

Preparing for the Department of Labor's Final Rule Amending the FLSA's 'White-Collar' Exemption Requirements

by Martin W. Aron and Allison J. Vogel

On May 23, 2016, the U.S. Department of Labor (DOL) published its final rule amending the federal Fair Labor Standard Act's (FLSA) overtime exemptions for 'white-collar' employees. The DOL's administrative action will result in approximately 4.2 million exempt employees becoming eligible to receive overtime and impose an increase in wages of \$1.2 billion per year upon the domestic business community throughout the United States.¹ The DOL also has created a mechanism that will automatically update the salary level for exemption every three years.² Based upon current estimates, 43 million employees may be impacted by these changes.³ The final rule will take effect on Dec. 1, 2016.

This article is intended to provide an overview of the DOL's changes to the white-collar exemptions and their impact on employers. Companies have already been undertaking preparations for implementation of the final rule. All impacted employers can and should take affirmative steps to adjust their employment practices in light of these changes in order to avoid lawsuits, fines, and other penalties. This article discusses the white-collar exemptions and the DOL's amendments to the regulations. The article also discusses preemptive steps employers can take to prepare for the anticipated changes before the new regulations become effective.

White-Collar Exemptions

Employees are generally classified as either exempt or non-exempt, which refers to their eligibility for overtime pay, although there are additional requirements for documentation of work time that apply as well. The FLSA guarantees a minimum wage and requires employers to pay overtime to nonexempt employees who work more than 40 hours in a given workweek, unless they meet certain exceptions.⁴ The FLSA provides an exemption from minimum wage and overtime pay protections for *bona fide* executive, administrative, professional, outside sales, and computer employees (*i.e.*, the white-collar exemptions).⁵

As a general rule, for an employee to be in an exempt executive position: 1) the employee must be compensated on a salary basis at a rate not less than \$455 per week; 2) the employee's primary duty must be managing the enterprise in which he or she is employed or of a customarily recognized department or subdivision thereof; 3) the employee must customarily and regularly direct the work of two or more other employees; and 4) the employee must have the authority to hire or fire other employees, or the employee's suggestions and recommendations regarding the hiring, firing, advancement, promotion or any other change of status of other employees must be given particular weight.⁶

Similarly, an employee qualifies for the administrative exemption if: 1) the employee is compensated on a salary or fee basis at a rate not less than \$455 per week; 2) the employee's primary duty is the performance of office or non-manual work directly related to the management or general business operations of the employer or the employer's customers; and 3) the employee's primary duties include the exercise of discretion and independent judgment with respect to matters of significance.⁷

An employee is considered exempt under the professional exemption if: 1) the employee is compensated on a salary or fee basis at a rate not less than \$455 per week, and 2) the

employee's primary duty is the performance of work requiring knowledge of an advanced type in a field of science or learning customarily acquired by a prolonged course of specialized intellectual instruction or requiring invention, imagination, originality or talent in a recognized field of artistic or creative endeavor.⁸

Lastly, a highly compensated employee (HCE), which is defined as an employee with total annual compensation of at least \$100,000, is considered to qualify for a white-collar exemption if he or she "customarily and regularly performs any one or more of the exempt duties or responsibilities of an executive, administrative, or professional employee."⁹

Proposed Amendments

On March 13, 2014, President Barack Obama directed the DOL to modernize and simplify the regulations for exempt white-collar employees.¹⁰ The DOL last updated the salary level requirements for the exemption in 2004.¹¹ As indicated above, prior to the proposed amendments, the salary threshold for exemption was set at \$455 per week (\$23,660 per year).¹²

In June 2015, the DOL issued a notice of proposed rulemaking (NPRM).¹³ On July 6, 2015, the NPRM was published in the *Federal Register*. The DOL stated the purpose of the final rule was "to update the salary level required for exemption to ensure that the FLSA's intended overtime protections are fully implemented, and to simplify the identification of nonexempt employees, thus making the [executive, administrative and professional employee] exemption easier for employers and workers to understand."¹⁴ The DOL stated it also sought to "automatically updat[e] the salary level to prevent the levels from becoming outdated with the often lengthy passage of time between rulemakings."¹⁵ In the course of its proposal, the DOL stated it was "considering revisions to the duties tests in order to ensure that they fully reflect the purpose of the exemption."¹⁶

