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Congress of the United States

U.S. House of Representatives

Committee on Small Business

2361 Rayburn House Office Building
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Memorandum

To: Members, Subcommittee on Investigations, Oversight and Regulations
From: Committee Staff
Date: October 5, 2015
Re: Hearing: "The Consequences of DOL's One-Size-Fits-All Overtime Rule for Small Businesses and their Employees"

On Thursday, October 8, 2015 at 10:00 a.m., the Subcommittee on Investigations, Oversight and Regulations will meet in Room 2360 of the Rayburn House Office Building for the purpose of examining the proposed rule issued by the Wage and Hour Division of the Department of Labor (DOL or Department) to revise and update the existing Fair Labor Standards Act (FLSA or Act)[1] regulations that implement the exemption from minimum wage and overtime pay for executive, administrative, professional, outside sales or computer employees.[2] The hearing will examine the potential effects of this proposed rule on small businesses.

I. Overview of the FLSA

Signed into law by President Franklin Delano Roosevelt in 1938, the FLSA was enacted to improve labor conditions for employees in the United States. The FLSA establishes minimum wage and overtime standards for most, but not all, private and public sector employees. Among other provisions, the FLSA requires that employees falling within its ambit must be compensated at one-and-a-half times their regular rate of pay for each hour worked over 40 hours in a workweek unless the employee is exempt from FLSA coverage.[3]

When the FLSA was enacted in 1938, the Act provided an exemption, from the overtime provisions of the Act, for bona fide executive, administrative, and professional (EAP) employees which is referred to as the "EAP" or "white collar" exemption. Rather than define the terms executive, administrative, or professional employee, the FLSA authorizes the Secretary of Labor to define and delimit these terms "from time to time" by regulations.[4]

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[1] 29 U.S.C. §§ 201-19 (1938).
[2] Defining and Delimiting the Exemptions for Executive, Administrative, professional, Outside Sales and Computer Employees, 80 Fed. Reg. 38,516 (July 6, 2015) [hereinafter "Proposed Rule"].
[3] 29 U.S.C. § 207 (a)(1).
[4] *Id.* at § 213 (a)(1). Those regulations are found at 29 C.F.R. Part 541.

Two primary reasons existed for an EAP exemption in FLSA. First, the nature of the work performed by EAP employees was not as clearly associated with hours of work per day as it was for typical nonexempt work.[5] Second, bona fide EAP employees were considered to have other forms of compensation (e.g., above-average benefits, stock options, and greater opportunities for advancement) unavailable to nonexempt workers.[6]

Although somewhat of an oversimplification, an employee generally has to meet three criteria for being considered exempt as an employee. Those are: the "salary basis" test; the "duties" test; and the "salary level" test. Since 1940, the regulations implementing the EAP exemption have each of the three tests to be met for the exemption to apply.[7] The Department has updated the salary level requirements seven times since 1938, most recently in 2004.[8]

As part of the process of defining and delimiting the EAP exemption, in 2004 DOL also created a "highly compensated employee" (HCE) exemption in which employees earning at least $100,000 annually are exempt from overtime requirements if they perform at least one of the responsibilities in the duties test for an EAP employee.[9] This new provision in 2004 was not linked to a specific percentage of salaried employees like the salary basis test; rather, the DOL established a salary of $100,000.[10]

II. The Proposed Rule

On March 13, 2014, President Obama directed the DOL to update the regulations defining which employees are currently exempt as EAP employees are protected by the FLSA's minimum wage and overtime standards.[11] The memorandum instructed the DOL to look for ways to modernize and simplify the regulations while ensuring that the FLSA's intended overtime protections are fully implemented.[12]

The DOL complied with the presidential directive and published the proposed rule on July 6, 2015. The agency's proposal increases the salaries test from $23,660 to $50,440 (or a

