

FLSA WHITE-COLLAR REGULATIONS

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On April 20, 2004, the Wage & Hour Division of the Department of Labor released the unofficial text of the final rule implementing the exemptions from overtime pay for executive, administrative, professional, outside sales and computer employees (known collectively as the “white collar” exemptions). The rule was published in the Federal Register on April 23, 2004, and goes into effect on August 23, 2004. Employers now have less than 120 days to come into compliance with the new rule.

To assist employers in this effort, this White Paper (1) describes the background to the rule and its promulgation, including the latest legislative efforts to counteract the rule; (2) contains a detailed analysis of the changes the rule makes to the white-collar exemptions; and (3) recommends important steps employers should take to evaluate their own compliance under the new standards before the new rule goes into effect.

I. BACKGROUND

In 1938, Congress enacted the Fair Labor Standards Act (“FLSA”) to establish federal wage and hour standards for covered employees in the public and private sectors. The FLSA sets a minimum wage and requires overtime compensation for hours worked in excess of 40 hours in a workweek. The overtime provisions, however, do not apply to any worker who qualifies for one of the so called white-collar exemptions. These exemptions were premised on “the belief that the workers exempted typically earned salaries well above the minimum wage, and they were presumed to enjoy other compensatory privileges such as above average fringe benefits, greater job security and better opportunities for advancement, setting them apart from the nonexempt workers entitled to overtime pay.” Federal Register, Vol. 68, No. 61, March 31, 2003.

First published in 1940, the regulations implementing the white-collar exemptions remained virtually unchanged for more than 50 years. The current effort to update the regulations began in 1999, when the U.S. General Accounting Office suggested that the Department of Labor amend the white-collar regulations to “better meet the needs of both employers and employees in the modern work place, and to anticipate future work place trends.” *Id.* Thereafter, in 2002, the Department of Labor solicited suggestions for changes from both employee and employer interest groups. On March 31, 2003, the Department of Labor published a proposed rule to amend the regulations.

A. **Reaction to the Proposed Rule**

The proposed rule incited a furor among employee interest groups and congressional

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democrats. Although the DOL estimated that as many as 1.3 million workers could become eligible for overtime pay for the first time, critics charged that as many as 8 million workers could lose their overtime eligibility.

The DOL received more than 80,000 comments regarding the proposed rule from interest groups and individuals alike, most voicing displeasure with the proposals. Editorial pages of many leading newspapers were critical of the proposal, with a *New York Times* columnist accusing the Bush administration of having “the very bad habit of smiling at working people while siphoning money from their pockets.”

Fueled by the public’s response to the proposed changes, the Senate passed, on a 54-45 vote, an amendment sponsored by Senator Tom Harkin (D-Iowa) that precluded funding for any rule that would take away overtime eligibility. Although a similar measure had been narrowly defeated in the House, on October 2, 2003, the House approved a nonbinding motion instructing its conferees on the bill to accept the Senate’s language. Nonetheless, the amendment died in the House-Senate conference on the bill.

B. Reaction and Challenges to the Final Rule

As discussed in more detail below, the final rule, released on April 20, 2004, made several worker-friendly changes to the initially proposed rule. The changes muted the criticism of the final rule, at least temporarily, with many critics having to acknowledge the shift that had been made in response to the comments and criticisms of the proposed rule.

Strong opposition to some or all of the final rule remains, however. On May 4, 2004, the Senate passed, on a 52-47 vote, Senator Harkin’s amendment to an unrelated export tax bill that precludes giving any force or effect to any portion of the DOL’s final rule that would take away eligibility for overtime from any employee who is eligible for overtime under the current regulations. The House has not yet voted on its version of this legislation.

Senator Harkin, however, has expressed concern that his amendment will once again be stripped from this bill in the House-Senate conference committee, and has threatened to add the amendment to the 2005 Labor Department appropriations bill or other legislation.

