium times 50 weeks per year) equals $47,500.

[9] Calculated as (40 regular hours times $20 per hour times 50 weeks per year) equals $40,000.

[10] Calculated as (1,980 regular hours times $20 per hour) plus (120 overtime hours times $20 per hour times 1.5 overtime premium) equals $43,200.

[11] One issue regarding the proposed regulations that is open for comment is allowing employers to include other earnings such as bonuses as part of the salary (up to 10 percent) for purposes of the salary level test (see pages 71-72 of the notice for proposed rulemaking); however, the bonuses would need to be paid monthly (or more frequently). Depending on the final rule, it is possible that firms will elect to eliminate bonuses over the 10 percent threshold, eliminate bonuses paid less frequently than monthly or eliminate bonuses of all types.

[12] Calculated as $2.38 per hour times 100 overtime hours times 0.5 overtime premium equals $119.

[13] The payroll procedures to properly calculate the incremental overtime due for delayed lump payments, such as bonuses and commissions also need to be designed and implemented.

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