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Vague Definitions On Overtime Pay Open Door to Litigation

by Allan G. King and Elizabeth Becker

ON MARCH 31, 2003, the Department of Labor [DOL] proposed regulations that make sweeping changes to the Fair Labor Standards Act [FLSA]. The intent of the proposal, the first major modification suggested in 25 years, is twofold. It is intended to balance employers' desires for less ambiguous regulatory requirements with employees' desires to limit exemptions to high-wage workers, preserving the 40-hour standard workweek, and the statutory right to overtime pay for as many employees as possible.

One of the proposed changes would raise the minimum salary that qualifies for an overtime exemption to $425 per week from its current level of $155 per week. The White House estimates that this and other proposed definitional changes would increase the number of non-exempt employees by 1.3 million, and require them to be paid overtime. Other rule changes, including one affecting highly compensated employees making $65,000 or more annually, on the other hand, would move employees from non-exempt to exempt status. The Administration concedes that approximately 644,000 white-collar workers would lose their entitlement to overtime pay under the new rules. The Economic Policy Institute, a nonpartisan research group, disputes this figure and suggests that the true number of employees who will lose their right to overtime is far higher, verging on eight million.[1]

Not surprisingly, with estimates varying so widely, a controversy rages. On Sept. 10, 2003, the Senate voted to block implementation of these regulations by denying the funding the DOL needs to finalize them. Thus, for the time being at least, the regulations are stalemated.

The FLSA, of course, is Depression-era legislation establishing a minimum wage, as well as requiring overtime pay for hours in excess of a standard workweek. The legislation was intended to provide a fair day's pay for a fair day's work. It also reflects the widely held view of those times that unemployment could be reduced, and overall demand stimulated, if hours of work were limited and rates of pay increased. Employers were expected to substitute hours of the unemployed for overtime hours of the employed, thereby reducing unemployment and increasing earnings, which would spur consumer spending. Economists continue to debate whether displacement effects associated with implementation of the minimum wage undermine its fairness objective. Evidence on the effect of the overtime pay requirement is clearer. An emerging body of economic research demonstrates, convincingly, that the overtime pay requirement has not achieved its intended effect of increasing employment.

Re-Calibration of Rates

Economic considerations suggest that much of the current discussion regarding the proposed overtime pay regulations, which emphasizes the number of workers whom the proposed regulations will classify as exempt from overtime coverage, should be re-focused. In our view, the value of any proposed changes to the exemptions depends far more on whether they bring clarity to determining who is exempt than on the number of employees affected by the change. Yet, the scorekeeping mentality, in which a lost ex-

[1] The New York Times, Sept. 11, 2003, p. A17.

emption counts as a win for employees and a loss for employers, and vice versa if an exemption is expanded, has been the dominant perspective in the public debate.

This misconception stems, in part, from a naive economics that assumes that by changing an employee's status to non-exempt, that employee will receive an automatic windfall. This argument ignores a fundamental principle of economics that changing an employee's status does not alter that employee's market value, and therefore will not alter his compensation. Suppose an exempt employee is paid $350 for regularly working 50 hours per week [an average of $7 per hour]. One might think that if new regulations declare him to be non-exempt, he will be paid $10.50 per hour for 10 hours per week that now are classified as overtime. Combined with the $280 received for the first 40 hours, this employee might look forward to earning $385 per week as a result of the new regulations.

His counterpart is a non-exempt employee newly classified as exempt, that fears he will receive a salary equal to his previous straight time pay for the standard 40-hour week, but nothing for overtime hours. For example, suppose he previously worked 50-hour weeks, earning $12 per hour for the first 40 hours, and $18 per hour for the last 10 hours. The proposed regulations would permit his employer to pay him a salary of $480 per week, with no additional pay for overtime. Thus, he would appear to lose $180 per week by the stroke of a pen.

Neither of these scenarios is likely. Economic studies of previous FLSA changes consistently report what seems a surprising finding -- extension of overtime coverage does not discourage long workweeks or expand the number of jobs as much as expected, and perhaps not at all. Nor does it lead to substantial earnings increases. How can this be? What naive analysts predicting these outcomes fail to consider is that pay rates, both hourly and salary, may adjust to neutralize the statutory overtime premium.