Also on May 4, 2004, the Senate passed, on a 99-0 vote, an amendment offered by Senator Gregg (R-N.H.) that claims to preserve current regulatory status for 55 occupations or job classifications – ranging from “blue-collar workers” and “team leaders,” to computer programmers, registered nurses, cooks, chefs and plumbers, *to more controversial job classifications such as “assistant retail managers,” “financial services industry workers,” “grocery store managers,” “technicians,” and “outside sales employees.”* The strength of support for this amendment in the Senate suggests that it stands a stronger chance of surviving in the House and in conference committee.

Another possible challenge to the new rule may come in the form of litigation. The AFL-CIO has stated that it may decide to challenge the rule in court. “We hold open all of our options, one of which would be litigation,” said Christine Owens, public policy director at the AFL-CIO.

Unless and until critics of the new rule mount a successful challenge, however, employers must prepare to comply with the revised regulations by August 23, 2004. To assist employers in this effort, a detailed discussion of the new regulations, and recommended steps to evaluate compliance, are set forth below.

II. CHANGES TO THE WHITE-COLLAR EXEMPTIONS

The white-collar exemptions have three components: a duties test, a salary level test and a salary basis test. The salary level test and the salary basis test have undergone significant change in the new regulations. The changes in the duties tests involve the elimination of the “long and short form” tests for administrative, professional and executive exemptions, and subtle changes that could lead to a new round of legal challenges.

A. Salary Level Tests

For the first time, the minimum compensation level for the Executive, Administrative, Professional and Computer Employee exemptions is set at a uniform level. Employees in Puerto Rico, the Virgin Islands and American Samoa must receive the same minimum salary level as employees in the United States. There are, however, many exceptions to the general salary level rule.

- The minimum salary level is \$455 per week. 29 C.F.R. § 541.600(a).
 - Executive employees must be paid on a “salary basis.” §541.605(a).
 - Administrative employees may be paid on a salary basis or a “fee basis.” § 541.605(a).
 - Professional employees may be paid on a salary basis or fee basis. §§ 541.605(a) & 541.301(c).
- Workers in American Samoa who work for an employer other than the federal government must receive a salary of at least \$380 per week.
- Academic Administrative employees may be paid a salary at a rate at least equal to the entrance salary for teachers in the educational establishment by which the employees are employed. §§ 541.600(c) & 541.204(a)(1).
- The salary level test does not apply to physicians, lawyers and teachers.

§ 541.600(e).

- Computer Employees may be paid on a salary basis or a fee basis of \$455 per week or, in the alternative, may be paid an hourly rate of at least \$27.63. §§ 541.401(b) & 541.600(d).
- As under the current regulations, there is no minimum compensation level or required method of payment for Outside Sales employees. § 541.500(c).
- An employee who receives total annual compensation of \$100,000, at least \$455 per week of which is paid on a salary or fee basis, and who customarily and regularly performs any one or more of the exempt duties or responsibilities of an exempt executive, administrative or professional employee will be “deemed exempt” under the new “Highly Compensated Employee” regulation. § 541.601.

B. Salary Basis Test and Safe Harbor/Window of Correction Provisions

The general rule—that employees are paid on a “salary basis” when they receive a predetermined amount that constitutes all or part of their compensation, which amount is not subject to reduction based on variations in the quality or quantity of work performed—remains unchanged. However, the new regulations clarify some ambiguous terms in the prior regulations and carve out an additional exception to the general “no pay docking” rule.

- Deductions for absences for personal reasons or for sickness or disability (if in accordance with a bona fide sickness or disability leave policy or practice) are permissible only for *full-day* absences. § 541.602(b)(1) & (2).
- The exceptions permitting salary offset of jury duty fees, witness fees and temporary military pay and deductions for penalties imposed in good faith for infractions of safety rules of major significance remain unchanged.
- Employers will now also be permitted to impose unpaid disciplinary suspensions on exempt employees of one or more *full days* pursuant to workplace conduct rules that are *in writing* and applicable to *all* employees. § 541.602(b)(5).
- The regulations expressly incorporate the Family and Medical Leave Act provision permitting *partial-day* deductions from an exempt employee’s salary for unpaid FMLA leave. § 541.602(b)(7). This is the *only* partial-day deduction for salaried, exempt employees’ pay that is permitted for private employers. Public employers may still make partial-day deductions pursuant to a policy promulgated under the principles of public accountability, if it meets basic requirements. § 541.710.

