SEYFARTH SHAW
MANAGEMENT ALERT

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The DOL's Proposed Revisions to Its Exempt Status Regulations: What Will They Mean for Your Company?

The U.S. Department of Labor (DOL) issued proposed revisions to its regulations on the "white-collar" exemptions to the Fair Labor Standards Act (FLSA) on March 31, 2003. If enacted in a version close to their present form, the revisions would contain the most substantial changes in more than 50 years to the way employers determine whether they are obligated to pay employees overtime compensation.

Background

The FLSA generally requires employers to pay their employees at least the federal minimum wage (currently $5.15 an hour), and overtime premium pay of time-and-one-half the regular rate of pay for all hours worked over 40 in a week. But the FLSA includes a number of exemptions from these requirements. The best-known and most significant of these exemptions is for "any employee employed in a bona fide executive, administrative, or professional capacity . . . or in the capacity of outside salesman" exemptions included when the FLSA originally was enacted by Congress in 1938, and which commonly are dubbed the *white-collar* exemptions. Congress has never defined the terms "executive," "administrative," "professional," or "outside salesman" as used in the FLSA, leaving that task to the DOL.

The DOL issued its first exempt-status regulations in 1940. Those regulations set forth three requirements that generally must be met for an employer to show that an employee is exempt under one of the white-collar exemptions: (i) that the employee is paid at least a certain compensation level; (ii) that the employee is paid on a salary, rather than on an hourly, basis; and (iii) that the employee performs certain exempt duties. Despite 63 years of a dramatically changing economy, those original regulations have remained relatively unchanged. The DOL has not changed the salary level required for exempt status since 1975. It has not altered the salary-basis test, at least as applied to the private sector, since 1958. It has not amended the duties test in any significant fashion since 1950.

The DOL's proposed revisions would alter all three of these requirements. In some cases, the revisions would make it more difficult for an employer to classify an employee as exempt. In probably more cases, the revisions would remove some of an employer's uncertainty in classifying an employee as exempt.

The DOL has invited interested parties and the general public to submit written comments by June 30, 2003. The DOL then will evaluate those comments and perhaps modify the proposed revisions. It hopes to enact these revisions to the white-collar exemptions by the end of this year (and certainly before the beginning of the federal campaign season).

The DOL's proposed revisions are discussed in detail below:

Salary Levels

As mentioned above, the DOL has set a minimum salary level for an employee to be classified as exempt under one of the white-collar exemptions. The current minimum salary level is $155 per week. That level has not been adjusted since 1975, and obviously is low. Indeed, a nonexempt employee who works a 40 hour week must be paid a minimum of $206 for that week, a level well above the minimum salary level for an exempt employee.

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The DOL proposes to raise the minimum salary level to $425 per week, an annualized salary of $22,100. How many employees this would affect remains to be seen. Due to market pressures, many employers in many parts of the country already pay all their exempt employees a weekly salary already above $425. Accordingly, while some media outlets have publicized this as a significant change, its not likely to be that big a change for most employers.

Salary Basis

A more significant change to the exempt-status regulations are the DOL's revisions to the salary basis test. To qualify as an exempt executive, administrative, or professional employee, an employee must be paid on a *salary basis*, under which the employee must regularly receive a predetermined compensation amount (salary) on a weekly or less frequent basis, that "is not subject to reduction because of variations in the quality or quantity of the work performed." With a few exceptions, therefore, an exempt employee must receive his or her full salary for any week in which the employee performs any work without regard to the number of days or hours worked. This requirement — and some of the highly technical exceptions to it — has resulted in substantial litigation, particularly throughout the 1990s, with sometimes disastrous results for employers.

The DOL proposes to make two changes to the salary basis test, both of which could provide employers some relief from potential salary basis lawsuits. The first revision would allow an exception to the so-called "no disciplinary docking" rule. Under the current test, an employer generally may not suspend an employee without pay for disciplinary reasons in any increment other than a full week, without violating the salary basis test. This has meant that in many cases exempt employees are subjected to different progressive discipline than nonexempt employees. For example, if a violation of a sexual harassment policy would result in a one-day or three-day unpaid suspension for a nonexempt employee, an employer could not discipline an exempt employee for the same infraction without running afoul of the salary basis test. Thus, the employee would have to be suspended *with* pay (which may not be viewed by a court in a harassment case as sufficiently appropriate corrective action) or be suspended for a week, a period *longer* than the period for which a nonexempt employee would be suspended. The proposed revisions would allow an employer to suspend an exempt employee without pay in full-day (but not partial-day) increments, instead of merely in full week increments. This will allow employers to hold exempt employees to the same standards of conduct as nonexempt employees, without violating the salary basis test.