If the "contract" between firms and workers consists implicitly of a package of weekly hours and compensation, adjusting the rate of pay can neutralize changes in the overtime exemption, provided the hourly rate exceeds the minimum wage. The apparent increase in compensation for our first employee arises only if the hourly rate of pay remains the same at $7 per hour. However, if both employer and employee were happy with the original terms, which presumptively reflect the market value of his services, the "regular hourly rate" could be modified to $6.36, for about $255 per week in regular pay. The 10 hours of overtime would be paid at the 50 percent premium, or $9.54 per hour, which provides the employee about $95 in overtime. He earns the same $350 in compensation for the 50-hour workweek, and all statutory requirements have been met. Comparable adjustments in the other direction could return our second employee to his original total compensation.

Indeed, this sort of re-calibration of the hourly wage rate is contemplated in the DOL's discussion of how employers may choose to adjust to the new regulations. One of several choices of affected employers facing potential payroll costs is "converting salaried employees' basis of pay to an hourly rate ... that results in virtually no ... changes to the total compensation paid to those workers." The DOL notes, "Nothing in the FLSA would prohibit an employer affected by the proposed rule, or under the current rule, from implementing" this choice.[2]

Apparently, this is the sort of recontracting that occurs when FLSA coverage is extended. Economists first reported these offsetting adjustments in pay rates over a decade ago.[3] New research reported in three separate academic journal articles published just this year confirms a neutralizing effect. The original research has been extended and confirmed with improved methodology and data.[4] The same effect has been reported in an assessment of the impact of extending overtime coverage to public sector labor markets through judicial interpretations of the FLSA.[5] And a timely study of wages, hours and overtime premiums in the British labor market offers supporting evidence.[6] Thus, the hours-compensation package associated with any job is likely, in large measure, to adjust and absorb the effect of any change in FLSA exempt status.

Classifications and Damages

In contrast to the rather benign effects of reclassifying employees is the harm wrought by definitions that are so vague as to make the exempt status of a large number of jobs largely uncertain. Ferreting out non-exempt positions that have been misclassified as exempt, under either the FLSA or comparable state statutes, is a rapidly growing cottage industry. Collective actions under the FLSA now outnumber class actions filed in federal court under all the anti-discrimination laws combined. These cases are exceptionally difficult for employers to litigate because they have the burden of proving that the claimed exemption applies. A usual concomitant of classifying employees as exempt, rightly or wrongly, is that there is no record of the actual hours worked. Not surprisingly, many collective actions claiming exempt employees have been wrongly classified have settled for very large sums. Yet, these lawsuits lack the socially redeeming effects they are thought to have, and are likely to be resolved with economically inappropriate damage payments.

The reason is that if these misclassified employees were correctly classified in the first instance, they likely would have been paid no more than they actually received as exempt employees. Had employers and employees both known that the jobs in question were non-exempt, the hourly wage would have adjusted to reflect the anticipated overtime premium. At the end of the week, the employee would have gone home with the same earnings he received as an exempt employee.

This reality, of course, is not reflected in the

[2] See Federal Register, Vol. 68, No. 61, [March 31, 2003], p. 15576.

[3] Stephen J. Trejo, "The Effects of Overtime Pay Regulation on Worker Compensation," The American Economic Review, September 1991: 719-740.

[4] Stephen J. Trejo, "Does the Statutory Overtime Premium Discourage Long Work Weeks?" Industrial and Labor Relations Review, April 2003: 530-551.

[5] John H. Johnson, IV, "The Impact of Federal Overtime Legislation on Public Sector Labor Markets," Journal of Labor Economics, January 2003: 43-69.

[6] David N.F. Bell and Robert A. Hart, "Wages, Hours, and Overtime Premia: Evidence from the British Labor Market," Industrial and Labor Relations Review, April 2003: 470-480.

damages provision of the FLSA, §[216[b]. Instead, the damage calculation is predicated on the fiction that the "regular rate" an employee would have received, had he been subject to the overtime pay requirement, may be calculated from the salary that he actually received, which was exclusive of overtime. Although the Supreme Court has indicated that it does not consider these damages to be punitive,[7] they bear no reasonable relationship to the amount the employee would have been paid, but for the misclassification.