- The regulations clarify that penalties imposed in good faith for infractions of safety rules of major significance may be in any amount. § 541.602(c).
- The regulations include a helpful discussion of the fact that an employer may provide additional compensation beyond an employee's salary to salaried, exempt employees without jeopardizing the exemption. For example, an employer may pay a salaried, exempt employee for hours worked beyond the normal workweek in the form of a flat rate, a straight-time hourly rate, a premium hourly rate or paid time off. § 541.604.

The new regulations clarify and expand the safe harbor and window of correction provisions when improper deductions are made.

- Only an “actual practice” of making improper deductions will lead to the loss of exemption for an employer's employees. The factors that will be considered in determining whether an employer has an actual practice of making improper deductions include the number of improper deductions, particularly in relation to the number of occurrences of the event which led to the deduction; the span of time during which deductions were made; the number and location of affected employees; the number and location of responsible managers; and whether the employer has a “clearly communicated policy” permitting or prohibiting improper deductions. § 541.603(a).
- An actual practice of deductions will result in the loss of “salary basis” and, therefore, exempt status, for salaried, exempt employees in the same job classification as the affected employees and working for the same responsible manager(s) for the workweek(s) of the improper deductions. § 541.603(b).
- Isolated or inadvertent deductions may be cured by the reimbursement of the improper deductions. § 541.603(c).
- Any employer that has a “clearly communicated policy that prohibits improper pay deductions and includes a complaint mechanism, reimburses employees for improper deductions and makes a good faith commitment to comply with its policy in the future” will not lose the exemption for any employees subject to improper deductions unless the employer willfully violates the policy by continuing to make deductions after receiving employee complaints. § 541.603(d).
- The best evidence of a “clearly communicated policy” is a written policy that was distributed to employees prior to the improper pay deductions, e.g., distributed at the time of hire, included in an employee handbook or posted on the employer's intranet site.

C. The Duties Tests—Generally

In addition to the elimination of the “long and short form tests” for the exemptions, the new regulations have a section dedicated to definitions and miscellaneous provisions that apply generally to all of the duties tests or that clarify terms used generally throughout the regulations. For the most part, these definitions are little more than clarification of the current state of the regulatory and case law.

- “Primary duty” is defined less in terms of the duties and responsibilities that occupy the majority of the exempt employee’s time and more in terms of the weight of the duties and responsibilities. § 541.700 (“The term ‘primary duty’ means the principal, main, major or most important duty that the employee performs.”).
- “Customarily and regularly,” a term used in the Executive and Outside Sales duties tests and the Highly Compensated employees salary level test, is defined for the first time to mean “a frequency that must be greater than occasional but which, of course, may be less than constant.” § 541.701.
- The regulations expressly acknowledge that the use of manuals that can be understood or interpreted only by persons with advanced or specialized knowledge in technical, scientific, legal, financial or other complex areas will not preclude exemption under the new white-collar regulations. § 541.704.
- The regulations expressly recognize that exempt employees will not lose their exempt status by virtue of performing nonexempt work in an emergency situation. § 541.706.

D. The Executive Duties Test

The primary change to the Executive duties test is the reintroduction of a requirement from the former “long test” that had been effectively written out of the test by salary inflation. § 541.100 (added requirement in *italics*, below).

- Primary duty must be management of an enterprise or a customarily recognized department or subdivision of the enterprise;
- The employee must customarily and regularly direct the work of at least two other full-time employees or their equivalent; and
- *The employee must have the authority to hire or fire other employees, or suggestions and recommendations from the employee about the hiring, firing, promotion or other status changes of subordinate employees must be given particular weight.*

Other changes to the Executive exemption are:

- The special exception for “sole charge” executives has been eliminated.
- The “business owner” exception for owners of at least a 20% interest in a business has been restricted to those owners who are actively engaged in the management of the enterprise. § 541.101.
- The “working foremen” section of the old regulations has been replaced by a more general “concurrent duties” section that distinguishes exempt executives who remain responsible for the success or failure of the business while performing nonexempt duties from nonexempt workers who are directed to perform exempt work for defined periods of time. The former are exempt, the latter are not. § 541.106.

