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ATTORNEY-CLIENT COMMUNICATION

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TO: The Council

FROM: Scott A. Sinder
Eva V. Rigamonti

RE: **Department of Labor Final Overtime Rule**

On September 27, 2019, the U.S. Department of Labor ("DOL" or "Department") published a Final Rule ("Final Rule" or "Rule") to update and revise regulations implementing overtime pay exemptions.[1] The Final Rule will rescind the Obama Administration's overtime rule[2]—which was published in May 2016 and subsequently put on hold by a federal district court—and finalize new federal overtime regulations.[3] **The Final Rule will go into effect on January 1, 2020**.

This memorandum provides an overview of the general contours of the Final Rule and is divided into two sections. Part I contains a summary of the legal background of the overtime rule as well as an explanation of existing regulatory requirements and the tests to determine overtime eligibility. Part II summarizes the Final Rule and the three areas where DOL had requested comments: the salary threshold, inclusion of nondiscretionary bonuses in the salary threshold, and the salary update mechanism.

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[1] Department of Labor, Final Rule, Defining and Delimiting the Exemptions for Executive, Administrative, Professional, Outside Sales and Computer Employees, 84 Fed. Reg. 51230 (Sept. 27, 2019) *available at* https://www.govinfo.gov/content/pkg/FR-2019-09-27/pdf/2019-20353.pdf [hereinafter *Final Rule*].

[2] Department of Labor, Wage and Hour Division, Final Rule, Defining and Delimiting the Exemptions for Executive, Administrative, Professional, Outside Sales and Computer Employees, 81 Fed. Reg. 32391 (May 23, 2016), *available at* https://www.gpo.gov/fdsys/pkg/FR-2016-05-23/pdf/2016-11754.pdf [hereinafter *2016 Final Rule*]; *see also* Final Rule, *supra* note 1, at 61 ("this final rule also formally rescinds the 2016 final rule").

[3] To review the Department's Proposed Rule, *see* Department of Labor, Proposed Rule, Defining and Delimiting the Exemptions for Executive, Administrative, Professional, Outside Sales and Computer Employees, *available at* https://www.dol.gov/whd/overtime/overtime2019-nprm.pdf [hereinafter *Proposal*].

Executive Summary

Under the Fair Labor Standards Act ("FLSA" or the "Act"), the overtime rule (also known as the "white collar" exemption) requires employers to pay eligible employees one and one-half times their regular hourly-rate when they work overtime (more than 40 hours in a week). Some employees, however, are exempt from this general rule (i.e., overtime ineligible) and do not need to be paid extra for overtime hours worked.

To determine whether an employee is exempt (ineligible) from receiving overtime, an employee must meet three tests. First, the employee must meet the "**salary basis test**," meaning s/he must be paid a predetermined and fixed salary that is not subject to reduction because of variations in the quality or quantity of work performed.[4] Second, the employee's salary must meet a minimum specified amount—the "**salary level test**."[5] Third, the employee's job duties must meet the "**duties test**," meaning they must primarily involve executive, administrative, or professional duties as defined under the regulations.[6] Under current law (and until this Final Rule goes into effect on January 1, 2020), to qualify for the FLSA "white collar" exemption, employees must be paid at least $455 per week ($23,660 per year) and perform "executive, administrative and professional" job-related duties.[7] In this Final Rule, the Department will:

- Update the salary threshold that triggers the overtime exemption from the current level of $455 per week (approximately $23,660 per year) to $684 per week ($35,568 per year);[8]

- Permit nondiscretionary bonuses and incentive payments (including commissions), which are paid yearly or more frequently, to count towards up to 10 percent of an employee's salary for purposes of the exemption;[9] and

- Commit to more "regular" updates of the salary level through a formal notice-and-comment rulemaking.[10]

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[4] 29 C.F.R. § 541.602.

[5] 29 C.F.R. § 541.600.

[6] *See generally* 29 C.F.R. §§ 541.100, 541.200, 541.300, 541.400, 541.500.

[7] The 2016 final rule promulgated by the Obama Administration would have increased the salary threshold to $47,476 per year ($913 per week).

[8] Final Rule, *supra* note 1, at 51231.

The Department also finalized updates to the highly-compensated employee ("HCE") threshold, bumping the threshold from $100,000 to $107,432. Final Rule, *supra* note 1, at 51231. The HCE test applies "only to employees whose primary duty includes performing office or non-manual work." 29 C.F.R. § 541.601(d). To be exempt from overtime under the HCE test, "an employee must earn at least the amount specified in the regulations in total annual compensation and must customarily and regularly perform any one or more of the exempt duties or responsibilities of an executive, administrative, or professional employee." 29 C.F.R. § 541.601(a).

