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Client Alert

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Retroactive Overtime for Misclassified Salaried Employees: The DOL Supports the Fluctuating Workweek's Half-Time Methodology

The U.S. Department of Labor's (the "DOL") Wage and Hour Division recently issued a Wage and Hour Opinion Letter, FLSA 2009-3, addressing how a company can compute overtime payments retroactively for salaried employees it had mistakenly classified as exempt (not overtime-eligible) under the Fair Labor Standards Act ("FLSA" or the "Act"). The DOL reiterated its support for the half-time methodology in calculating back overtime due, endorsing the so-called "fluctuating workweek" model on a *retroactive* basis for remedying the misclassification of salaried employees. This is a significant development and, in so deciding, the DOL has "weighed in" on an issue that remains a source of lively debate in the federal courts.

Generally, the FLSA requires that overtime pay be calculated weekly (notwithstanding that an employer's payroll period might be semi-monthly or bi-weekly) and that employees receive one and one-half times their regular hourly rate of pay for each hour worked in excess of 40 hours in a workweek. Here, the employer paid a guaranteed salary bi-weekly and expected the employees to work a minimum of 50 hours per week. The employer's payroll software even converted the bi-weekly salary to an hourly rate by dividing the salary by 100, without regard to whether the employees worked more or less than 100 hours in the payroll period. When the employer concluded that it had mistakenly classified certain salaried employees as exempt, it wished to pay them back overtime retroactively, using a half-time methodology, reasoning that the employees had already been compensated straight-time for each hour over 40 worked in the workweek.

The DOL agreed. Since the fixed salary covered all the hours the employees worked in a workweek, straight-time already was included in the salary covering the hours worked over 40 and, as a result, the employees needed only to be paid an additional one-half of their actual regular rate for each overtime hour. Important to the DOL's decision was the fact that the fixed salary was paid to the employees even when they worked less than 100 hours in the bi-weekly payroll period.

The Opinion Letter is particularly noteworthy for its generous interpretation of the fluctuating workweek's "clear mutual understanding" requirement which, heretofore, many had understood meant that there had to be a "clear and mutual understanding" at the outset of how salary and overtime would be calculated and paid for hours worked. According to this Opinion Letter, the "clear and mutual understanding" criterion does *not* need to be set forth in writing and intent can be inferred from the parties' conduct that the fixed salary was compensation for all hours actually worked by the employee in a given week, rather than for a fixed number of hours per week – a stance that adopts the minority view among judicial decisions that have considered the issue.

The Fluctuating Workweek Method

The Act provides that employees must be paid time and one-half pay for all hours worked over 40 in a workweek. However, the DOL's regulations interpreting and clarifying the Act provide an alternative method for calculating the compensation of certain salaried non-exempt employees, called the "fluctuating workweek." See 29 C.F.R. § 778.114. This method permits an employer to pay its employee whose hours fluctuate from week to week a fixed amount per week as straight time, irrespective of the number of hours worked. Under the fluctuating workweek, payment for overtime hours is *one-half* times the

regular rate, instead of one and one-half times the rate, because the straight-time rate is understood to compensate employees for all hours actually worked. Accordingly, the regular rate of hourly compensation will vary from week to week depending on the number of actual hours worked in any given workweek and the hours worked must be subject to some fluctuation for this overtime methodology to apply. The regular rate is calculated by dividing the number of hours actually worked into the amount of the straight time salary for the workweek, rather than dividing the salary by 40 hours.

For instance, an employee who receives a weekly salary of $1000 and who works 50 hours in a week would be paid $100 in overtime under the fluctuating workweek method: first divide the weekly salary ($1000) by the total number of hours worked (50), which results in a regular rate of $20/hour, then multiply that amount by one-half, resulting in an additional $10/hour for each hour of overtime, and then multiply the half-time rate ($10/hour) by the number of hours worked over 40 in the workweek (10 hours).

Contrast the fluctuating workweek paradigm with the time and one-half model. At time and one-half (1.5), the employee would receive $375 (more than three times as much) for the same number of hours worked. Specifically, divide the employee's $1000 weekly salary by 40, to arrive at a regular rate of $25 per hour, then multiply that amount by 1.5, resulting in an overtime hourly rate of $37.50, and then multiply again by 10, the number of overtime hours worked over 40. Significantly, the mathematics of the fluctuating workweek method means that the more hours the employee works at a fixed weekly salary, and the more overtime the employee logs, the less s/he is paid for each additional hour of overtime work.