E. The Administrative Duties Test

The high hopes generated by the proposed rule published in March 2003—which would have abandoned the “discretion and independent judgment” prong of the duties test in favor of a “position of responsibility” standard—were dashed by the bruising political fight waged against the proposed rule by organized labor. After a year of contentious public debate, the “new” Administrative duties test is essentially unchanged from the “old.”

- The employee’s primary duty must be the performance of office or nonmanual work directly related to the management or general business operations of the employer or the employer’s customers; and
- The employee’s primary duty must include the exercise of discretion and independent judgment with respect to matters of significance. § 541.200.

The regulations provide a number of examples of positions that “generally” meet the duties test for the Administrative exemption, in an apparent attempt to resolve the current ambiguity raised by inconsistent case law and regulatory opinion letters. For example, insurance claims adjusters, employees in the financial services industry who assess customers’ needs and advise on the relative merits of investment options, team leaders of major business projects, executive assistants to senior executives, human resources managers and purchasing agents are listed and discussed as “generally eligible for the Administrative exemption.”

Employees who administer functions directly related to academic instruction or training in an “educational establishment” are eligible for the Administrative exemption. The new regulations clarify the factors that are relevant in determining whether post-secondary career programs qualify as “educational establishments.” § 541.204. A school that is licensed by a state agency or accredited by a nationally recognized accrediting agency for career schools will meet the definition, whether the school is public or private. Moreover, academic counselors are expressly included in the list of academic administrators.

F. Professional Duties Test

There are no major changes to the Professional duties test, beyond the placement of the former “Computer Related Occupations” into a separate exemption category, now called “Computer Employees.” The Professional exemptions now encompass “Learned Professionals” (§ 541.301), “Creative Professionals” (§ 541.302), and “Teachers” (§ 541.303).

- The Learned Professional exemption will still require a primary duty of (a) work requiring advanced knowledge; (b) in a field of science and learning; (c) and the advanced knowledge must be customarily acquired by a prolonged course of specialized intellectual instruction. § 541.301. Some new fields have been incorporated into the text or the examples: theologians, archeologists, chefs with specialized degrees, dental hygienists, certified athletic trainers, some specialized paralegals, and funeral directors and embalmers with college degrees.
- The Creative Professional exemption has been expanded to include work requiring originality, in addition to work requiring invention, imagination or talent, in a recognized field of artistic or creative endeavor. § 541.302. There is a special discussion of journalists that distinguishes the exempt writer from the nonexempt writer. § 541.302(d).
- The Professional exemption for Teachers has been placed in a separate section from the Learned Professional exemption but has not changed in substance. § 541.303.

G. Computer Employees

The new regulations simply incorporate, verbatim, the statutory language of the FLSA. They offer no interpretation of the statutory language. They exempt employees whose primary duty consists of:

- The application of systems analysis techniques and procedures, including consulting with users, to determine hardware, software or system functional specifications;
- The design, development, documentation, analysis, creation, testing or modification of computer systems or programs, including prototypes, based on and related to user or system design specifications;
- The design, documentation, testing, creation or modification of computer programs related to machine operating systems; or
- A combination of the aforementioned duties, the performance of which requires the same level of skills.

One change from the prior regulations that may have significance is the deletion of the

statement that employees engaged in the *operation of computers* are not exempt. Now the regulations say that this exemption does not include employees engaged in the manufacture or repair of computer hardware or related equipment. § 541.401. The new regulations expand the discussion of the possible application of the Executive and/or Administrative exemptions for computer employees who do not meet the Computer Employees exemption. § 541.402.

H. Outside Sales Employees

The second prong of the prior duties test, which limited the time that an exempt outside sales employee could spend performing non-sales work, has been deleted. The test has been restated as follows:

- The employee's primary duty is making sales or obtaining orders or contracts for services; and
- The employee is customarily and regularly engaged away from the employer's place or places of business in performing the primary duty. § 541.500.