[9] Final Rule, *supra* note 1, at 51231, 51247-49.

The Final Rule makes no changes to the "duties test," which is part of the existing overtime regulations and helps employers determine if their employees are performing tasks that would exempt them (or not) from overtime.

The Final Rule will have a significant impact on businesses of all shapes and sizes, including the insurance industry, as employers will have to reevaluate the classification of their employee population with special attention to existing and potential overtime obligations based on the Rule. Fortunately, however, DOL's Final Rule is a significant improvement over the rule finalized by the Obama Administration, which was halted by a federal court.

The Final Rule will utilize the methodology that was used the last time the overtime rule was adjusted back in 2004. While the Final Rule will make necessary adjustments to the overtime salary threshold so that the salary level will be aligned with the growth in wages since 2004, it will not be such a drastic shift as to render almost every employee eligible for overtime. The Obama-era rule, in contrast, would have doubled the minimum salary threshold required to qualify for the Act's "white collar" exemptions to $47,476 per year.

In addition, the Final Rule will allow bonuses and commissions to count towards 10 percent of an employee's salary. While the Department has allowed employers to pay other compensation in the form of bonuses in addition to required salary, DOL has never permitted employers to include such bonuses and commissions in actual salary calculations. (The Obama-era rule tried to do this but it never went into effect.)

[10] Final Rule, *supra* note 1, at 51252 (noting the Department's "intention to update the . . . regulations more regularly using notice-and-comment rulemaking . . . .").

I. **Background**

A. The Fair Labor Standards Act of 1938

The Fair Labor Standards Act of 1938 ("FLSA" or "Act") was a landmark piece of legislation that introduced the forty-hour work week and established a national minimum wage (25 cents an hour at the time), overtime pay eligibility for select jobs, record keeping requirements, and child labor standards for public and private sector employees.[11] The FLSA is administered and generally enforced by the Wage and Hour Division ("WHD") of the DOL.

The FLSA requires employers to pay covered employees, who are not otherwise exempt under Section 13(a)(1) of the Act, at least the federal minimum wage and overtime pay of one-and-one-half-times the regular rate of pay.[12] The so-called overtime exemption, which applies to specific types of businesses and/or specific types of work, was premised on the notion that exempted employees—i.e. employees *ineligible* to receive overtime—typically were compensated substantially above the minimum wage and enjoyed other privileges, such as above-average fringe benefits, to reward them for their long hours of work.

Over time, amendments to the FLSA have changed the number of employees eligible for that exemption. In the first iteration, for example, the FLSA exempted persons employed in a "local retailing capacity," but this exemption was removed in 1961 when Congress expanded the FLSA to cover retail and service enterprises. Generally speaking, however, the exemption, often referred to as the "EAP" or "white collar" exemption, exempts "any employee employed in a bona fide **e**xecutive, **a**dministrative, or **p**rofessional capacity" from minimum wage and overtime pay.[13]

B. Determining Overtime Eligibility

To determine whether an employee is exempt (ineligible) from receiving overtime, an employee must meet three tests. First, the employee must meet the "**salary basis test**," meaning s/he must be paid a predetermined and fixed salary that is not subject to reduction because of variations in the quality or quantity of work performed.[14] Second, the employee's salary must meet a minimum specified amount—the "**salary level test**."[15] Third, the employee's job duties must meet the "**duties test**," meaning they must primarily involve executive, administrative, or

[11] 29 U.S.C. § 201, *et seq*.

[12] The exemptions from these basic standards can be found in 29 U.S.C. § 213.

[13] 29 U.S.C. § 213(a)(1). The regulations setting forth criteria for exempt status under the FLSA are codified in the Code of Federal Regulations. *See* 29 C.F.R. Part 541.

[14] 29 C.F.R. § 541.602.

[15] 29 C.F.R. § 541.600.

professional duties as defined under the regulations.[16] Since 1938, the Department has successfully updated the salary level requirements seven times, most recently in 2004.[17]

C. Existing Regulatory Requirements

Currently, the regulations delineate specific criteria that define each category of exemption provided under FLSA for bona fide EAP employees. The burden of establishing whether any FLSA exemption applies to a particular employee falls on the employer. Mere job titles and descriptions are not sufficient to determine exempt status, nor is paying an employee a fixed (non-hourly) salary adequate to establish that an employee is not eligible for overtime. Rather, to qualify for a white collar exemption, an employee must meet the job duties and salary tests. Since DOL's last rulemaking in 2004 (and until this Final Rule goes into effect), for an employee to be ineligible for overtime, s/he usually has to be paid on a salary basis of not less than $455 per week, approximately $23,660 per year for a full-time worker.