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[5] IV CONRAD F. FRITSCH & KATHY VANDELL, EXEMPTIONS FROM THE FAIR LABOR STANDARDS ACT: OUTSIDE SALESWORKERS AND EXECUTIVE, ADMINISTRATIVE, AND PROFESSIONAL EMPLOYEES, 240 (1981).
[6] *Id.*
[7] Proposed Rule, 80 Fed. Reg. at 38,517. In order to meet the duties test, the employee's actual job duty must be to act in an "executive", "administrative", or "professional" manner. Executive employees are defined as high level workers who manage the overall operations of the business or a customarily recognized department or subdivision. Administrative employees are defined as high level employees who perform office or non-manual work that is concerned with implementing and administering management policies rather than supervising or carrying out day to day business operations or production activities. Professional employees are defined as employees who apply "advanced" knowledge in a recognized field of science or learning.
[8] *Id.*
[9] 29 C.F.R. § 541.601(a).
[10] Defining and Delimiting the Exemptions for Executive, Administrative, Professional, Outside Sales and Computer Employees, 69 Fed. Reg. 22,122 (Apr. 23, 2004).
[11] Memorandum of March 13, 2014 – Updating and Modernizing Overtime Regulations, 79 Fed. Reg. 15,211 (Mar. 18, 2014).
[12] *Id.*

weekly change from $455 to $970),[13] a 102 percent increase. The proffered regulation utilizes Bureau of Labor and Statistics (BLS) data from 2013 to set the salary level equal to the 40th percentile of all full-time salaried workers (at least 35 hours per week) in the nation rather than the 10th percentile previously used in DOL FLSA regulations.[14] The DOL also is proposing to modify the HCE exemption following the same BLS data sets to determine the 40th percentile weekly wage for the regular salaried employees, the DOL also proposes to increase to the 90th percentile the annual salary threshold for the HCE exemption from $100,000 to $122,148, a 22.1 percent increase.[15]

The proposed rule also would – and for the first time – establish an indexing mechanism that automatically increases the salary thresholds on a periodic basis. DOL seeks comments on two indexing proposals: 1) using a fixed percentile of wage earnings; or 2) using the Consumer Price Index for all urban consumers (CPI–U).[16] The DOL would publish the new salary and compensation levels annually and provide businesses and other organizations subject to 60 days to prepare before the update levels become effective.[17] It is questionable whether merely an indexing scheme satisfies the requirement that exemptions be developed through rulemaking procedures set out in the Administrative Procedure. [18]

While no changes to the "salary basis" and "duties" test are proposed, the DOL solicits comment on five general questions about the duties tests, specifically asking if changes to the duties test are necessary.[19] It is unclear whether the DOL would use the responses to these questions to justify making changes to the duties test in a final rule or issue a new proposal to address changes to the duties test. Any changes to the duties test will exacerbate compliance issues for small organizations, including small businesses subject to the FLSA.

III. DOL Compliance with the Regulatory Flexibility Act

Under the Regulatory Flexibility Act, 5 U.S.C. §§ 601-12 (RFA), agencies must assess the effects of rules on small businesses and other small organizations.[20] An agency that determines a proposal will have a significant economic impact upon a substantial number of small businesses must prepare an initial regulatory flexibility analysis (IRFA) assessing the burdens on small businesses and examining alternatives that would lessen such burdens.[21]

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[13] Proposed Rule, 80 Fed. Reg. at 38,517 n.1. When DOL finalizes the rule, it will rely on updated BLS data. The Department, projected the weekly wage would be $970, or $50,440 annually by assuming two percent growth between the first quarter of 2015 and the first quarter of 2016 when the agency expects to issue the final rule.
[14] *Id.*
[15] Proposed Rule, 80 Fed. Reg. at 38,584.
[16] *Id.* at 38,539.
[17] *Id.* at 38,540.
[18] *Compare* 29 U.S.C. § 213(a)(1). A full exegesis of this legal matter is beyond the scope of the hearing and will not be addressed further in this memorandum. Should any member or staff with wish a fuller explanation, please contact the committee staff.
[19] Proposed Rule, 80 Fed. Reg. at 38,543.
[20] The RFA applies to any rule affecting small businesses, small not-for-profits, and small governmental jurisdictions.
5 U.S.C. § 601 (3)-(6). For easier reference, the memorandum will simply refer to small businesses or small entities.
[21] 5 U.S.C. § 603.