Contrary to the statute's implicit assumption, the overtime obligation and the employee's "regular rate" under the FLSA are mutually dependent. To the extent the employee's non-exempt status is unambiguous, as when a bright-line rule defines the exemption, the "regular rate" will be correspondingly less, and the total of regular and overtime compensation will tend toward the salary previously paid to the exempt classification.

The issue is one of foreseeability. If overtime is a routine aspect of a job, known both to the employer and the employee, then it is reasonable to suppose that the agreed upon exempt salary reflects the parties' understanding both as to hours and compensation. Because any combination of salary and hours can be stated in terms of a corresponding straight-time and overtime wage [provided the wage exceeds the statutory minimum], both employer and employee should be largely indifferent to which arrangement prevails. Therefore, to require payments to the employee that neither party anticipated, because of a statutory violation, seems gratuitous.

Information Symmetry

On the other hand, suppose only the employer knows the job's overtime requirements. With asymmetrical information, the bargain that is struck no longer has the same claim to fairness and could result in the employee receiving less than he would have demanded had the job's overtime requirements been known. Consequently, a rule that requires additional compensation for overtime hours may bring this employee's compensation closer to the salary he would have negotiated had he possessed full information. Only if a job's overtime requirements are known and controlled exclusively by the employer will an overtime penalty play a salutary role in compensating for the employee's misinformation. Further, because the incentive to gather information, and the ability to assimilate information, is likely to be greater for higher paying jobs, information asymmetry is probably greatest among lower paid employees. The statute should focus on bringing these employees within its protections.

Even then, employees do not remain forever ignorant about a job's requirements. Although an employee initially may be surprised by the extent of overtime, no one can be perpetually surprised. Eventually, expectations and reality converge. At that time it is reasonable to suppose that salaries are re-contracted to reflect the actual demands of the job. This period of convergence should be reflected in the statute of limitations. Although learning takes time, the notion that an employee may spend two or three years -- the statute of limitations under the FLSA -- in ignorance of his job requirements, and that the salary prevailing during this entire period reflects the employer's informational advantage, is groundless. Thus, even if one believes that employers and employees initially are mismatched in terms of their understanding of a job's requirements, the FLSA's statute of limitations is far longer than the problem's likely duration.

Additionally, the mutual unpredictability of overtime to employees and employers provides no rationale for the statute's damages formula. Indeed, the "Belo Plan," codified at §[207[f], permits a salary to be paid to employees who work irregular hours, up to 60 hours per week. Although the statute requires the employer and employee to enter into a "bona fide individual contract," or else be subject to a collective bargaining agreement, it is far-fetched to suppose that these technical requirements ensure a salary that is materially greater than workers receive when no formal agreements exist. Accordingly, there is no basis for penalizing technical violations of the Belo requirements with damages far greater than any financial injury those violations are likely to cause.

At this point, a reader may well ask: If employers are largely indifferent to paying salaries or hourly wages, why not pay all employees an hourly wage and avoid the risk of misclassifying them? Employers do not make the choice between hourly and salaried compensation willy-nilly. Payoffs in labor contracts are chosen to align the incentives of firms and workers.[8] Salaried compensation is appropriate for jobs requiring intangible inputs like mental effort, where hours at work are not a reliable measure of output or effort. Compensation on a salaried basis also has been shown to spur on-the-job training.[9] Hourly compensation makes sense only when hours worked are informative about output. Absent such information, hourly payoffs create incentives for workers to supply hours without effort. Ultimately, this reduces the workers' contribution to the firm and results in lower pay or dismissal. Thus, there are efficiency costs to an excessively narrow definition of the FLSA exemptions.

Nevertheless, we believe that concerns regarding the contours and the number of exemptions are vastly overshadowed by the uncertainty and confusion regarding their definition. A bright-line rule, perhaps based solely upon compensation levels, would go far toward demystifying the statute and freeing the market to ensure that employers pay what a job is worth and employees receive what their labor commands.

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[7] *Brooklyn Sav. Bank v. O'Neil*, 324 U.S. 697, 708-10 [1945].

[8] Eugene F. Fama, "Time, Salary, and Incentive Payoffs in Labor Contracts," Journal of Labor Economics, 1991: 25-44.

[9] Sheldon E. Haber and Robert S. Goldfarb, "Does Salaried Status Affect Human Capital Accumulation?" Industrial and Labor Relations Review, January 1995: 322-337.