The second proposed revision greatly reduces the potential for "gotcha"-type salary basis litigation. Throughout the 1990s, employers faced claims by groups of employees that they were rendered nonexempt (and thus owed overtime) because a few of the employees in that group suffered improper deductions, and thus all employees in that group who were *subject* to these improper deductions also become nonexempt. Where an improper deduction occurred, sometimes the employer's only defense was to utilize the "window of correction" under which an employer who inadvertently makes impermissible deductions can, in some circumstances, retain the exemption by reimbursing the employee for any improper deductions. But that window of correction has been the subject of several lawsuits, and some courts have interpreted it narrowly. The DOL's proposed regulation expands the window of correction by stating that an employer who makes improper deductions from salary loses the exemption only "if the facts demonstrate that the employer has a pattern and practice of not paying employees on a salary basis," and that isolated or inadvertent deductions will not result in loss of the exemption. It specifically provides that when an employer has a written policy that prohibits improper pay deductions from exempt employees, notifies employees of that policy, and reimburses employees for any improper deductions, the employer does not violate the salary basis test, unless it repeatedly and willfully violates such a policy. This proposed revision would remove much of the mystery from the salary basis test, and would not unduly penalize employers for innocent violations.

Duties Test

Perhaps the most significant body of proposed changes is to the "duties test." Each white-collar exemption has its own duties test, most of which have confused employers, employees, DOL investigators, and courts. With the exception of the computer professional exemption — to which no material substantive changes are proposed — the DOL proposes to alter the duties test for each of the major white-collar exemptions.

As to all of the white-collar exemptions, the DOL proposes to eliminate the distinction between the "short test" and the "long test." Under the current regulations, the executive, administrative, and professional exemptions contain two duties tests: a long test for employees who make less than $250 per week, and a shorter, more simplified test for those who make $250 or more per week. Because so few truly exempt employees make less than $250 per week, the long test has not served a useful purpose for many years. Its presence in the regulations only sidetracked employers, practitioners, and courts that attempted to read the regulations. The short test has been the test under which nearly all exempt employees' classifications have been analyzed. The DOL proposes to create one standard test, for each white-collar exemption, so long as the employee is paid the minimum salary of $425 per week.

The highlights of the DOL's proposed duties test changes as to each white-collar exemption are as follows:

- ***Executive employees***. Under the current short test, an exempt executive employee must: (i) have a primary duty of the management of the enterprise or a recognized department or subdivision; and (ii) customarily and regularly direct the work of two or more other employees. Additional requirements exist under the long test, including the requirement that the employee have the authority to hire or fire other employees, or at least make effective recommenda-

tions as to the hiring and firing of other employees. The DOL's proposed rule would place all three of these requirements from the short and long tests into one standard test. Under the proposed revisions, greater emphasis is placed on disciplinary authority.

- ***Administrative employees***. Among the more significant aspects of the proposed regulations is the modification to the administrative exemption. The current short test provides that an employee is exempt if he or she: (i) has a primary duty of performing office or nonmanual work directly related to management policies or general business operations of the employer or the employer's customers; and (ii) regularly exercises discretion and independent judgment. Of all the white-collar exemptions, this exemption has been the most difficult to apply, stemming mainly from questions about whether an employee exercises sufficient "discretion and independent judgment." This exemption has generated significant confusion and litigation, most notably with respect to insurance adjusters. Indeed, a California court recently held that an insurance company owed in excess of $90 million to its current and former claims adjusters due to their misclassification under the administrative exemption. Even more fundamental, the discretion and independent judgement requirement has, in two respects, proven difficult to apply in an information- and technology- based economy: First, many employers have sought to gain efficiencies and streamline decision-making by issuing guidelines, manuals, or computer programs that arguably restrict their employees' discretion and independent judgment. Second, many intelligent employees perform technical and highly-skilled work, but do not exercise discretion and independent judgment to a substantial degree.

