Calculating Back Overtime Wages in Misclassification Cases

By Richard Alfred* and Rebecca Bromet**

I. Introduction

Wage and hour litigation continues to out-pace all other types of workplace class actions. Collective actions pursued in federal court under the Fair Labor Standards Act ("FLSA") currently outnumber all other types of employment-related class actions. Significant growth in wage and hour litigation also is centered at the state court level, and especially in California, Florida, Illinois, New Jersey, New York, Massachusetts, Minnesota, Pennsylvania, and Washington. This trend, one likely to continue into the foreseeable future, is reflected in the value of the top ten wage and hour settlements in 2009, which totaled $363.6 million, as compared to only $253 million in 2008.

The most prevalent wage and hour cases are misclassification cases, where employees allege they were improperly classified as exempt from overtime pay requirements. Some of the largest misclassification settlements in 2009 and 2010 include:

- *Poole v. Merrill Lynch* (D. Or. Feb. 8, 2010) - $43.5 million: Misclassification case related to stock brokers.
- *In Re Staples Wage & Hour Litigation* (D.N.J. Jan. 29, 2010) - $42 million before reverter: Misclassification case related to assistant store managers.
- *In Re Wachovia* (C.D. Cal. 2009). - $39 million before reverter: Misclassification case related to stock brokers, referred to as financial advisers or financial adviser trainees.
- *Westerfield v. Washington Mutual* (E.D.N.Y. 2009) - $38 million: Misclassification case related to loan consultants.
- *Veliz v. Cintas Corp.*, $22.75 million (N.D. Cal. 2009). Misclassification case related to delivery drivers.

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- *Conley v. Pacific Gas & Electric*, $17.25 million (Cal. 2009). Misclassification case related to salary basis issues for variety of positions..

As these settlements reveal, misclassification cases cut across industries and can significantly impact a company's bottom line.

II. Calculating Back Overtime Pay In Misclassification Cases

In the typical misclassification case, employees in a particular position were treated as exempt and received a salary, but did not receive overtime compensation. If these employees were legally misclassified as exempt, the employer would owe the employees back wages for unpaid overtime. Courts have taken at least three different approaches in calculating those back overtime wages. Under the first, and most common approach, misclassified employees receive an additional half-time their regular rate of pay for all overtime hours worked ("half-time multiplier") based on the principles outlined in the fluctuating workweek interpretive guideline, 29 C.F.R. § 778.114 ("FWW method"). Under the second approach, courts have found that the FWW method is inapplicable in misclassification cases and award misclassified employees one-and-a-half times their regular rate of pay for all overtime hours worked ("one-and-a-half time multiplier"). Most recently, the Seventh Circuit in *Urnikis-Negro v. American Family Property Services*, __ F.3d ___, 2010 U.S. App. LEXIS 16126 (7th Cir. 2010), found the FWW method inapplicable to misclassification damages, but, nonetheless, applied the half-time multiplier to calculate damages for a misclassified employee. The *Urnikis-Negro* Court primarily based its decision on the Supreme Court's analysis in *Overnight Motor Transportation Co. v. Missel*, 316 U.S. 572 (1942) ("Overnight Motor method"). Each of these approaches is discussed more fully below.

A. Courts Are Divided As To Whether The FWW Method Applies In Misclassification Cases

- Faced with calculating damages in a misclassification case, a majority of courts have turned to 29 C.F.R. § 778.114 to guide their decision-making process.

Section 778.114 outlines five criteria which must be established before it is appropriate to use the half-time multiplier to calculate overtime compensation:

> (1) the employee's hours fluctuate from week to week; (2) the employee receives a fixed weekly salary that remains the same regardless of the number of hours worked per week; (3) the fixed salary is sufficient to provide compensation at a regular rate not less than the legal minimum wage; (4) the employee receives at least 50 percent of his regular hourly pay for all overtime worked; and (5) the employer and the employee have a clear mutual understanding that the fixed salary is compensation (apart from overtime premiums) for the hours worked each workweek.

Perez v. Radioshack Corp., 2005 U.S. Dist. LEXIS 33420, *7-8 (N.D. Ill. Dec. 14, 2005); *see also* 29 C.F.R. § 778.114. If the employer can establish these five elements, then the employee's back overtime pay is calculated according to the following formula:

> the regular rate of the employee will vary from week to week and is determined by dividing the number of hours worked in the workweek into the amount of the salary to obtain the applicable hourly rate for the week. Payment for overtime hours at one- half such rate in addition to the salary satisfies the overtime pay requirement because such hours have already been compensated at the straight time regular rate, under the salary arrangement.