Under the FLSA's regulations, the fluctuating workweek method of calculating compensation can *only* be used if: (1) the employer and the employee clearly and mutually understand that the straight salary covers whatever hours the employee is required actually to work; (2) the straight salary is paid irrespective of whether the workweek is one in which a full schedule of hours is worked (meaning, if an employee works only 30 hours one workweek, s/he still gets paid the fixed salary without diminution); (3) the straight salary is sufficient to provide a pay rate not less than the applicable minimum wage rate for every hour worked in those workweeks in which the number of hours worked is greatest; and (4) in addition to straight-salary, the employee is paid for all hours in excess of the 40-hour federal statutory maximum at a rate not less than one-half the regular rate of pay.

Application of Fluctuating Workweek to Misclassified Employees

By its very nature, the fluctuating workweek overtime methodology is designed to apply prospectively, yet here, the DOL has permitted its *retroactive* application, as well. Usually, the employer and employee (whom the employer concedes is non-exempt) agree, *in advance*, as to how overtime will be calculated and paid. The pertinent regulation at 29 C.F.R. § 778.114 is silent as to whether the fluctuating workweek may be used retroactively to reimburse employees for back overtime damages in misclassification cases. When an employer (or court) determines that a salaried exempt employee has been misclassified, by definition there is no prior agreement as to how overtime will be paid because an exempt employee usually receives only a fixed salary, and no overtime pay was ever contemplated by the parties. At the same time, the parties did agree that the employer would pay a fixed salary no matter how many, or few, hours the employee actually worked in a workweek.

The relatively few cases that have addressed whether the fluctuating workweek method may be used retroactively to compensate misclassified employees have arrived at opposite conclusions. While no case in the United States Court of Appeals for the Second Circuit (New York and Connecticut) has squarely addressed the issue, the Tenth Circuit recently held that merely because the parties initially agreed that no overtime would be paid did not mean that "no agreement as to the overtime ever existed." *Clements v. Serco, Inc.*, 530 F.3d 1224, 1230 (10th Cir. 2008). Citing an older First Circuit decision, *Valerio v. Putnam Associates Inc.*, 173 F.3d 35, 40 (1st Cir. 1999) (also cited in the Opinion Letter), *Clements* reasoned that the fluctuating workweek regulation "calls for no such enlarged understanding"; rather, "the parties must only have reached 'a clear mutual understanding' that while the employee's hours may vary, his or her base salary will not." *Clements*, 530 F.3d at 1230. Several federal district court cases have ruled, as well, that where employees have been misclassified, the overtime damages due them may be calculated at half-time the hourly rate because the employee already has been compensated by the fixed salary for all hours worked.

In contrast, more recent cases have held that applying the fluctuating workweek method retroactively "runs counter to the plain meaning of the [DOL's] regulations," *Scott v. OTS, Inc.*, 2006 U.S. Dist. LEXIS 15014 (N.D. Ga. 2006), and further that to do so would be "inappropriate." *Hunter v. Sprint Corporation*, 453 F. Supp. 2d 44 (D.D.C. 2006). Indeed, one recent district court decision boldly announced

that it would refuse to follow established Fifth Circuit precedent permitting the retroactive use of the fluctuating workweek method because it was "wholly inconsistent with the FLSA and cannot be reconciled with the purposes of the Act." *In re EZPawn FLSA Litigation*, 2008 U.S. Dist. LEXIS 53636 (W.D. Tex. 2008).

What To Do Now

The Opinion Letter is welcome news for employers who discover that they have misclassified employees as exempt. As the DOL strongly suggests that employers, from time to time, conduct classification audits, this Opinion Letter may help persuade reluctant employers to proactively address reclassification issues because the half-time methodology for coming into compliance is far less onerous than the risks associated with a continuing liability and possible lawsuits.

Given the explosion in wage and hour litigation, coupled with increased scrutiny by state regulatory agencies (many of which have assembled special misclassification or wage and hour task forces), it is prudent for employers to examine whether their employees have been correctly classified and paid (as exempt or as independent contractors) under both the FLSA *and* state laws, and consider appropriate remedial action, if warranted. In light of the recent GAO report criticizing lax enforcement by the DOL of its minimum wage/overtime oversight responsibilities, and the recent nominations by the Obama Administration for Deputy Secretary of Labor and Solicitor of Labor, we anticipate re-invigorated, aggressive enforcement of the wage and hour laws by the DOL.

Employers should be aware, however, that not all states permit the use of the fluctuating workweek method (such as California). Therefore, before any classification audit is conducted, employers should consult with counsel to discuss risks, consequences and remedies that will be followed should the audit identify misclassified employees.

If you have any questions concerning this Client Alert, or would like to discuss employee classification issues or any other wage and hour issues, please contact any of the attorneys listed below or your Proskauer relationship counsel.

Client Alert

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If you have any questions about the impact of this new law, please contact your Proskauer relationship lawyer or one of the lawyers listed below:

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