The DOL correctly determined that the proposed rule would have a significant economic effect on a substantial number of small entities and published an IRFA along with the proposed rule. DOL used data from the United States Census Bureau's Statistics of United States Businesses (SUSB) and made assumptions to arrive at its estimate of affected small entities.[22] According to DOL's analysis, the proposed rule will apply to 211,000 small establishments and affect 1.8 million workers employed by those establishments.[23] The IRFA identifies the education and health services, professional and business services, wholesale and retail trade, and financial activities industries as those with the most affected small entities.[24] In addition, the DOL's expects that small entities will incur four kinds of costs to comply with the proposed rule: 1) regulatory familiarization costs; 2) adjustment costs; 3) managerial costs; and 4) wage costs.[25]

In total, the DOL expects that small entities will incur between $134.5 to $186.6 million in direct costs to comply with the proposed rule[26] and $561.5 million in wage increases to workers.[27] On average, DOL estimates that an establishment will spend $100 to $600 in direct costs and $320 to $2,700 in additional payroll to workers in the first year.[28] How these costs will affect a particular small business will vary depending on its size, profit margins, whether it has in-house human resources personnel or must get advice from outside advisors, and the wage rates for its industry and geographic area.

Although DOL prepared an IRFA, the adequacy and accuracy has been questioned by various commenters in the proceeding.[29] While the IRFA does provide an assessment of the effects of the proposed rule for small businesses, concerns have been raised that the DOL's analysis relies on numerous assumptions, lacks detailed industry information although it is available, and appears to underestimate the costs of compliance for small employers.[30] DOL did not use the most precise data available in the SUSB – data on firms – to identify the number of small businesses that would be affected, did not examine the effects on different types of small businesses by industry sub-sectors, regions, and revenue sizes, and did not assess the effects on

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[22] *Id.* at 38,603.

[23] Proposed Rule, 80 Fed. Reg. at 38,604. An establishment is "a single physical location where business is conducted or where services or industrial operations are performed." http://www.census.gov/econ/susb/definitions.html.

[24] Proposed Rule, 80 Fed. Reg. at 38,604.

[25] *Id.* at 38,605. DOL expects that each establishment will spend one hour to familiarize itself with the regulation, one hour per each affected employee in adjustment costs; and five minutes per week monitoring and scheduling each affected worker that may be reclassified as eligible for overtime under the proposed rule. *Id.* DOL refers to regulatory familiarization costs, adjustment costs, and managerial costs as "direct employer costs," while it refers to wage increases as "transfers from employers to workers." *Id.* at 38,563. Regardless of the terminology that DOL uses, small businesses will count the wage increases as new costs.

[26] *Id.* at 38,605.

[27] *Id.*

[28] *Id.*

[29] There were almost 290,000 comments filed in response to the proposed rule. http://www.regulations.gov/#!docketDetail;D=WHD-2015-0001.

[30] Letter from Claudia Rodgers, Acting Chief Counsel for Advocacy, SBA and Janis Reyes, Assistant Chief Counsel, Office of Advocacy, SBA, to the Hon. Thomas E. Perez, Secretary, DOL and the Hon. David Weil, Administrator, Wage and Hour Division, DOL (Sept. 4, 2015), *available at* https://www.sba.gov/advocacy/942015-defining-and-delimiting-exemptions-executive-administrative-professional-outside.

other small entities subject to the FLSA. Further, the IRFA does not analyze any regulatory alternatives that would minimize the significant economic impact on small entities.[31]