29 C.F.R. § 778.114(a).

The first three elements of 29 C.F.R. § 773.114 typically are easily satisfied in a misclassification case: (1) the hours worked by exempt employees generally varies from week to week; (2) the very nature of being an exempt employee means that the employees salary remains the same regardless of the quantity of hours worked; and (3) exempt employees typically receive a salary sufficient to compensate them for all hours worked at a rate of at least equal to minimum wage. Disputes arise over whether the fourth and fifth elements are satisfied – namely, when the employee must receive the overtime payment and the nature of the understanding required.

1. Courts Are Divided On Whether The FWW Method Applies Where An Employee Did Not Receive The Contemporaneous Payment Of Overtime

The FWW method sanctions the use of the half-time multiplier to calculate overtime pay provided that the employee "receives extra compensation, in addition to such salary, for all overtime hours worked at a rate not less than one-half his regular rate of pay." 29 C.F.R. § 778.114(a). Courts that have applied § 778.114 in misclassification cases have found that the contemporaneous payment of overtime compensation is not necessary and have found this element satisfied when the employer makes overtime payments on a retroactive basis. *See Perez*, 2005 U.S. Dist. LEXIS 33420, at *23-26 ("Nothing in the language of § 778.114 mandates that the fluctuating workweek method of calculations is precluded where the overtime payments are awarded retroactively as a remedy"); *see e.g., Valerio v. Putnam Assocs., Inc.*, 173 F.3d 35, 39-40 (1st Cir. 1999) (affirming the use of the fluctuating workweek method of calculating back overtime pay on a retroactive basis); *Tumulty v. FedEx Ground Package Sys., Inc.*, No. 04-cv-1425, 2005 U.S. Dist. LEXIS 25997 (W.D. Wash. Aug. 16, 2005) (holding the contemporaneous payment of overtime is not required). This reasoning is supported by the Department of Labor's own interpretation of § 778.114, which does not require such a contemporaneous payment. *See* Department of Labor Opinion Letter FLSA 2009-3 (approving the retroactive application of the half-time method of calculating overtime for a misclassified employee; "because the fixed salary covered whatever hours the employees were called upon to work in a workweek; the employees will be paid an additional one-half their actual regular rate for each overtime hour worked, which at all times exceeds minimum wage; and the employees received and accepted the salary knowing that it covered whatever hours they worked, it is our opinion that the employer's method of computing retroactive payment of overtime complies with the FLSA.").

Courts that have rejected the use of the FWW method in misclassification cases have held that "contemporaneous payment of overtime compensation is a necessary prerequisite for application of the fluctuating workweek method." *See Rainey v. American Forest & Paper Ass'n, Inc.*, 26 F. Supp. 2d 82, 100 (D. D.C. 1998); *see also Cowan v. Treetop Enters., Inc.*, 163 F. Supp. 2d 930, 941 (M.D. Tenn. 2001) (explaining that section 773.114 "requires a contemporaneous payment of the half-time premium for an employer to avail itself of the fluctuating workweek provision"). Courts find support for this contemporaneous payment requirement in the text of section 773.114, which states "[w]here all facts indicate that an employee is being paid for his overtime hours at a rate of no greater than that which he receives for non-overtime hours, compliance with the Act cannot be rested on any application of the fluctuating workweek overtime formula." *See also Russell v. Wells Fargo & Co.*, 672 F. Supp. 2d 1008, 1012 (N.D. Cal. 2009) (finding section §773.114 requires the contemporaneous provision of overtime pay). This reasoning leads those courts that have adopted it to the conclusion that 29 C.F.R. § 778.114 is not satisfied where an employee merely received his salary and did not receive any overtime payments at the time the overtime was worked, such as in a misclassification case. Courts following this line of authority, therefore, conclude that misclassified employees are entitled to time-and-one-half their regular rate of pay for all overtime hours worked. *See Russell*, 672 F. Supp. 2d 1008.

2. Courts Are Divided On The Nature Of The Understanding Required By The FWW Method

The final requirement of 29 C.F.R. § 778.114 is that "there is a clear mutual understanding of the parties that the fixed salary is compensation (apart from overtime premiums) for the hours worked each workweek, whatever their number, rather than for working 40 hours or some other fixed weekly work period…" Courts have grappled with what the "clear mutual understanding" must relate to.

Courts applying the FWW method in misclassification cases have held that the requisite understanding is established when the employer and employee agree that the employee will be paid a salary for all hours worked. *See Clements v. Serco, Inc.*, 530 F.3d 1224, 1230 (10th Cir. 2008) ("our inquiry is whether the Employees and [the employer] had a clear and mutual understanding that they would be paid on a salary basis for all hours worked."); *Valerio v. Putnam Assocs.*, 173 F.3d 35, 40 (1st Cir. 1999) ("The parties must only have reached a 'clear and mutual understanding' that while the employee's hours may vary, his or her base salary will not."). Several courts have found this understanding to be an "implied term of one's employment agreement if it is clear from the employee's actions that he or she understood the payment plan…" *Mayhew v. Wells*, 125 F.3d 216, 219 (4th Cir. 1997) (explaining that the requisite agreement may be implied from the parties actions); *see also Clements*, 530 F.3d at 1231 ("the Employees understood they would not be docked when they worked fewer than forty hours and would not be paid more when they worked over forty hours. This is sufficient to establish the Employees understood they would receive a fixed salary"); *Blackmon v. Brookshire Grocery Co.*, 835 F.2d 1135, 1138 (5th Cir. 1988) (using the fluctuating workweek method where the employees understood "they would be paid a fixed weekly salary, and would work whatever number of hours were required to get the job done").