The major disappointment is that the new test expressly excludes employees who sell by mail, by telephone or over the Internet unless these means are simply an adjunct to personal calls on customers.

I. Combination Exemption

With the elimination of "short" and "long" duties tests and the application of the "primary duty" standard to all white-collar duties tests, this concept has become more straightforward and practical. It is now discussed in the "Miscellaneous" section of the white-collar regulations and expressly recognizes that exempt work, under any test, may be aggregated to reach the overall "primary duty" threshold for exemption. § 541.708 ("[W]ork that is exempt under one section of this part will not defeat exemption under any other section.").

III. RECOMMENDED ACTION

Prior to the August 23, 2004 effective date of the new regulations, employers should take the following actions:

- Identify all currently exempt employees who earn less than \$455 per week. Either reclassify them as nonexempt or raise their salaries to at least \$455 per week.
- Prepare a written policy prohibiting improper deductions from the predetermined compensation of exempt, salaried employees. The policy

should include a mechanism for employees to complain about improper deductions. While the policy need not be written if it is “clearly communicated,” we recommend that you reduce the policy to writing and publish it in some form to employees prior to August 23, 2004.

- Review new regulations and existing pay docking policies and practices with human resources and payroll staff to identify and complete necessary revisions in policies and practices.
- Review any written existing disciplinary policies concerning workplace conduct for possible revision to permit *full-day* suspensions of *all* employees for violations of workplace conduct rules. Any such policies must be in writing and published to employees at the time of or before implementation.
- Review your Family and Medical Leave Act policies for possible revision to permit partial-day docking of salaried, exempt employees during unpaid FMLA absences.
- Consider policies that permit additional compensation of salaried, exempt employees for work beyond scheduled hours.
- Identify any current nonexempt employees who receive guaranteed compensation (including nondiscretionary bonuses) of at least \$100,000 and assess whether they would qualify for exemption under the new “Highly Compensated Employee” provision.
- Review the job duties of all current exempt Executive employees to assess whether they have the necessary hire/fire authority (or whether their recommendations are given particular weight). Either reclassify Executive employees who do not have this authority or change their duties to grant them this authority.
- Identify any employees who are currently exempt under the “sole charge” exception to the Executive exemption. Reclassify them as nonexempt unless they meet another exemption.
- Identify any employees who qualify for exemption under the “business owner” exception to the Executive exemption. Assess whether they meet the changed requirements under the new regulations.
- Review the duties of all exempt “lead” or “working foremen” employees to assess whether they meet the changed requirements of the “Concurrent Duties” provision of the new regulations. If they do not, reclassify them as nonexempt.
- Review the duties of any current nonexempt employees who may qualify for the Administrative exemption based on new examples of exempt administrative work, e.g., insurance claims adjusters, financial services employees, and team leaders of special projects.

- Review the duties of any current nonexempt employees who may qualify for the Professional exemption based on new examples of exempt learned professional occupations, e.g., archeologists, chefs, specialized paralegals, and certified athletic trainers.
- Review the duties of current exempt Professional employees whom you may not have reclassified in anticipation of relaxed educational requirements that did not materialize in the new regulations.
- Review the status of all employees classified as exempt under the current Computer-Related Occupation exemption. Assess whether they meet the newly expressed Computer Employees duties test. If they do not, assess whether they meet any other exemption. Reclassify as needed.
- Reassess any current nonexempt positions that might qualify for the Combination Exemption.
- Identify other “borderline” positions that you may have deferred review of in anticipation of major changes in the new regulations that did not materialize.
- Educate and train administrative and management employees about the realities of the new regulations and dispel the myths that have circulated in the press during the political debate of the proposed and final regulations.
- Retain documentation of your internal efforts to comply with the new regulations.

IV. CONCLUSION

The Morgan Lewis Labor & Employment Law Practice Group is poised to assist you with understanding these changes and their impact on your business. If you have any questions about the new regulations and their impact, please contact any one of the following members of the FLSA Team:

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