The DOL's proposal focused primarily on updating the salary and compensation levels needed for white-collar workers to be exempt.¹⁷ Specifically, the DOL proposed setting the standard salary level at the 40th percentile of earnings for full-time salaried workers from \$455 per week (or \$23,660 annually) to \$921 per week (or \$47,892 annually) and increasing the highly compensated annual compensation level to the 90th percentile of weekly earnings of full-time salaried workers from \$100,000 annually to \$122,148 annually.¹⁸ The DOL stated it considered these levels to be appropriate in distinguishing between exempt and nonexempt employees.¹⁹

Further, the DOL proposed a mechanism to automatically update the standard salary level and HCE annual compensation level annually.²⁰ In so doing, the DOL acknowledged that nominal increases in wages typically expand the number of employees who qualify for the white-collar exemption despite no change in job duties or real earnings. The DOL stated the implementation of such a mechanism would allow these levels "to keep pace with changes in either prices or earnings, keeping the real value of the salary level constant over time" and "to continue to serve as an effective dividing line between potentially exempt and nonexempt workers."²¹

The proposed regulations were subject to a 60-day comment period, which closed on Sept. 4, 2015. In March 2016, the DOL submitted the final rule to the White House's Office of Management and Budget (OMB) for review.

Summary of the Final Rule

On May 23, 2016, the final rule was published in the *Federal Register*.²² While the DOL increased the standard salary level, enhanced the HCE annual compensation level, and established a mechanism for automatically updating these levels, the extent of the increases and timing of the adjustments differ between the NPRM and the final rule.²³ The final rule does not contain any changes to the duties tests for the white-collar exemptions.²⁴

As anticipated, the final rule increased the standard salary level to the 40th percentile of earnings for full-time salaried workers, but set the rate based upon the salary of workers in the lowest wage Census region (currently, the South) rather than nationally.²⁵ The prior salary level of \$455 per week (or \$23,660) in 2004 using salary data from the South, was set at the 20th percentile.²⁶ Under the final rule, the salary level will increase from \$455 per week (or \$23,660 annually) to \$913 per week (or \$47,476 annually).²⁷ The new salary level will require employers nationwide to pay exempt employees a greater salary than the minimum salary level necessary for a white-collar employee to be exempt from state overtime laws in California (\$41,600 in 2016) and New York (\$35,100 in 2016).²⁸

Additionally, the final rule increased the highly compensated annual compensation level to the 90th percentile of weekly earnings of full-time salaried workers from \$100,000 annually to \$134,004 annually.²⁹ Unlike the standard salary level, which was based upon the salary of workers in the lowest income Census region, the salary level for HCEs was based on nationwide data for full-time workers.³⁰ While the NPRM proposed setting the salary level to \$122,148, the DOL explained that the figure represented the annualized weekly earnings of the 90th percentile of full-time salaried workers nationally in 2013.³¹ The DOL set the salary level at \$134,004 based upon the annualized weekly earnings of the 90th percentile of full-time salaried workers nationally in the fourth quarter of 2015.³²

The final rule established a mechanism to automatically update the standard salary level and HCE annual compensation level every three years.³³ This differs from the NPRM, which proposed updating the standard salary level and HCE annual compensation level annually. No specific rulemaking will be required for adjustments to the salary level.³⁴ The increases will be set at the 40th percentile for the lowest wage Census region for the standard salary level and the 90th percentile nationally for the HCE annual compensation requirements.³⁵ The final rule provides that the DOL will publish the new rates in the *Federal Register* at least 150 days before their effective date and post the new information on their website.³⁶

Considerations for Compliance

It is prudent for employers to take affirmative steps to review workforce classifications of exempt and non-exempt employees before the new regulations take effect on Dec. 1, 2016. Under the final rule, employees who are currently classified as exempt but whose salaries fall below the new salary threshold will be considered nonexempt and entitled to overtime, unless their employers increase their salaries in attempting to retain the exemption.