As mentioned previously, employers must keep in mind that to meet the requirements of an overtime exemption under the FLSA, employees must be compensated at the rate described above and meet the duties test for the applicable exemption. Therefore, employers must evaluate whether an employee's primary job duties fall into one of the below exemptions. DOL has indicated that the employee must perform this work 50% or more of their working time:

- **Executive employees** must have a *primary duty* of managing the enterprise or a department or subdivision of the enterprise.[18] Moreover, the exempt executive employee must "customarily and regularly" direct the work of at least two employees and have the ability to hire or fire them; or that employee's suggestions and/or recommendations vis-à-vis the hiring, firing, or change in status of the other employees must be given particular weight.

- **Administrative employees** must *primarily* perform office or non-manual work directly related to the management or general business operations of the employer or the

[16] *See generally* 29 C.F.R. §§ 541.100, 541.200, 541.300, 541.400, 541.500.

[17] From 1949 until 2004, there were two different "duties tests" for EAP employees, which varied according to the employee's salary level, and were designed to ensure that overtime-eligible employees were not swept into the exemption by mistake. For those EAP employees paid a lower salary, there was a "long duties test," which included a 20 percent limit (40 percent for retail or service industries employees) on the time employees could spend on nonexempt tasks, meaning those tasks that typically are not considered EAP tasks and are thus generally performed by employees who are eligible for overtime. In contrast, for those employees paid at a higher salary level, there was a "short duties test." In 2004, however, the DOL replaced the two duties tests with a single standard test that did not include a cap on the amount of nonexempt work that could be performed.

[18] 29 C.F.R. § 541.100(a)(1)-(2). *Primary duty* "means the principal, main, major or most important duty that the employee performs. Determination of an employee's primary duty must be based on all the facts in a particular case, with the major emphasis on the character of the employee's job as a whole. Factors to consider when determining the primary duty of an employee include, but are not limited to, the relative importance of the exempt duties as compared with other types of duties; the amount of time spent performing exempt work; the employee's relative freedom from direct supervision; and the relationship between the employee's salary and the wages paid to other employees for the kind of nonexempt work performed by the employee." *Id.* § 541.700.

employer's customers. The employee's primary duty must also involve the "exercise of discretion and independent judgment with respect to matters of significance."[19]

- **Professional employees** must have a *primary duty* of (1) work requiring advanced knowledge in a field of science or learning that is usually achieved by a "prolonged, course of specialized intellectual instruction" or (2) work requiring originality, invention, imagination, or talent in a recognized field of artistic or creative endeavor.[20] Generally, professional employees perform work "requiring the consistent exercise of discretion and judgment, as distinguished from the performance of routine mental, manual, mechanical or physical work."

The EAP exemptions listed above provide the traditional duties exemptions for "white collar" employees. However, there are also exemptions for outside sales and computer employees:

- **Outside sales employees** must *primarily* make sales or obtain orders or contracts for services for which a consideration will be paid by the client or customer.[21] The employee must also be customarily and regularly engaged *away* from the employer's place of business.

- **Computer employees** must be "skilled in the computer field" and will be generally exempt from overtime if, in performing his duties, he applies systems analysis techniques to determine hardware, software, or system functional specifications or otherwise designs, develops, or modifies computer systems and programs.[22] An employee could also be exempt if his primary duty involves "planning, scheduling, and coordinating activities" necessary to develop systems to solve complex business problems for the employer.

Employees who meet the requirements set forth above, while also meeting the salary test, are excluded from the Act's minimum wage and overtime pay protections. Such employees are thus permitted to work any number of hours in the workweek beyond the traditional 40 hours and

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[19] 29 C.F.R. § 541.200.

[20] 29 C.F.R. § 541.300. Professional employees also include those teaching in a school system or educational institution as well as computer system analysts, programmers, software engineers, or other similarly-skilled worker in the computer-science field. *See id.* §§ 541.303, 541.400.