Accordingly, the DOL proposes to eliminate the discretion and independent judgment requirement. It proposes to retain the requirement that an exempt administrative employee have a primary duty of office or nonmanual work, directly related to management policies or general business operations and add the requirement that the employee hold a "position of responsibility." A position of responsibility is defined as performing work: (a) "of substantial importance"; or (b) "requiring a high level of skill or training." This revision would help ensure that the administrative exemption is not denied to an employee merely because he or she uses a procedures manual or computer program to aid in his or her duties. It potentially could result in substantial expansion of the administrative exemption to those who probably should have been considered exempt all along.

- ***Learned Professional employees***. The DOL proposes to revise the learned professional exemption in two ways. The current short test for that exemption provides that no overtime compensation need be paid to those who: (i) have a primary duty of performing work requiring knowledge of an advanced type in a field of science or learning, customarily acquired from a prolonged course of specialized intellectual instruction and study; and (ii) consistently exercise discretion and judgment. The main source of concern to employers from the current professional exemption test has been uncertainty about the treatment of some "knowledge workers" that are more prevalent in an information- and technology-based economy. While the current regulations contain some flexibility, they have often been interpreted to limit the professional exemption to those who have obtained four-year degrees in a field of science or learning, and exclude from the exemption those who have acquired analogous advanced knowledge through some combination of college education, training, apprenticeship, and/or work experience.

The proposed revision to the professional exemption would make clear that such employees are not necessarily to be excluded from the exemption. It explicitly states that advanced knowledge "may be acquired by alternative means such as an equivalent combination of intellectual instruction and work experience." Consistent with the administrative exemption, the proposed revision would also eliminate the discretion and judgment requirement.

- ***Highly Compensated employees***. The proposed regulations include a special rule for so-called highly-compensated employees. Employees paid $65,000 or more annually and performing nonmanual work, would be exempt if they have one identifiable executive, administrative, or professional function as described in the standard duties tests. They would not have to meet *all* of the duties tests under either the executive, administrative, or professional exemptions. Rather, they would only have to meet one of the requirements set forth in one of those exemptions to be exempt, provided they make at least $65,000 per year, including commissions and non-discretionary bonuses. It also appears that such employees would not need to be paid "on a salary basis."

- ***Outside Salespersons***. The DOL proposes to make one minor change to the outside sales exemption. The current test provides generally that exempt outside sales employees must regularly and customarily be engaged away from the employer's business for the purpose of making sales or of obtaining orders or contracts. The current test also states that such an employee cannot devote more than 20 percent of his or her time to nonexempt, non-sales related activity. The DOL proposes to remove this 20 percent limitation on nonexempt work, and instead require that making outside sales be the employee's "primary duty" without any percentage or numerical limitations on nonexempt, non-sales work.

What These Revisions Will Not Do

No one should bank on last month's action by the DOL. It has made only proposed revisions at this point. The DOL could modify them substantially after the notice and comment period, or withdraw them altogether — particularly if unions and employee advocacy groups strenuously object to the proposed revisions, and if the White House believes that the prospect of its own reelection and that of a Republican-majority House and/or Senate in November 2004 require a retreat.

Further, these revisions — if enacted — may well not have retroactive application. However they possibly may influence the way courts consider pending cases. This means that, for the remainder of this year, employers should make any exempt status determinations based primarily on the regulations that are and have been in place, not on what the revised regulations might be. This also means that a company currently subject to exempt status litigation cannot place much reliance on the proposed regulations. It will have to litigate the classification of its exempt employees essentially under the current regulations, but can make the argument that they shouldn't be accorded as much deference.

Moreover, employers must not forget the impact of state wage-and-hour laws. States often have their own overtime laws, some of which diverge from the FLSA in significant respects, especially in the details of the white-collar exemptions. Although some states' exemptions to their overtime laws provide that they change as the FLSA's overtime exemptions change, other states define the white-collar exemptions in their own ways. Merely because the federal regulations on the white-collar exemptions change does not necessarily mean that certain states' white-collar exemptions will change as well, or at the same time. Accordingly, employers should continue to determine their employees' exempt status under both federal and state laws.

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