In its 2009 Opinion Letter, the DOL explained that its guidelines "do not require that the 'clear and mutual understanding' extend to the method used to calculate the overtime pay. … Rather, 29 C.F.R. § 778.114 only requires that the employees have a 'clear and mutual understanding that they would be paid on a salary basis for all hours worked.'" (internal citations omitted).

Courts rejecting the FWW method, by contrast, have required that the understanding extend to an agreement that the employee would receive overtime premiums in addition to his salary. Where an employee has been misclassified as exempt and has not received any overtime compensation, the reasoning goes, "it was not possible for [the employer] to have had a clear mutual understanding with [the employee] that she was subject to a calculation method applicable only to non-exempt employees who are entitled to overtime compensation." *Rainey v. American Forest & Paper Ass'n, Inc.*, 26 F. Supp. 2d 82, 102 (D.D.C. 1998); *see also In re: Texas EZPawn FLSA Litigation*, 633 F. Supp. 2d 395, 402 (W.D. Tex. 2008) ("Attempting to ascertain whether there was a 'clear mutual understanding'… becomes awkward at best in a misclassification suit, as there was obviously *no* understanding on the issue, given that both employer and employee were acting on the assumption that the employee was exempt from overtime, and that the rule had no application to that job."); *Russell*, 672 F. Supp. 2d 1008 (declining to apply § 773.114 in a misclassification case where it was not established that there was "a clear mutual understanding between an employer and employee that the employee will be paid a fixed salary for fluctuating weekly hours but nonetheless receive overtime premiums"). Courts applying this line of reasoning apply the one-and-a-half multiplier to calculate back overtime wages due.

3. Recent Seventh Circuit Decision Affirms Use Of Half-Time Multiplier But Rejects Reliance On The FWW Method

In August 2010, the Seventh Circuit addressed the issue of how to calculate back overtime pay in a misclassification case and held that the half-time multiplier should be used, although the Court rejected the application of § 778.114 in misclassification cases. *See Urnikis-Negro*, 2010 U.S. App. LEXIS 16126. In contrast to the many other courts, including all of the other Circuit Courts that have addressed this issue, the Seventh Circuit based its decision on long-standing Supreme Court precedent underlying the proper method for calculating an employee's regular rate of pay and for calculating overtime for a salaried employee.

In the *Urnikis-Negro* case, the District Court ruled that the plaintiff had been misclassified as exempt. *See Urnikis-Negro v. American Family Property Services*, 2008 U.S. Dist. LEXIS 102034 (N.D. Ill. July 21, 2008). The plaintiff received a salary of $1,000 per week, which, according to the District Court, the plaintiff understood was intended to compensate her for all hours worked in any workweek. The District Court held that the requirements of 29 C.F.R. § 778.114 were satisfied and used the half-time multiplier to calculate the plaintiff's unpaid overtime compensation. The plaintiff appealed, arguing that the District Court erred in applying 29 C.F.R. § 778.114 in a misclassification case.

The Seventh Circuit affirmed the District Court's holding, but rejected its reasoning and reliance on § 778.114, which the Seventh Circuit deemed a "dubious source of authority" for

calculating a misclassified employee's damages. *Urnikis-Negro*, 2010 U.S. App. LEXIS 16126, at * 41-42. First, the Seventh Circuit explained, § 778.114 is "forward looking" in that it describes a way an employer may compensate an employee for variable hours with a fixed wage. *Id.*, at *37. Second, the guideline requires a "clear mutual understanding" between employer and employee that the fixed wage will constitute the employee's regular or straight-time pay for any and all hours worked in a given week *and* the separate payment of an overtime premium for any hours in excess of 40 that are worked in that week. *Id.* Where an employee was wrongly classified as exempt, there can be no "clear mutual understanding" that overtime premiums would be received because the employee receives no contemporaneous overtime premium payment. *Id.* Finally, the Seventh Circuit explained, § 778.114 is not a remedial measure—it describes how an employer may comply with the FLSA in the first instance, but says nothing about how a court is to calculate damages. *Id.* at 37-38.