There are several ways employers can prepare for the new regulations. Since the DOL's primary focus is on increasing the standard salary level, employers should identify which employees and positions may be impacted by the regulations. Employers should audit their payroll and timekeeping records in order to identify exempt employees who earn less than \$913 per week (or \$47,476 annually). Companies should consider conducting a wage and hour audit to prepare for the upcoming changes and to assess previous classifications that may have been problematic.

Once employers identify the impacted employees and positions, they will need to determine whether to increase employee salaries in order to retain the exemption, reclassify the employees as nonexempt and pay overtime for hours worked over 40, or reassign work to avoid overtime hours. Notably, under the final rule, employers will be able to use commissions, nondiscretionary bonuses, and other incentive compensation, in part, to satisfy the salary level requirement.³⁷ The final rule clarifies, however, that only 10 percent of the salary level can be paid in the form of this incentive pay, and it must be paid quarterly.³⁸ Further, employers may make a “catch up” payment if an employee fails to satisfy the salary level requirement in order to avoid losing the exemption.³⁹ By reviewing the number of hours worked by these employees in excess of 40 hours in a given work week, employers can determine whether it would be more cost effective to increase employee salaries, pay overtime or reassign work. Employers will need to take these factors into consideration when budgeting labor costs.

Companies must bear in mind that reclassifying a group of employees requires consideration of non-legal factors that impact the manner in which employees respond to the reclassification. The reclassification must be presented in a favorable light to the reclassified employees. If the reclassification is not explained to employees, it can create irreversible harm to workplace morale. Additionally, employers should be prepared for questions from reclassified employees and train managers to respond appropriately to questions regarding the reasons and consequences of the reclassification.

Conclusion

The DOL’s final rule imposes significant changes on the classification of employees. The changes to the white-collar exemptions will inevitably impact the way employers compensate their employees, structure their positions and conduct their business. While the new salary levels will not be effective until Dec. 1, 2016, employers should not wait until the end of the year to assess their employment practices. By examining employee classifications, job duties, and timekeeping and payroll records, employers can take affirmative steps to comply with the final rule. The time and expense of proactively preparing is minimal when compared to the costs of overtime lawsuits, agency action, fines, and penalties that can arise from noncompliance.

Martin W. Aron is a principal and litigation manager in the Morristown office of Jackson Lewis P.C. Allison J. Vogel is an associate of the firm.

Endnotes

1. Defining and Delimiting the Exemptions for Executive, Administrative, Professional, Outside Sales and Computer Employees, 81 Fed. Reg. 32391 (May 23, 2016).
2. *Id.*
3. *Id.*
4. 29 U.S.C. § 207(a).
5. 29 U.S.C. § 213(a)(1); 29 U.S.C. § 213(a)(17).
6. 29 C.F.R. 541.100(a).
7. 29 C.F.R. 541.200(a).
8. 29 C.F.R. 541.300(a).
9. 29 C.F.R. 541.601(a).
10. Defining and Delimiting the Exemptions for Executive, Administrative, Professional, Outside Sales and Computer Employees, 80 Fed. Reg. 38516 (July 6, 2015).
11. *Id.*
12. *Id.*

13. *Id.*
14. *Id.*
15. *Id.*
16. *Id.*
17. *Id.*
18. *Id.*
19. *Id.*
20. *Id.*
21. *Id.*
22. 81 Fed. Reg. 32391 (May 23, 2016).
23. *Id.*
24. *Id.*
25. *Id.*
26. *Id.*
27. *Id.*
28. *Id.*
29. *Id.*
30. *Id.*
31. *Id.*
32. *Id.*
33. *Id.*
34. *Id.*
35. *Id.*
36. *Id.*
37. *Id.*
38. *Id.*
39. *Id.*