[21] 29 C.F.R. § 541.500 *et seq*. Outside sales involve predominately "face-to-face" sales "at the customer's place of business" or home, and "does not include sales made by mail, telephone or the Internet unless such contact is used merely as an adjunct to personal calls." 29 C.F.R. § 541.502; *see also* Wage and Hour Division, Fact Sheet #17F: Exemption for Outside Sales Employees Under the Fair Labor Standards Act (Jun. 2008), https://www.dol.gov/whd/overtime/fs17f_outsidesales.htm; Wage and Hour Division, Opinion Letters – Fair Labor Standards Act FLSA2009-28 (Jan. 16, 2009), *available at* https://www.dol.gov/whd/opinion/flsa/2009/2009_01_16_28_flsa.htm (concluding that "depending on the duties actually performed, an insurance agent may qualify for either the outside sales or administrative exemption").

[22] 29 C.F.R. § 541.400-401. The exemption does not cover employees "engaged in the manufacture or repair of computer hardware and related equipment."

are not subject to the overtime pay requirements under the FLSA. Nevertheless, despite the standards set by the FLSA, the Act does not preempt state standards that may be stricter than the federal standards.[23]

II. **Final Rule**

This Final Rule is the Department's latest attempt to update the overtime threshold. On May 23, 2016, the Obama Administration updated the overtime rule doubling the minimum salary threshold required to qualify for the Act's "white collar" exemptions to $47,476 per year ($913 per week).[24] It also instituted an automatic update that would have increased the salary level automatically every three years. That 2016 final rule never went into effect.[25] In this Final Rule, the Department is rescinding the 2016 Obama Administration rule and will make the following changes:

- Update the national salary threshold triggering the overtime exemption to the 20th percentile of earnings of full-time salaried workers in the lowest-wage census region (the South) and in the retail sector nationwide: $684 per week, approximately $35,568 for a full-year worker;[26]

- Permit up to 10 percent of the overtime salary threshold to be met with nondiscretionary bonuses, incentive payments, or commissions that are paid *at least annually or more frequently*; and

- Commit to more "regular" updates of the salary level through a formal notice-and-comment rulemaking to prevent the level from becoming outdated between rulemakings.

Finally, the Department will not adjust the duties test. Further details on the Final Rule can be found below.

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[23] California, for example, has a stricter duties test than the federal standard.

[24] Department of Labor, Wage and Hour Division, Final Rule, Defining and Delimiting the Exemptions for Executive, Administrative, Professional, Outside Sales and Computer Employees, 81 Fed. Reg. 32391 (May 23, 2016), *available at* https://www.gpo.gov/fdsys/pkg/FR-2016-05-23/pdf/2016-11754.pdf.

[25] On November 22, 2016, a federal district court issued a preliminary injunction, enjoining the Department from implementing and enforcing the 2016 final rule. *See Nevada v. U.S. Dep't of Labor*, 218 F. Supp. 3d 520 (E.D. Tex. 2016). On August 31, 2017, the district court granted summary judgment against the Department of Labor, invalidating the final rule. The district court found that the 2016 final rule's salary level exceeded the Department's authority by "exclud[ing] so many employees who perform exempt duties" thereby making "salary rather than an employee's duties determinative" of the applicability of the EAP exemption. *Nevada v. U.S. Dep't of Labor*, 275 F. Supp. 3d 795, 807 (E.D. Tex. 2017).

[26] Although it is not the focus of this memorandum, DOL also raised the highly compensated employee ("HCE") annual compensation level equal to the 80th percentile of earnings for full-time salaried workers nationally, approximately $107,432 per year.

A. Update to Salary Threshold

The Final Rule updates the salary and compensation levels that trigger the managerial exemption, which the Department has long considered the "best single test" of exempt status. Specifically, DOL is retaining the methodology used in the 2004 final rule and sets the standard salary level at the 20th percentile of earnings of full-time salaried workers in the lowest-wage census region (then and now the South) and in the retail sector nationwide.[27] This amounts to $684 per week, approximately $35,568 for a full-year worker. According to DOL, it chose to use the 2004 methodology for simplicity's sake because "the approach has withstood the test of time" and "would restore the salary level to its traditional purpose of serving as a dividing line between nonexempt and potentially exempt employees . . . ."[28]

While this threshold is higher than the current level ($23,660) set in 2004, it is $11,908 lower than the salary threshold finalized by the Obama Administration ($47,476 per year).