Rejecting the application of the FWW method in a misclassification case, the Court in *Urnikis-Negro* turned instead to the principles outlined in Supreme Court precedent, which led the Seventh Circuit to the same result. Following this approach, the first step in determining back overtime compensation due is to calculate the employee's regular rate of pay. *See Walling v. Youngerman-Reynolds Hardwood Co.*, 325 U.S. 419, 424 (1945) ("The keystone of § 7(a) is the regular rate of compensation"). "An employee's regular rate of pay is the amount of compensation he receives per hour." *Urnikis-Negro*, 2010 U.S. App. LEXIS 16126, at *23 (citing *Overnight Motor Transportation Co. v. Missel*, 316 U.S. 572 (1942). For a salaried employee, such as a misclassified employee, the regular rate of pay is determined by dividing the weekly salary "by the number of hours which the salary is *intended* to compensate." 29 C.F.R. § 778.113 (emphasis added). Thus, it is important to determine the nature of the parties' agreement about the number of hours the employee's salary was intended to compensate for. *See Urnikis Negro*, 2010 U.S. App. LEXIS 16126, at *44 (explaining that "[t]he employee's regular rate of pay is a factual matter"). Once the employee's regular rate of pay is determined, "[t]he employee is then entitled to an overtime premium of one-half of that rate." *Id.* at 49 (discussing that it is *Overnight Motor* that controls these calculations).

Thus, according to the Seventh Circuit, where the employer and employee have agreed that the employee's salary is intended to compensate the employee for all hours worked in each workweek, a misclassified employee's unpaid overtime wages are calculated using the following formula:

- Divide the employee's weekly salary by the employee's hours worked in each workweek to determine the regular hourly rate;
- Multiply the resulting regular rate by one-half;
- Multiply the half-time rate by the number of overtime hours worked in each workweek.

The Seventh Circuit is not the first Court to find the half-time multiplier to be appropriate in misclassification cases independent from § 773.114. *See e.g.*, *Desmond v. PNGI Charles Town Gaming, LLC*, No. 3:06-CV-128, 2009 U.S. Dist. LEXIS 84632 (N.D. W.Va. Sept. 16,

2009) (finding a misclassified employee is only entitled to an additional half-time compensation for any overtime worked; explaining its decision "is based upon the logic of *Overnight Motor* as well as the general tenets of the calculation of compensatory damages"); *Torres v. Bacardi Global Brands Promotions, Inc.*, 482 F. Supp. 2d 1379, 1382 (S.D. Fl. 2007) (finding misclassified employee is only entitled to an additional half time compensation for overtime worked because the misclassified employee, by receiving his salary each week, "has already received his regular rate for all hours worked" and therefore, "he is entitled to half-time for those hours worked in excess of forty per week.").

III. Impact Different Methods Of Calculating An Employee's Regular Rate Of Pay And Overtime

The method of overtime calculation has a dramatic impact on the amount of back overtime owed. For example, assume an employee with a weekly salary of $1,000 works a total of 50 hours a week.

	Calculation of Regular Rate			**Calculation of Unpaid Overtime**		
	Weekly Salary	**Weekly Hours**	**Regular Hourly Rate**	**Calculation of Amount**		**Amount of Unpaid Weekly Overtime**
Half-time Method	$1,000	50	$20.00	$20.00 x 0.5 x 10 overtime hours		$100.00
Time-and-a half Method and Regular Rate With All Hours Worked[1]	$1,000	50	$20.00	$20.00 x 1.5 x 10 overtime hours		$300.00
Time-and-a half Method	$1,000	50	$25.00	$25.00 x 1.5 x 10 overtime hours		$375.00

Using the above example for one employee, for one workweek, the impact of these different calculations is obvious. In a class action, the impact of applying a time-and-a-half method can be devastating to a defendant. For example, if an employer faced three years of liability related to misclassifying 500 employees who worked an average of 50 hours a week and were paid a

[1] The *Urnikis-Negro* Court explained that "[a]ssuming without deciding that it might be appropriate to presume that a misclassified employee's fixed salary was meant to compensate him solely for 40 hours, the presumption cannot be irrebutable." 2010 U.S. App. LEXIS 16126, at *44.

salary of $1,000 per week, the employer's damages would be $6,000,000 using the half-time method and $22,500,000 using the time-and-a-half method.[2]

IV. Conclusion

The weight of authority, especially after *Urnikis-Negro*, supports the position that employers typically have taken for calculating back overtime wages where exempt employees are found to have been misclassified. Whether under the FWW method or *Overnight Motor* method, the proper approach to determining damages in such cases, assuming the above-discussed requirements have been met, is to multiply all overtime hours worked by one-half the regular rate of pay. By applying this method, employers will dramatically reduce their exposure in misclassification cases, including those cases seeking collective or class treatment.

[2] Assuming all 500 employees worked 40 overtime workweeks each year.