In addition to concerns regarding the adequacy and accuracy of the IRFA prepared by the DOL, several other concerns have coalesced around the proposed regulation. For instance, the proposed minimum salary threshold is set at an unprecedented level. While DOL has utilized salary information in setting the minimum salary level, it has never been as high as the 40th percentile.[32] In 1958, for example, DOL set the threshold at a level that included the lowest 10th percentile of employees. If this method was applied today, the resulting minimum salary would be $657 per week or $34,167.[33] Further, DOL provides no rationale for selecting the 40th percentile.[34] While an agency can change its mind, it must explain why it is doing so. *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Ins. Co.*, 463 U.S. 27, 43 (1983).

Many commenters noted that the proposed rule adopts a "one-size-fits-all" standard[35] without recognizing the geographic diversity of the American economy that will particularly hurt small businesses in rural areas.[36] Gross revenues in rural areas are far less than those in urban areas.[37] Further, lower salaries go further in rural areas. As an example, a salaried employee in Washington, D.C. currently making $55,000 annually has the same purchasing power as a similarly employed individual in Enid, Oklahoma earning $37,121.[38]

Commenters also expressed concerns with automatically updating the threshold. Indexing the threshold would likely result in instability in labor and administrative costs for small businesses in perpetuity.[39] Small firms will need to consistently review the effect the automatic increases have on salary compression, merit increases, and budgets.[40] Furthermore, these automatic increases may subject employers to civil suits under FLSA for inadvertent violations.[41]

Finally, the proposed regulation has the potential to harm the very employees it is intending to help. Employers may not be able to raise an individual's salary from $35,000 to $50,440 in one year. For example, the American Hotel and Lodging Association is confident

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[31] *Id.* at 3-7.
[32] Letter from Michael K. Layman, Vice President, Regulatory Affairs, International Franchise Association, et.al., to the Hon. David Weil, Administrator, Wage and Hour Division, DOL, 4 (Sept. 4, 2015), *available at* http://www.regulations.gov/#!documentDetail;D=WHD-2015-0001-5469.
[33] Letter from Gerald R. Howard, President and Chief Executive Officer, National Association of Home Builders, to the Hon. David Weil, Administrator, Wage and Hour Division, DOL, 4 (Sept. 4, 2015), *available at* http://www.regulations.gov/#!documentDetail;D=WHD-2015-0001-4637.
[34] *Id.*
[35] *Id.* at 7.
[36] Letter from Amanda Austin, Vice President, Public Policy, National Federation of Independent Business to Wage and Hour Division, DOL, 5 (Sept. 3, 2015), *available at* http://www.regulations.gov/#!documentDetail;D=WHD-2015-0001-4142.
[37] *Id.*
[38] *Id.*
[39] *Id.*
[40] *Id.*
[41] This may be one reason Congress required DOL to promulgate FLSA changes to EAP status through the rulemaking procedures of the Administrative Procedure Act.

that changes to the minimum salary level will serve to eliminate many middle-management positions in their industry.[42] Similarly, many employees view being classified as exempt as indicia of professional status and career achievement. Being reclassified could have long-ranging effects relating to loss of personal schedule flexibility, potential loss of benefits, and career advancement opportunities.[43]

VI. Conclusion

This proposed regulation, taken individually and in conjunction with several other regulatory actions examined by this Subcommittee and the full Committee, has the potential to reduce economic growth in the small business sector of the economy, eliminate jobs, and make it harder for small firms to survive. The hearing represents an opportunity for members explore in-depth the regulatory burden being placed on small firms.

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[42] Letter from Brian C. Crawford, Vice President, Government and Political Affairs, American Hotel and Lodging Association to Mary Ziegler, Director, Division of Regulations, Legislation and interpretation, Wage and Hour Division, DOL, 5 (Sept 4, 2015), *available at* http://www.regulations.gov/#!documentDetail;D=WHD-2015-0001-4639.

[43] *Id.* at 5-6.