1. *A Note on Methodology*

Throughout the FLSA's regulatory history, DOL has relied upon a common methodology to set appropriate salary levels. With some slight variation, the Department has, in almost every prior rulemaking, surveyed a broad set of data on actual wages paid to salaried employees and then set the salary level at an amount slightly lower than might be indicated by the data.[29] In the 2004 rulemaking, for example, DOL used Current Population Survey ("CPS") data that encompassed "most salaried employees, and set the salary level to exclude roughly the bottom 20 percent of those salaried employees in each of the subpopulations (1) the South and (2) the retail industry."[30] The Department specifically utilized "lower-salary" data sets from the South and the retail industry to *accommodate those businesses for which salaries were generally lower due to geographic or industry-specific reasons*. In this Final Rule, DOL has returned to the 2004 methodology, which it had abandoned in the Obama-era 2016 final rule.[31]

Lastly, it is important to note that historically, DOL has assessed compliance with the salary level test by looking only at the actual salary or fee payments made to employees. It had **never** included bonus payments of any kind in this calculation.[32] To rephrase, DOL had allowed

[27] Final Rule, *supra* note 1, at 51231.

[28] Final Rule, *supra* note 1, at 51235.

[29] *See* Department of Labor, Wage and Hour Division, Proposed Rule, Defining and Delimiting the Exemptions for Executive, Administrative, Professional, Outside Sales and Computer Employees," 80 Fed. Reg. 38516, at 38526 (proposed July 6, 2015), available at http://www.gpo.gov/fdsys/pkg/FR-2015-07-06/pdf/2015-15464.pdf.

[30] *Id.*

[31] In that rulemaking, DOL had set the salary threshold at the 40th percentile of wages in the lowest-wage census region (the South) but did not adjust that number for wages in the retail sector.

[32] This is slightly different for the highly compensated employee test, which is not the focus of this memorandum.

employers to pay other compensation in the form of bonuses *in addition to* the required salary but those payments had never figured in the salary calculations for the purpose of overtime. The Obama-era proposal was the first time the Department had proposed to include such bonuses in actual salary calculations.[33] The Obama-era final rule, however, never went into effect. Thus, when this Final Rule goes into effect, it will be the first time employers will be able to count bonus payments towards actual salary.

B. Inclusion of Nondiscretionary Bonuses, Incentive Payments, and Commissions in the Salary Level Requirement

Per the Final Rule, up to 10 percent of the overtime salary threshold may be met with nondiscretionary bonuses, incentive payments, or commissions. However, such bonuses will only count towards the salary threshold if they are paid *at least annually*.[34] In other words, an individual's base salary before commission must still be at least 90 percent of the threshold—approximately $32,011—but an employer could count $3,556.80 of nondiscretionary bonuses or commissions towards the individual's salary provided these payments are incorporated into the individual's salary annually or more frequently. If an employer fails to incorporate such nondiscretionary bonus, incentive, and commission payments by the end of the 52-week period, s/he is allowed to make one "catch-up" payment "within one pay period after the end of the 52-week period," to make up for the shortfall.[35] This will represent an important and valuable change to existing overtime regulations benefitting both employers and employees.[36]

C. Future Updates

Due to the long periods of time between rulemakings, which have resulted in salary levels that are based on outdated salary data and distorted overtime determinations, the Department had proposed to update the standard salary test (according to traditional methodology), as well as the total annual compensation requirement for highly compensated employees *every four years* via a formal notice-and-comment rulemaking. In the Final Rule, however, the Department has declined to establish a formal quadrennial update schedule and only has committed to updating the standard salary test "regularly."[37]

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[33] 40 C.F.R. § 541.604(a).

[34] Final Rule, *supra* note 1, at 51231, 51248.

[35] Final Rule, *supra* note 1, at 51249.

[36] In the insurance space, many firms use a "draw against commission" pay structure whereby the employee makes a base draw amount (e.g., $50,000) but ultimately, the majority of the compensation is by commission. The base amount, however, is guaranteed although the commission earned is offset against it. While the inclusion of nondiscretionary bonuses and commissions towards salary will benefit the insurance industry, the 10 percent cap will limit the benefit of this change.

[37] Final Rule, *supra* note 1, at 51252 (noting the Department's "intention to update the . . . regulations more regularly using notice-and-comment rulemaking . . . .").

D. Duties Tests

The Final Rule makes no changes to the duties test. As described above, the duties test has always functioned in tandem with the salary requirements to determine whether an employee qualifies as exempt from overtime. If the salary test is met, the duties test comes into play afterwards to ensure that overtime-eligible employees are not erroneously identified as overtime exempt. To meet the duties test—and be determined overtime *ineligible*—an employee's work must *primarily* involve executive, administrative, or professional duties as defined under the regulations.[38]

III. **Conclusion**

The Department's Final Rule will have far-reaching implications for the insurance industry and we encourage Council members to review the Final Rule carefully.

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[38] *See generally* 29 C.F.R. §§ 541.100, 541.200, 541.300, 541.400, 541.500.